



# Exempt Organizations Technical Guide

## TG 59: Taxes on Foundation Failure to Distribute Income – IRC Section 4942

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## **I. Overview**

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

## **A. Background / History**

- (1) Under Chapter 42, excise taxes are imposed on a private foundation under Section 4942 where the foundation fails to distribute a minimum amount of income to charity in a timely manner.
- (2) Before the Tax Reform Act of 1969 (TRA '69), there was little legal pressure on private foundations to distribute income to charity. Prior law said that a private foundation would lose its exemption if its aggregate accumulated income was unreasonable in amount or duration for carrying out its exempt purposes.
- (3) The unreasonable accumulation of income limitation proved largely ineffective. Since reasonableness or unreasonableness is difficult to determine, and since the only available sanction, loss of exempt status, was often viewed as unduly harsh, the prior law was rarely enforced. As a result, while the creator of a private foundation may have received immediate and substantial tax benefits from his or her contribution, charity may have received no benefit whatever or very belated benefits. Congress responded to this situation by establishing a minimum distribution requirement for private foundations as part of the TRA '69, specifically through enacting Section 4942, which imposes excise taxes on private foundations for failure to distribute income for Section 170(c)(2)(B) purposes.
- (4) Section 4942 was changed significantly by the Pension Protection Act of 2006, P.L. 109-280, 120 Stat. 780 (PPA 2006). The Section 4942(a) first tier excise tax was doubled from 15% to 30% and Section 4942(g)(4) was amended to provide that a nonoperating private foundation may not count as a qualifying distribution any amount paid to (1) a non-functionally integrated Type III supporting organization or (2) any other Section 509(a)(3) supporting organization if a disqualified person with respect to the foundation directly or indirectly controls the supporting organization or a supported organization of such supporting organization.
- (5) 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.

- (6) 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.
- (7) 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.
- (8) 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.
- (9) 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. 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 instructions to Form 4720 for further information.

## B. Relevant Terms

- (1) **Taxable period:** With respect to the undistributed income of a private foundation for any taxable year, the period beginning with the first day of the taxable year and ending on the earlier of the date of mailing of a notice of deficiency under Section 6212(a) with respect to the initial excise tax imposed under Section 4942(a) or the date on which the initial excise tax imposed under Section 4942(a) is assessed. See Treas. Reg. 53.4942(a)-1(c)(1).
- (2) **Undistributed income:** Defined in Section 4942(c) as the amount by which the distributable amount (defined in Section 4942(d)) for that taxable year exceeds the qualifying distributions (defined in Section 4942(g)) made before that time out of such distributable amount. See Treas. Reg. 53.4942(a)-2(a).
- (3) **Distributable amount:** Equals the foundation's minimum investment return, reduced by any income taxes and the tax on net investment income imposed by Section 4940, increased by certain amounts listed in Section 4942(f)(2)(C). See Section 4942(d) and Treas. Reg. 53.4942(a)-2(b). The amounts listed in Section 4942(f)(2)(C) are: amounts received or accrued as repayments of amounts which were considered as a qualifying distribution for any taxable year, amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of such property was considered as a

qualifying distribution for any taxable year, and any amount set aside under Section 4942(g)(2) to the extent it is determined that such amount is not necessary for the purposes for which it was set aside.

- (4) **Minimum investment return:** Defined in Treas. Reg. 53.4942(a)-2(c) as 5% of the excess of the 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 purpose as described in Treas. Reg. 53.4942(a)-2(c)(3); or certain other assets which are excluded as described in Treas. Reg. 53.4942(a)-2(c)(2)) over the amount of the acquisition indebtedness for those assets (determined under Section 514(c)(1), but without regard to the taxable year in which the indebtedness was incurred). However, under Treas. Reg. 53.4942(a)-2(c)(5)(iii), for a taxable year shorter than 12 months, the minimum investment return is calculated by using a percentage equal to five multiplied by a fraction the numerator of which is the number of days in the short taxable year and the denominator of which is 365. See Treas. Reg. 53.4942(a)-2(c)(5)(iii).
- (5) **Qualifying distribution:** Defined as an amount paid to accomplish one or more purposes described in Section 170(c)(2)(B), an amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in Section 170(c)(2)(B), or an amount set aside for a specific project that comes within one or more purposes described in Section 170(c)(2)(B). See Section 4942(g).

### C. Law / Authority

- (1) Section 4942 is one of several private foundation excise tax provisions enacted by the TRA '69. Section 4942 requires private foundations to distribute a current minimum amount to charity for taxable years beginning after December 31, 1969. During the early years after the TRA '69, a foundation was required to distribute the greater of its adjusted net income or minimum investment return on its assets other than those which are used (or held for use) directly in the carrying out of the foundation's exempt purpose. However, Section 823 of Economic Recovery Act of 1981, P.L. 97-34, 95 Stat. 172, 351 (1981), reduced the required payout for private foundations so that they are only required to distribute a "distributable amount," which is based largely on an organization's minimum investment return, statutorily defined as 5% of the value of the non-charitable use assets, effective for taxable years beginning after December 31, 1981. Failure to make timely distributions at the required level will result in the imposition of excise taxes, and, if the failure is willful or flagrant, additional penalty taxes, including a possible termination tax.



## **II. Requirements**

- (1) Generally, Section 4942 imposes a tax on certain private foundations if they have “undistributed income,” which is defined by Section 4942(c) as the foundation’s “distributable amount” for the taxable year less “qualifying distributions” attributable to that year. The “distributable amount” is equal to the foundation’s “minimum investment return” reduced by the Section 4940 tax and any unrelated business income tax imposed on the foundation. See Section 4942(d).

### **A. General Rules Governing Required Distributions**

- (1) Section 4942 and the applicable regulations contain an extensive set of rules governing required distributions for private foundations. Generally, the rules require the following:
  - a. A private foundation, other than an operating foundation, is required to distribute its distributable amount for each taxable year beginning after December 31, 1969. Distributable amount generally means a private foundation’s minimum investment return (an imputed return on non-charitable use assets), reduced by any taxes imposed under subtitle A and Section 4940. See Section 4942(d) and Treas. Reg. 53.4942(a)-2(b)(1)(ii).
  - b. The required distributions must be qualifying distributions. In general, a qualifying distribution is any expenditure or grant, and certain set-asides, for charitable, educational, religious, or similar purposes (Section 170(c)(2)(B) purposes). Certain conditions and restrictions apply to payments to nonoperating foundations, controlled organizations, and certain supporting organizations. See Treas. Reg. 53.4942(a)-3(a)(2).
  - c. When the distributable amount for a taxable year exceeds the amount of the qualifying distributions made for that distributable amount, the difference constitutes undistributed income of the taxable year. See Treas. Reg. 53.4942(a)-2(a) and Section 4942(c).

### **B. Taxes Imposed**

- (1) A private foundation that fails to pay out the distributable amount in a timely manner is subject to excise taxes. See Section 4942(a).

#### **B.1. Taxes on Private Foundation**

- (1) Generally, Section 4942 requires a private foundation to distribute the distributable amount for each taxable year by the end of the succeeding taxable year. If a private foundation is considered to have undistributed income of a taxable year at the end of the second or any succeeding taxable year, it’s subject to an initial excise tax equal to 30% of the amount of that undistributed income for each of such second and succeeding taxable years if it remains undistributed. See Treas. Reg. 53.4942(a)-1(a)(1) and Section 4942(a).

- (2) After imposition of the initial excise tax on undistributed income of a specific taxable year, if any portion of such income remains undistributed at the close of the taxable period, a tax equal to 100% of the amount remaining is imposed. See Section 4942(b) and Treas. Reg. 53.4942(a)-1(a)(2).
- (3) Payment of the excise taxes imposed by Section 4942(a) or (b) is in addition to, and not in lieu of, making the distribution of such undistributed income required by Section 4942. Treas. Reg. 53.4942(a)-1(a)(3).

### **C. Distributable Amount Defined**

- (1) The distributable amount equals the foundation's minimum investment return, reduced by any income taxes and the tax on net investment income imposed by Section 4940, increased by certain amounts listed in Section 4942(f)(2)(C). See Section 4942(d) and Treas. Reg. 53.4942(a)-2(b). The amounts listed in Section 4942(f)(2)(C) are:
  - a. Amounts received or accrued as repayments of amounts which were considered as a qualifying distribution for any taxable year;
  - b. Amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of such property was considered as a qualifying distribution for any taxable year; and
  - c. Any amount set aside under Section 4942(g)(2) to the extent it is determined that such amount is not necessary for the purposes for which it was set aside.
- (2) The distributable amount of a taxable year may be subject to adjustment for excess distributions made during certain prior taxable years. See Treas. Reg. 53.4942(a)-3(b)(5)(iii).
- (3) The regulations require the distributable amount to be increased by the income portion of distributions from trusts described in Section 4947(a)(2) for amounts placed in trust after May 26, 1969. See Treas. Reg. 53.4942(a)-2(b)(2)(i). However, in *Ann Jackson Family Foundation v. Commissioner*, 97 T.C. 534 (1991), in which a private nonoperating foundation received distributions totaling \$350,000 per year from a split-interest trust as defined by Section 4947(a)(2), the court held that the distributions from the split-interest trust are not included in the distributable amount as defined in Section 4942(d) and that Treas. Reg. 53.4942(a)-2(b)(2) was invalid. The Ninth Circuit affirmed in its opinion at 15 F.3d 917 (1994). Notice 2004-36, 2004-1 C.B. 889, states that the Treasury Department and the IRS intend to propose regulations modifying the regulations under Section 4942 in a manner consistent with the holdings of the Tax Court and the Ninth Circuit in *Ann Jackson Family Foundation*. Until further guidance is promulgated, private foundations should compute the distributable amount under Section 4942(d) without regard to Treas. Reg. 53.4942(a)-2(b)(2)(i).

### **D. Computation of Minimum Investment Return**

- (1) The minimum investment return, as defined in Treas. Reg. 53.4942(a)-2(c), of a private foundation for any taxable year is 5% of the excess of the 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 purpose or described in (3) below) over the amount of the acquisition indebtedness for those assets (determined under Section 514(c)(1), but without regard to the taxable year in which the indebtedness was incurred). However, for a taxable year shorter than 12 months, the minimum investment return is calculated by using a percentage equal to five multiplied by a fraction the numerator of which is the number of days in the short taxable year and the denominator of which is 365. See Treas. Reg. 53.4942(a)-2(c)(5)(iii).
- (2) The aggregate fair market value of all assets of the foundation includes:
  - a. The average of the fair market values on a monthly basis of securities for which market quotations are readily available,
  - b. The average of the foundation's cash balances on a monthly basis, and
  - c. The fair market value of all other assets except those described in (3) below for the period during the taxable year for which such assets are held by the foundation. See Treas. Reg. 53.4942(a)-2(c)(1).
- (3) Certain Assets Excluded. Treas. Reg. 53.4942(a)-2(c)(2) specifically excludes the following categories of assets from the determination of the minimum investment return:
  - a. Any future interest (such as a vested or contingent remainder, whether legal or equitable) of a foundation in the income or corpus of any real or personal property until all intervening interests in, and rights to the actual possession or enjoyment of such property have expired, or, although not actually reduced to the foundation's possession, has been constructively received by the foundation,
  - b. The assets of an estate until the assets are distributed to the foundation or, due to a prolonged period of administration, that estate is considered terminated for income tax purposes by operation of Treas. Reg. 1.641(b)-3(a),
  - c. Any present interest of a foundation in any trust created and funded by another person,
  - d. Any pledge to the foundation of money or property, and
  - e. Any assets used, or held for use, directly in carrying out the foundation's exempt purpose.
- (4) Treas. Reg. 53.4942(a)-2(c)(3)(i) lists the following guidance on assets used, or held for use, in carrying out a foundation's exempt purpose.
  - a. Used or held for use. An asset is used, or held for use, directly in carrying out the foundation's exempt purpose only if the asset is actually used by the

foundation in carrying out its charitable, educational, or other similar Section 170(c)(2)(B) purpose which gives rise to the exempt status of the foundation, or if the foundation owns the asset and establishes to the satisfaction of the IRS that its immediate use for such exempt purpose is not practical, based on the facts and circumstances of the particular case, and that definite plans exist to commence such use within a reasonable period of time.

- b. Whether a particular asset is used, or held for use, directly by the foundation to carry out its exempt purpose is a question of fact. For example, management of a foundation's endowment fund isn't a direct implementation of its exempt function. Consequently, an office building used for providing offices for employees managing the endowment fund is not being used (or held for use) directly by the foundation to carry out its exempt purpose. Similarly, assets held for production of income or for investment aren't held for carrying out the foundation's exempt purpose even though the income from such assets is used to carry out exempt purpose.
- c. Dual use assets. Where property is used both for exempt purposes and for other purposes, if the exempt purposes use represents 95% or more of the total use, the property is considered to be used exclusively for exempt purposes. If the exempt use is less than 95%, a reasonable allocation between exempt and non-exempt use must be made for purposes of minimum investment return computation.
- d. Temporary Lease of Property Acquired for Exempt Use. Property acquired by the foundation to be used for exempt purposes may be considered as used, or held for use, directly to carry out exempt purposes even though the property is leased, in whole or in part, for a limited period during which arrangements are made for its conversion to the use for which it was acquired, provided such income-producing use does not exceed a reasonable period of time. Generally, one year is deemed to be a reasonable period for such purpose. Income derived under such lease is includible in the foundation's adjusted net income. If the income-producing use exceeds a reasonable period, the property, thereafter, shall not be deemed to be used for exempt purposes. Further, if acquisition of the property had been treated as a qualifying distribution of a prior year, the value of the property is added to the adjusted net income computation for the taxable year in which the income-producing use becomes unreasonable in length of time. If, subsequently, the property is used directly for exempt purposes, a qualifying distribution of its then fair market value will be deemed to have been made.

## **E. Illustrations of Exempt Purpose Assets**

- (1) Treas. Reg. 53.4942(a)-2(c)(3)(ii) illustrates when assets are used, or held for use, in carrying out exempt purposes with the following examples:

- a. Administrative assets, such as office equipment and supplies which are used by employees or consultants of the foundation, to the extent such assets are devoted to and used directly in the administration of the foundation's charitable, educational, or other similar exempt activities;
  - b. Real estate or the portion thereof used by the foundation directly in its charitable, educational, or other similar activities;
  - c. Physical facilities used in exempt activities such as housing paintings owned by the foundation which are on public display, fixtures and equipment in classrooms, qualified research facilities and related equipment which, under the facts and circumstances, serve a useful purpose in the conduct of such activities;
  - d. Any interest in a functionally related business as defined in Treas. Reg. 53.4942(a)-2(c)(3)(iii) or in a program-related investment as defined in Section 4944(c);
  - e. The reasonable cash balances necessary to cover current administrative expenses and other normal and current disbursements directly connected with exempt activity; and
  - f. Any property leased by a foundation in carrying out its charitable, educational or other similar exempt purpose at no cost, or at a nominal rent, to the lessee or for a program-related purpose within the meaning of Section 4944(c), such as the leasing of renovated apartments to low-income tenants at a low rental as part of the lessor-foundation's program for rehabilitating a blighted portion of a community.
- (2) Two revenue rulings give additional examples of exempt purpose assets. Rev. Rul. 74-498, 1974-2 C.B. 387, describes a collection of paintings loaned under an active loan program for exhibition in museums, universities, and similar institutions. Rev. Rul. 75-207, 1975-1 C.B. 361, describes an island preserved in its natural state and to which access is limited to invited public and private researchers.

## **F. Functionally Related Businesses**

- (1) A functionally related business is defined in Section 4942(j)(4) and Treas. Reg. 53.4942(a)-2(c)(3)(iii)(a) as:
- a. A trade or business which is not an unrelated trade or business as defined in Section 513, or
  - b. An activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the charitable, educational, or other similar exempt purpose of the organization.
- (2) Treas. Reg. 53.4942(a)-2(c)(3)(iii)(b) gives the following examples of functionally related business:

**Example 1:** X, a private foundation, maintains a community of historic value which is open to the public. For the convenience of the public, X, through a wholly owned, separately incorporated, taxable entity, maintains a restaurant and hotel in such community. Such facilities are within the larger aggregate of activities which makes available for public enjoyment the various buildings of historic interest and which is related to X's exempt purpose. Thus, the operation of the restaurant and hotel under such circumstances constitutes a functionally related business.

**Example 2:** Y, a private foundation, as part of its medical research program under Section 501(c)(3), publishes a medical journal in carrying out its exempt purpose. Space in the journal is sold for commercial advertising. Notwithstanding the fact that the advertising activity may be subject to the tax imposed by Section 511, such activity is within a larger complex of endeavors which makes available to the scientific community and the public developments with respect to medical research and is therefore a functionally related business.

- (3) In Rev. Rul. 76-85, 1976-1 C.B. 357, the IRS ruled that because a trade or business in which substantially all of the work is performed without compensation is a functionally related business, a foundation may exclude its interest in the business from the computation of its minimum investment return.

## **G. Cash Held for Charitable Activities**

- (1) To determine the amount of the exclusion from the minimum investment return base for cash needed to cover current administrative expenses and other normal and current disbursements directly connected with the foundation's charitable, educational, or other similar exempt activities, the necessary cash amount is generally deemed to be 1.5% of the fair market value of the minimum investment return base without regard to this exclusion. The amount is computed on an annual basis. However, if the IRS is satisfied that under the facts and circumstances that a greater amount is needed for current expenses and disbursements, then an additional amount may be excluded from the fair market value of the minimum investment return base. See Treas. Reg. 53.4942(a)-2(c)(3)(iv).
- (2) All remaining cash balances, including amounts necessary to pay any tax imposed by Section 511 or Chapter 42 of the Code, except Section 4940 tax, are included in the minimum investment return base. See Treas. Reg. 53.4942(a)-2(c)(3)(iv).
- (3) In Rev. Rul. 75-392, 1975-2 C.B. 447, the IRS concluded that a private foundation whose average cash balance during the tax year represented 1% of the fair market value of its minimum investment return base may exclude 1.5% of the fair market value. Under the regulations, this amount is considered a reasonable cash balance even though it exceeds the actual average cash balance.

## H. Valuation of Assets

- (1) Treas. Reg. 53.4942(a)-2(c)(4) has specific rules for the valuation of publicly traded securities, cash balances, common trust funds, real estate, and other assets for purposes of calculating the private foundation's minimum investment return.

### H.1. Securities with readily available market quotations, cash, and common trust funds

- (1) Fair Market Value Based on Readily Available Market Quotations. A private foundation may use any reasonable method to determine the monthly fair market value of securities for which market quotations are readily available if such method is consistently used. The term "securities" includes but is not limited to, common and preferred stocks, bonds, and mutual fund shares. See Treas. Reg. 53.4942(a)-2(c)(4)(v).
- (2) Market quotations are readily available if a security is:
  - a. Listed on NASDAQ, the New York Stock Exchange, NYSE American ("American Stock Exchange" in the regulations), or any city or regional exchange in which quotations appear daily, including foreign securities listed on a recognized foreign national or regional exchange;
  - b. Regularly traded in a national or regional over-the-counter market, for which published quotations are available; or
  - c. Locally traded, for which quotations can readily be obtained from established brokerage firms.
- (3) Examples of Reasonable Valuation Methods for Readily Marketable Securities. Treas. Reg. 53.4942(a)-2(c)(4)(i)(e) gives various examples of reasonable valuation methods for readily marketable securities. These include consistently valuing a security:
  - a. On the last day of each trading month based upon the quoted closing price,
  - b. By taking the mean of the closing prices on the first and last trading days and the trading day on or closest to the 15th day of each month,
  - c. By taking the mean of the highest and lowest quoted prices on the last trading day of each month, or
  - d. By taking the mean of the bid and asked prices on the first trading day of month.
- (4) Under Treas. Reg. 53.4942(a)-2(c)(4)(i)(c), a reduction is available for listed securities for blockage or similar factors under Section 4942(e)(2)(B). The allowable reduction is limited to 10% of the value as determined above. The value is reduced to the extent that the private foundation shows that the



securities couldn't be liquidated within a reasonable period except at a price less than fair market value because of:

- a. The size of the block of securities,
  - b. The fact that the securities are in a closely held corporation, or
  - c. The fact that the sale of the securities would result in a forced or distress sale.
- (5) Computer Pricing System. Readily marketable securities which are held in trust for, or on behalf of, a foundation by a bank or other financial institution which values such securities periodically by use of a computer, may be valued using the computer pricing system, provided the IRS has accepted such computer pricing system as a valid method for valuing securities for federal estate tax purposes. See Treas. Reg. 53.4942(a)-2(c)(4)(i)(d).
- (6) Cash. The amount of a foundation's cash balances for purposes of the minimum investment return base is determined by valuing cash monthly taking the average of the amount of cash on hand as of the first and last days of each month. See Treas. Reg. 53.4942(a)-2(c)(4)(ii).
- (7) Common Trust Funds. Valuation of a foundation's participating interest in a common trust fund, as defined in Section 584, on the basis of the average of the valuations reported to the foundation during its taxable year will ordinarily constitute an acceptable method of valuation where the common trust fund is established and administered under a plan providing for the periodic valuation of participating interests during the fund's taxable year and the reporting of such valuation to participants. See Treas. Reg. 53.4942(a)-2(c)(4)(iii).
- (8) Unlisted securities of a controlled corporation. If a private foundation owns voting stock of an issuer of unlisted securities and has, or together with disqualified persons or another private foundation has, effective control of the issuer (within the meaning of Treas. Reg. 53.4943-3(b)(3)(ii)), then, if the issuer's assets consist of shares of listed securities, the assets are valued as described in (1) above, including any allowable reduction for blockage or similar factors. See Treas. Reg. 53.4942(a)-2(c)(4)(iv).

## **H.2. Other assets, including real property**

- (1) Other Assets. The fair market value of assets other than those described above is determined annually except that valuations of real property may be determined on either an annual basis or on the five-year basis described below. The determination of value of assets (except real property which must be evaluated by an independent, non-disqualified person where the valuation is to be used for five years) may be made by employees of the private foundation or any other person, without regard to whether that person is a disqualified person with respect to the foundation. Except as provided below, valuations of assets, if accepted by the IRS, are valid only for the taxable year for which made. A



new valuation is required for succeeding taxable years. See Treas. Reg. 53.4942(a)-2(c)(4)(iv)(a).

- (2) Five-year determinations. The value of any interest in real property may be determined on a five-year basis, or in other words for the taxable year of the valuation and four succeeding taxable years, provided the determination is made by means of a certified, independent appraisal made in writing by a qualified person who is neither a disqualified person with respect to, nor an employee of, the private foundation and provided further that the valuation made falls within the range of reasonable values for the appraised property. See Treas. Reg. 53.4942(a)-2(c)(4)(iv)(b).
- (3) Certified appraisal. An appraisal is certified only if it contains a statement at its end that in the opinion of the appraiser the values placed on the assets appraised were determined in accordance with valuation principles regularly employed in making appraisals of such property using all reasonable valuation methods. The foundation must keep a copy of the appraisal in its records.
- (4) Replacement of five-year determinations. Any five-year determination of value may be replaced during the five-year period by another five-year valuation made according to the requirements for five-year valuations, or an annual valuation made under the "Other Asset" requirements above. The most recent valuation must be used in computing the foundation's minimum investment return.
- (5) Five-year valuation. The five-year valuation must be made no later than the last day of the first taxable year for which such new valuation is applicable.
- (6) Presumptive validity of five-year valuation. A five-year valuation of a real property interest, if properly made per the above-described rules, won't be disturbed by the IRS during the applicable five-year period even if the actual fair market value of the property changes during that period. See Treas. Reg. 53.4942(a)-2(c)(4)(iv)(b).
- (7) Methods of valuation. Commonly accepted methods of valuation must be used in making an appraisal. Valuations made per the principles in the regulations under Section 2031 constitute acceptable methods of valuation. "Appraisal" means a determination of fair market value and is not to be construed in a technical sense peculiar to property or any interests such as, for example, mineral interests in real property. See Treas. Reg. 53.4942(a)-2(c)(4)(iv)(c).

### **H.3. Valuation Date**

- (1) Assets that are required to be valued on an annual basis may be valued as of any day in the private foundation's taxable year to which that valuation applies, if the foundation follows a consistent practice of valuing those assets as of such date in all taxable years. See Treas. Reg. 53.4942(a)-2(c)(4)(vi)(a).
- (2) A valuation of an interest in real property pursuant to a certified, independent appraisal made in writing by a qualified person may be made as of any day in

the first taxable year of the private foundation to which such valuation is to be applied. See Treas. Reg. 53.4942(a)-2(c)(4)(vi)(b).

- (3) Assets held for less than a taxable year. If an asset in the minimum investment return base has been held for only part of a taxable year, it's taken into account in determining the minimum investment return by multiplying its fair market value by a fraction, the numerator of which is the number of days in such taxable year that the foundation held the asset and the denominator of which is the number of days in that taxable year. See Treas. Reg. 53.4942(a)-2(c)(4)(vii).

## **I. Qualifying Distributions**

- (1) "Qualifying distribution" is another crucial concept under Section 4942. It is the amount subtracted from the distributable amount in computing the amount of undistributed income taxable under Section 4942(a).
- (2) Section 4942(g) defines "qualifying distributions." In general, and without regard to the specific limitations discussed below, a qualifying distribution pursuant to Treas. Reg. 53.4942(a)-3(a)(2) means:
  - a. An amount paid to accomplish one or more purposes described in Section 170(c)(2)(B),
  - b. An amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in Section 170(c)(2)(B), or
  - c. An amount set aside for a specific project that comes within one or more purposes described in Section 170(c)(2)(B).
- (3) Distributions or expenditures that are creditable against a private foundation's obligation to distribute its distributable amount are referred to as qualifying distributions. Treas. Reg. 53.4942(a)-3(a)(2) defines the term qualifying distribution as:
  - a. Any amount paid by a private foundation to accomplish one or more purposes described in Section 170(c)(2)(B), or Section 170(c)(1) (amounts paid to accomplish charitable, religious, and educational purposes or amounts contributed to a governmental unit for exclusively public purposes).
  - b. Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in Section 170(c)(2)(B) or Section 170(c)(1).
  - c. Any amount set aside which meets the criteria for set-asides.
  - d. Included in amounts paid for one or more purposes described in Section 170(c)(2)(B), or Section 170(c)(1), are amounts paid for program-related investments, as defined in Section 4944(c). Also included is that portion of reasonable and necessary expenses, direct and indirect, that a foundation

incurs in implementing these purposes. See Treas. Regs. 53.4942(a)-3(a)(2)(i) and 53.4942(a)-3(a)(8).

- e. For purposes of determining whether an organization is an operating foundation under Section 4942(j)(3): If a foundation awards scholarships, grants or other payments to individuals as a part of an active program in which the foundation maintains some significant involvement, then such scholarships, grants or other payments and related administrative expenses are considered direct charitable activities. Examples of active programs and a definition of the term "significant involvement" are contained in Treas. Reg. 53.4942(b)-1(b)(2). Additional examples are in Treas. Reg. 53.4942(b)-1(d). Merely reviewing grant applications, interviewing, or testing applicants, selecting grantees, and performing other related administrative actions doesn't constitute a significant involvement in an individual grant program.
- f. To determine whether an organization is an operating foundation under Section 4942(j)(3): In determining whether any expenditure is for the direct active conduct of a charitable activity, the definitions and special rules of Section 4942(j)(3) and the related regulations (which define an operating foundation) generally apply. However, except for expenses related to "significant involvement" grants, grant administrative expenses don't constitute expenditures directly for the active conduct of charitable activities even though they're treated that way under Section 4942(j)(3). If a foundation maintains some significant involvement in an individual grant program, both the grants and the related grant administrative expenses (and qualified set-asides for those purposes) are expenses of a direct charitable activity. Direct charitable activities also include all qualifying distributions that consist of amounts paid or set aside to acquire assets used in the conduct of the foundation's charitable activities, including its grant programs whether or not the foundation maintained a significant involvement in those programs. See Treas. Reg. 53.4942(b)-1(b)(1).
- g. Examples of expenditures for direct charitable activities include, among others, amounts paid or set aside to acquire or maintain the operating assets of a museum, library, or historic site or to operate any such facility; to provide goods, shelter, or clothing to indigents or disaster victims if the foundation maintains some significant involvement in the activity rather than merely making grants to the recipients; to conduct educational conferences and seminars; to operate a home for the aged or disabled; to conduct scientific, historic, public policy, or other research with significance beyond the foundation's grant program and which doesn't constitute a proscribed attempt to influence legislation; to publish and disseminate the results of such research, reports of educational conferences, or similar educational material; to support the service of foundation staff on boards or advisory committees of other charitable organizations or on public commissions or task forces; to provide technical advice or assistance to a governmental

body, a governmental committee or subdivision of either in response to a written request by the governmental body, committee or subdivision; and to conduct performance in the performing arts.

- h. Expenses paid in connection with providing direct technical assistance to grantees are also considered direct charitable activities. This assistance must have significance beyond the purposes of the grants made to those grantees and must not consist merely of monitoring or advising the grantees in their use of the grant funds. Technical assistance involves furnishing of expert advice and related assistance such as compliance with governmental regulations; reducing operating costs or increasing program accomplishments; fundraising methods; and maintaining complete and accurate financial records. See Treas. Reg. 53.4942(b)-1(d).

## **J. Distributions to Another Private Foundation or to a Controlled IRC 501(c)(3) Organization**

- (1) General. Private foundations other than operating foundations primarily carry on their charitable activity in an indirect manner by making grants to individuals or to other organizations directly engaged in charitable activities. If, therefore, one private foundation, A, makes a qualifying distribution to another foundation, B, the stream of funds currently expended for active and direct charity will not, in the ordinary case, be increased. In a related but different vein, if private foundation A makes a distribution to an organization which A or its disqualified persons (Section 4946) control, the common control may serve to unduly delay use of the income in active charity. To ensure that distributions by private foundation flow promptly into the stream of funds sustaining current direct charitable activity, Section 4942 imposes strict requirements on distributions to another private foundation or to a controlled organization. A distribution to another private foundation or to a controlled organization may be counted as a qualifying distribution of the contributor only if the recipient places an equivalent amount in the active charitable stream within 12 months after the taxable year in which the contribution is received. This and other conditions of the "12-month pass-through" are discussed below.
- (2) Meaning of Controlled Organization. Controlled organization, for purposes of Section 4942, means an organization controlled, directly or indirectly, by the contributing private foundation or one or more disqualified persons, as defined in Section 4946, with respect to the contributing foundation. An organization is controlled by a foundation or one or more disqualified persons with respect to the foundation if any of such persons may, by aggregating their votes or positions of authority, require the donee organization to make an expenditure or prevent the donee organization from making an expenditure, regardless of the method by which the control is exercised or exercisable. "Control" is determined without regard to any conditions imposed upon the donee such as a restriction on the way the distribution is to be used unless the restriction is described in Treas. Reg. 1.507-2(a)(7). In general, it is the donee, not the distribution, which

must be controlled for the limitation to apply. Thus, the imposition of budgetary control isn't control within the meaning of this paragraph. The controlled organization may be any type of exempt or nonexempt organization. See Treas. Reg. 53.4942(a)-3(a)(3).

- (3) When a private foundation with a carryover of excess qualifying distributions, transfers all its assets to a private foundation controlled by the same persons who controlled the transferor pursuant to Section 507(b)(2) the transferee may reduce its distributable amount by the transferor's carryover. Rev. Rul. 78-387, 1978-2 C.B. 270. See also Rev. Rul. 2002-28, 2002-1 C.B. 941, in which the IRS issued a ruling addressing a private foundation's responsibilities relating to Section 507 and Sections 4940-4945 when it transferred all its assets to one or more effectively controlled private foundations. The IRS concluded for the Section 4942 issue that the transfers don't constitute qualifying distributions for the transferor foundation under Section 4942. A transferee foundation assumes its proportionate share of the transferor foundation's undistributed income under Section 4942 and reduces its own distributable amount for purposes of Section 4942 by its proportionate share of the transferor's excess qualifying distributions under Section 4942(i).

## **K. Payments to Certain Supporting Organizations**

- (1) A nonoperating private foundation may not count as a qualifying distribution under Section 4942 any amount paid to (1) a non-functionally integrated Type III supporting organization, or (2) any other Section 509(a)(3) supporting organization if a disqualified person with respect to the foundation directly or indirectly controls the supporting organization or a supported organization of such supporting organization. See Section 4942(g)(4). The grant will also constitute a taxable expenditure under Section 4945 if the private foundation does not exercise expenditure responsibility with respect to the grant.
- (2) Notice 2006-109, 2006-2 C.B. 1121. This notice offers guidance on four aspects of applying these newer provisions of the Code:
  - a. Section 3 lists criteria for private foundations that might make distributions to supporting organizations that can be used to determine for purposes of Sections 4942(g)(4) and 4945(d)(4) whether an organization is a Type I, Type II, or functionally integrated Type III supporting organization. Section 3 also provides criteria for determining whether a supporting organization, or any of its supported organizations, are controlled by disqualified persons. This Notice may continue to be relied upon as modified by Notice 2014-4, 2014-2 I.R.B. 274 (Jan. 6, 2014) and Revenue Procedure (Rev. Proc.) 2018-32, 2018-23 I.R.B. 739, which states that private foundations, for grant making purposes under Sections 4942 and 4945, may rely on an organization's supporting organization type to the extent set forth in Tax Exempt Organization Search (Pub. 78 data) or the EO BMF Extract. Section 3 of Notice 2006-109 also gives similar guidance for Section 4966 for donor advised funds that make grants to supporting organizations.

- b. Section 4 clarifies the date the Section 4958(c)(3) excise tax applies on certain excess benefit transactions involving supporting organizations.
- c. Pursuant to the authority under Section 4966(d)(2)(C), Section 5.01 excludes certain employer-sponsored disaster relief funds from the definition of donor-advised fund.
- d. Section 5.02 clarifies how the IRS will apply Section 4966(a) excise taxes for payments made per educational grants awarded before the PPA 2006 enactment date.

## **L. Accounting Principles Applicable to Qualifying Distributions**

- (1) An organization's qualifying distributions will be determined solely on the cash receipts and disbursements method of accounting. See Treas. Reg. 53.4942(a)-3(a)(1).

## **M. Value of Property Distribution**

- (1) The amount of a qualifying distribution of property is the fair market value of the property on the date the qualifying distribution is made. See Treas. Reg. 53.4942(a)-3(a)(1).

## **N. Funds Borrowed for Exempt Purposes**

- (1) Treas. Reg. 53.4942(a)-3(a)(4) describes the treatment of a private foundation's repayment of funds borrowed to make charitable expenditures. This type of payment ordinarily isn't a qualifying distribution; only the distribution or expenditure of the borrowed funds for specific charitable, educational, or similar purposes is treated as a qualifying distribution.
- (2) Interest paid for borrowed funds is treated as a deduction from gross income in the taxable year in which it is paid. See Treas. Reg. 53.4942(a)-3(a)(4)(iii).

## **O. Changes in Use of an Asset**

- (1) If an asset not used, or held for use, for exempt purposes is subsequently converted to such a use, the foundation may treat the conversion as a qualifying distribution. The amount of the qualifying distribution is the fair market value of the asset as of the date of its conversion. Fair market value is determined by making a valuation of the asset as of the conversion date in accordance with the valuation rules discussed above. See Treas. Reg. 53.4942(a)-3(a)(5).
- (2) The correct conversion date of real property converted from nonexempt to exempt uses is the date the foundation adopts and immediately proceeds to implement a plan for the exempt use, even though the actual conversion isn't completed until the following year. Rev. Rul. 78-102, 1978-1 C.B. 379.

## **P. Certain Foreign Organizations**

- (1) A private foundation may wish to treat grants to foreign grantees as qualifying distributions that satisfy the distribution requirements imposed by Section 4942

and not as expenditures requiring expenditure responsibility in order to not be subject to the excise tax on taxable expenditures imposed by Section 4945. If a private foundation makes a good faith determination that a foreign grantee qualifies as a qualifying public charity, the grant will generally be a qualifying distribution that doesn't require expenditure responsibility to not be a taxable expenditure. A distribution for Section 170(c)(2)(B) purposes to a foreign organization which has not received a ruling or determination letter that it is an organization described in Section 509(a)(1), (2), or (3) or in Section 4942(j)(3) will be treated as a distribution to an organization described in Section 509(a)(1), (2), or (3) (other than an organization described in Section 4942(g)(4)(A)(i) or (ii)) or in Section 4942(j)(3) if the distributing foundation has made a good faith determination that the donee organization is an organization described in Section 509(a)(1), (2), or (3) (other than an organization described in Section 4942(g)(4)(A)(i) or (ii)) or in Section 4942(j)(3). See Treas. Reg. 53.4942(a)-3(a)(6)(i).

- (2) A good faith determination that a foreign donee organization is described in Section 509(a)(1), (2), or (3) (other than an organization described in Section 4942(g)(4)(A)(i) or (ii)) or in Section 4942(j)(3) ordinarily will be considered made if both of the following are true:
  - a. It's based on current written advice received from a qualified tax practitioner concluding that the donee is an organization described in Section 509(a)(1), (2), or (3) (other than an organization described in Section 4942(g)(4)(A)(i) or (ii)) or in Section 4942(j)(3), and
  - b. The foundation reasonably relied in good faith on the written advice per the requirements of Treas. Reg. 1.6664-4(c)(1). The written advice must give sufficient facts on the operations and support of the donee organization for the IRS to determine that the donee organization would be likely to qualify as an organization described in Section 509(a)(1), (2), or (3) (other than an organization described in Section 4942(g)(4)(A)(i) or (ii)) or in Section 4942(j)(3) as of the date of the written advice. See Treas. Reg. 53.4942(a)-3(a)(6)(i).
- (3) Rev. Proc. 2017-53, 2017-40 I.R.B. 263. This revenue procedure:
  - a. Modifies and supersedes Rev. Proc. 92-94, 1992-2 C.B. 507, which provided a simplified requirement process that private foundations could follow in making good faith determinations (also known as equivalency determinations).
  - b. Reflects the changes to the equivalency determination final regulations published in 2015 (Treasury Decision 9740), including the elimination of the ability of a private foundation to rely on a grantee affidavit for purposes of the special rule.
  - c. Reflects the changes to the public support tests for Section 170(b)(1)(A)(vi) and Section 509(a)(2) organizations set forth in final regulations published



in 2011 (Treasury Decision 9549) and applies these changes in the context of equivalency determinations.

- d. Includes other updates and changes in response to comments from the public.

## Q. Payment of Tax

- (1) Payment of any tax imposed under Chapter 42 of the Code shall not be treated as a qualifying distribution. See Treas. Reg. 53.4942(a)-3(a)(7).

## R. Examples of Qualifying Distributions

- (1) Treas. Reg. 53.4942(a)-3(a)(8) illustrates qualifying distributions with the following examples:

**Example 1:** M, a private foundation which uses the calendar year as the taxable year, makes the following payments in 1970: (i) a payment of \$44,000 to five employees for conducting a foundation program of educational grants for research and study; (ii) \$20,000 for various items of overhead, 10% of which is attributable to the activities of the employees mentioned in payment (i) of this example and the other 90% of which is attributable to administrative expenses which were not paid to accomplish any Section 170(c)(1) or (2)(B) purpose; and (iii) a \$100,000 general purpose grant paid to an educational institution described in Section 170(b)(1)(A)(ii) which is not controlled by M or any disqualified persons with respect to M. Payments (i) and (ii) of this example are qualifying distributions to the extent of \$46,000 (\$44,000 of salaries and 10% of the overhead, both of which are reasonable administrative expenses paid to accomplish Section 170(c)(1) or (2)(B) purposes). Payment (iii) of this example is also a qualifying distribution, since it is a contribution for Section 170(c)(2)(B) purposes to an organization which isn't described in Treas. Reg. 53.4942(a)-3(a)(2)(i)(a) or (b). The other 90% of payment (ii) of this example may constitute items of deduction under Treas. Reg. 53.4942(a)-2(d)(1)(ii) if such items otherwise qualify.

**Example 2:** On February 21, 1972, N, a private foundation which uses the calendar year as the taxable year, pays \$500,000 for real property on which it plans to build hospital facilities to be used for medical care and education. The real property produces no income and the hospital facilities will not be constructed until 1974 according to the set-aside plan submitted to and approved by the IRS pursuant to Treas. Reg. 53.4942(a)-3(b). The purchase of the land is a qualifying distribution under Treas. Reg. 53.4942(a)-3(a)(2)(ii). If, however, the property were used to produce rental income for more than a reasonable period of time before construction of the hospital is begun, then as of the time such rental use becomes unreasonable (i) such purchase would no longer be deemed to constitute a qualifying distribution under Treas. Reg. 53.4942(a)-3(a)(2)(ii) and (ii) the amount of the qualifying distribution would be included in N's gross income. See Treas. Regs. 53.4942(a)-2(c)(3)(i) and 53.4942(a)-2(d)(2)(iii)(b).



**Example 3:** In 1971, X, a private foundation engaged in holding paintings and exhibiting them to the public, purchases an additional building to be used to exhibit the paintings. Such expenditure is a qualifying distribution under Treas. Reg. 53.4942(a)-3(a)(2)(ii). In 1975, X sells the building. Under Treas. Reg. 53.4942(a)-2(d)(2)(iii)(b), all the proceeds of the sale (less direct costs of the sale) are included in X's gross income for 1975.

**Example 4:** In January 1969, M, a private foundation which uses the calendar year as the taxable year, borrows \$10 million to give to N, a private college, for the construction of a science center. M borrowed the money from X, a commercial bank. M is to repay X at the rate of \$1.1 million per year (\$1 million principal plus \$0.1 million interest) for 10 years beginning in January 1973. M distributed \$5 million of the borrowed funds to N in February 1969, and the other \$5 million in March 1970. M files a statement with the form it is required to file under Section 6033 for 1973 which contains the information required by Treas. Reg. 53.4942(a)-3(a)(4)(ii)(b). Pursuant to M's election, each repayment of loan principal constitutes a qualifying distribution in the year of repayment. Accordingly, the distribution of \$5 million to N in March 1970 will not be treated as a qualifying distribution. Each payment of interest (\$0.1 million annually) with respect to M's loan from X is treated as a deduction under Treas. Reg. 53.4942(a)-2(d)(1)(ii) in the taxable year in which it's made.

**Example 5:** Private foundation Y engages in providing care for the aged. Y makes a distribution of cash to H, a hospital described in Section 170(b)(1)(A)(iii) which is not controlled by Y or any disqualified person with respect to Y. The distribution is made subject to the conditions that H will invest the money as a separate fund which will bear a name commemorating the creator of Y and will use the income from such fund only for H's exempt hospital purposes which relate to care for the aged. Under these circumstances, the distribution from Y to H is a qualifying distribution pursuant to Treas. Reg. 53.4942(a)-3(a)(2)(i).

- (2) In addition, several revenue rulings illustrate IRS determinations on classification of payments as qualifying distributions.
- (3) In Rev. Rul. 74-560, 1974-2 C.B. 389, the IRS ruled that a private foundation may not treat as a qualifying distribution an amount equal to straight-line depreciation on a building it constructed for charitable purposes.
- (4) In Rev. Rul. 75-495, 1975-2 C.B. 449, the IRS considered legal fees paid in a suit brought to determine the proper beneficiary of a portion of a private foundation's net income. Because the payment was a reasonable and necessary administrative expense, it met the requirements for classification as a qualifying distribution.
- (5) In Rev. Rul. 78-90, 1978-1 C.B. 380, the IRS ruled that low-interest loans made to blind persons to enable them to establish themselves in business serve charitable purposes and constitute program-related investments within the meaning of Section 4944(c) and, accordingly, are qualifying distributions.

- (6) In *H. Fort Flowers Foundation, Inc. v. Commissioner*, 72 T.C. 399 (1979), the court agreed with the IRS that a private foundation's use of its income to restore to corpus an amount earlier contributed to a university wasn't a qualifying distribution. See also, GCM 39808 (Jan. 16, 1990), which states the IRS can adjust the excess distribution carryover applicable for years not barred by the statute of limitations by recalculating the distributable amount or the amount of qualifying distributions for years that are closed.

## **S. Set-Asides**

- (1) Certain amounts set aside, rather than currently distributed, for one or more purposes described in Section 170(c)(2)(B) or Section 170(c)(1), may be treated as qualifying distributions.
- (2) Under Section 4942(g)(2) and Treas. Reg. 53.4942(a)-3(b), as they existed before the Tax Reform Act of 1976, a set-aside was treated as a qualifying distribution only if it was approved in advance by IRS. To obtain this approval, Section 4942(g)(2) required a private foundation to establish both that (i) the set-aside would be paid for the specific project within five years and (ii) the suitability of the set-aside would achieve the goals of the specific project (suitability test).
- (3) While the rules for advance approval remain unchanged, Section 4942(g)(2), as amended by the Tax Reform Act of 1976, effective for set-asides made in taxable years beginning after December 31, 1974, provides another way to treat a set-aside as a qualifying distribution under which a private foundation must distribute minimum amounts of cash during specific test years (cash distribution test).
- (4) The legislative history of the Tax Reform Act of 1976 states that the cash-distribution test was intended to alleviate a situation which was unforeseen at the time of the 1969 Act that is, the case of new foundations or certain existing foundations whose assets are suddenly multiplied many times over, which find it impossible to meet the Section 4942 payout requirements in their early years if their set-aside programs under the suitability test did not receive timely advance IRS approval. There are two major advantages to the cash distribution test:
  - a. The set-aside doesn't need advance approval from IRS.
  - b. The private foundation doesn't need to establish that the project for which the amount is set-aside can be better accomplished by the set-aside than by the immediate payment of funds.

### **S.1. Suitability Test**

- (1) Under Treas. Reg. 53.4942(a)-3(b)(1) and (2), a set-aside may be treated as a qualifying distribution only if, at the time of the set-aside, the private foundation shows the IRS that:

- a. The set-aside amount will be paid for the specific project within 60 months from the date of the first set-aside, and
  - b. The project is one which can be better accomplished by such set-aside than by the immediate payment of funds.
- (2) Specific Project defined. Under Treas. Reg. 53.4942(a)-3(b)(2), the term "specific project" includes, but is not limited to, situations where relatively long-term grants or expenditures must be made to assure the continuity of particular charitable projects or program-related investments or where grants are made as part of a matching-grant program. "Specific project" may include, for example, a plan:
- a. To erect a building to house a direct charitable, educational, or other similar exempt activity of the foundation, such as a museum building in which paintings are to be hung, even though the exact location and architectural plans have not been finalized;
  - b. To purchase an additional group of paintings offered for sale only as a unit which requires an expenditure of more than one year's income; or
  - c. To fund a specific research program which is of sufficient magnitude to require an accumulation prior to commencement of the research, even though not all the details of the program have been finalized.

## **S.2. Revenue Rulings**

- (1) In Rev. Rul. 75-511, 1975-2 C.B. 450, a foundation whose primary activity was making renewable scholarships and fixed sum research grants was unable to show that its grant-making program could be better accomplished by using set-asides than by the immediate payments of funds.
- (2) Rev. Rul. 75-511, in quoting the applicable regulations, further states that specific projects of the kind that might qualify for a set-aside are those involving relatively long-term grants or expenditures that must be made in order to assure the continuity of particular charitable projects; for example, a plan to fund a specific research program which is of such magnitude as to require an accumulation of funds prior to commencement of the research. The ruling also states that the foundation's grant-making program is regularly carried on as part of its normal ongoing charitable activities. In most instances, the foundation had been able to fund these activities out of current income, and it had given no compelling reasons why it couldn't continue to fund its grant-making program in this manner. Under these circumstances, the ruling concluded that the foundation hadn't shown that its grant-making program could be better accomplished using set-asides than by the immediate payment of funds. However, while this conclusion is still correct under the suitability test, this factual situation could now qualify under the cash distribution test, assuming the other parts of that test are satisfied, because the foundation need not show that

its grant-making program could be better accomplished using set-asides than by the immediate payment of funds.

- (3) In Rev. Rul. 77-7, 1977-1 C.B. 354, the term "specific project" was held to include a building project to be undertaken by a public charity unrelated to the foundation making the set-aside.
- (4) In Rev. Rul. 74-450, 1974-2 C.B. 388, an operating foundation's conversion of a portion of newly acquired land into an extension of an existing wildlife sanctuary and the remainder into a public park under a four-year construction contract, under which payments were made mainly during the last two years, was held to constitute a "specific project".
- (5) Rev. Rul. 74-450 further states that entering into the above contract would commit the organization to a major project costing substantially more than the foundation's total available income on an annual basis, notwithstanding the fact that a major part of the required disbursement wouldn't fall due until after the entire project was well along towards completion. Therefore, the project is one which can be better accomplished by a set-aside than by the immediate payment of funds.

### **S.3. Advance Approval**

- (1) According to Treas. Reg. 53.4942(a)-3(b)(7)(i), a private foundation must apply for approval of a set-aside under the suitability test before the end of the taxable year in which the amount is set aside. The regulations state that the request for advance approval of a set-aside under the suitability test must include:
  - a. A statement describing the nature and purposes of the specific project and the amount of the set-aside for which approval is requested;
  - b. A statement describing the amounts and approximate dates of any planned additions to the set-aside after its initial establishment;
  - c. A statement of the reasons why the project can be better accomplished by a set-aside than by the immediate payment of funds;
  - d. A detailed description of the project including estimated costs, sources of any future funds expected to be used for completion of the project, and the location(s) (general or specific) of any physical facilities to be acquired or constructed as part of the project; and
  - e. A statement by an appropriate foundation manager (as defined in Section 4946(b)) that the amounts to be set aside will actually be paid for the specific project within a specified period of time that ends not more than 60 months after the date of the first set-aside, or a statement showing good cause why the period for paying the amount set aside should be extended (including a showing that the proposed project could not be divided into two or more projects covering periods of no more than 60 months each) and setting forth the extension of time required.

## **S.4. Cash Distribution**

- (1) In general, the cash distribution test under Treas. Reg. 53.4942(a)-3(b)(3) is satisfied if:
  - a. The specific project for which the amount is set aside will not be completed before the end of the taxable year in which the set-aside is made;
  - b. The private foundation actually distributes in cash or its equivalent for a Section 170(c)(1) or (2)(B) purpose (a charitable purpose) the "start-up period minimum amount" during the foundation's "start-up period" (see below definitions for both phrases); and
  - c. The private foundation distributes in cash or its equivalent for a charitable purpose, the "full-payment period minimum amount" in each taxable year of the foundation's "full-payment period" (both phrases are described below).
- (2) For these tests, an amount set aside will be treated as distributed in the year in which actually paid and not in the year in which set aside.

## **S.5. Minimum Distribution Required During Start-Up Period**

- (1) For foundations created after December 31, 1971 (or for organizations that first become foundations after that date), the "start-up period" is the four taxable years following the taxable year in which the foundation was created or became a foundation. For these purposes, a foundation will be considered created in the taxable year in which its distributable amount (Section 4942(d)) first exceeds \$500. See Treas. Reg. 53.4942(a)-3(b)(4).
- (2) Under Treas. Reg. 53.4942(a)-3(b)(4)(ii), the start-up period minimum amount is the amount a foundation must distribute in its start-up period and can't be less than the sum of:
  - a. 20% of its distributable amount for the first taxable year of the start-up period,
  - b. 40% of its distributable amount for the second taxable year of the start-up period,
  - c. 60% of its distributable amount for the third taxable year of the start-up period, and
  - d. 80% of its distributable amount for the fourth taxable year of the start-up period.
- (3) The above requirement means that the total amount must be distributed before the end of the start-up period and is not a requirement that any portion of this amount be distributed in any particular year of the start-up period. See Treas. Reg. 53.4942(a)-3(b)(4)(iii).
- (4) Examples. Treas. Reg. 53.4942(a)-3(b)(4)(v) provides the following examples to illustrate this principle.

**Example 1:** F, a private foundation created on January 1, 1975, uses the calendar year as its taxable year. The start-up period for F is January 1, 1976, through December 31, 1979. F has distributable amounts under Section 4942(d) for taxable years 1976 through 1979 in the following amounts: 1976, \$100,000; 1977, \$120,000; 1978, \$150,000; 1979, \$200,000. F's start-up period minimum amount is the sum of the following amounts: 20% of \$100,000 (\$20,000); 40% of \$120,000 (\$48,000); 60% of \$150,000 (\$90,000); and 80% of \$200,000 (\$160,000); which equals \$318,000. Thus, F is required to distribute at least \$318,000 in cash or its equivalent during the start-up period.

**Example 2:** F, a private foundation created in 1969, uses the calendar year as its taxable year. F's start-up period is the calendar years 1972 through 1975. F makes two cash distributions in 1972. The first distribution is made because of a set-aside made in 1969. Under Section 4942(g), that distribution is treated as a qualifying distribution made in 1969. The second distribution is treated under Section 4942(h) as made from F's undistributed income for 1971. In addition, F makes a cash distribution in 1976 that is treated under Section 4942(h) as made from F's undistributed income for 1975. In determining whether F had distributed its start-up period minimum amount within the start-up period, the 1972 distributions are both considered because they were made during F's start-up period. The 1976 distribution is not considered, however, because that distribution was not actually made during F's start-up period.

- (5) Exception. Generally, only a distribution made during the start-up period is considered in determining whether a foundation has distributed the start-up period minimum amount. However, in the case of a foundation created after December 31, 1971 (or which first became a foundation after that date), a distribution made during the taxable year in which it was created (the year preceding the first taxable year of its start-up period) may be treated as a distribution made during the start-up period. In addition, a distribution made within 5 1/2 months after the end of the start-up period will be treated as a distribution made during the start-up period if (see Treas. Reg. 53.4942(a)-3(b)(4)(iv):
- a. The foundation was unable to determine its distributable amount for the fourth taxable year of the start-up period until after it ended, and
  - b. The foundation made distributions before the end of the start-up period based on a reasonable estimate of its distributable amount for the fourth taxable year of the start-up period.

## **S.6. Minimum Distribution Required During Full-Payment Period**

- (1) A private foundation's full-payment period is each taxable year that begins after the end of the start-up period. During this period, it must distribute in cash or equivalent 100% of its distributable amount (Section 4942(d)) with respect to the taxable year (without regard to Section 4942(i)). See Treas. Reg. 53.4942(a)-3(b)(5)(ii).

- (2) For taxable years beginning after December 31, 1975, if a foundation distributes more than the full-payment period minimum amount for a taxable year, the excess can be carried forward to reduce the full-payment period minimum amount for the next 5 taxable years (referred to as an "adjustment period"). An excess distribution made in one taxable year must be completely applied to future years before a subsequent excess distribution can be considered. See Treas. Reg. 53.4942(a)-3(b)(5)(iii).
- (3) Generally, pursuant to Treas. Reg. 53.4942(a)-3(b)(5)(iv), only a distribution made during a taxable year of the full-payment period may be considered in determining whether a foundation has distributed the full payment period minimum amount for a taxable year. Treas. Reg. 53.4942(a)-3(b)(5)(v) provides the following examples to show this rule.

**Example 1:** F, a private foundation created on January 1, 1973, uses the calendar year as its taxable year. F has a start-up period of January 1, 1974, through December 31, 1977, and a full-payment period that includes every taxable year beginning after December 31, 1977. F's distributable amount (as determined under Section 4942(d)) for 1978 is \$500,000. Thus, F's full-payment minimum amount for 1978 is \$500,000. During 1978 F distributes \$100,000 in cash to Charity X and \$400,000 in cash to Charity Y because of a set-aside made in 1973. F has distributed its full-payment period minimum amount for 1978 because it has made actual cash distributions during that year which total \$500,000. However, F has made qualifying distributions (as determined under Section 4942(g)) with respect to 1978 of only \$100,000. To avoid liability for the tax on undistributed income under Section 4942(a), F must distribute or set-aside an additional \$400,000 before January 1, 1980.

**Example 2:** Assume the facts as stated in Example 1 except that in 1978 F makes cash distributions totaling \$600,000. Since the total cash distributions made in 1978 (\$600,000) exceed the full-payment period minimum amount for 1978 (\$500,000), there exists a \$100,000 excess which must be used by F to reduce its full-payment period minimum amounts for the years 1979-1983 (the taxable years in the adjustment period with respect to the 1978 excess). Therefore, if F's distributable amount (as determined under Section 4942(d)) for 1979 is \$500,000, F's full-payment period minimum amount for 1979 is \$400,000 (\$500,000 – \$100,000). See Treas. Reg. § 53.4942(a)-3(b)(5)(v).

## **S.7. Failure to Distribute Minimum Amounts**

- (1) Under Treas. Reg. 53.4942(a)-3(b)(6)(i), if a foundation fails to distribute the start-up period minimum amount during the start-up period or the full-payment period minimum amount during the full-payment period:
  - a. Any set-aside made during either period that wasn't approved in advance under the suitability test will not be treated as a qualifying distribution.



- b. Any set-aside made after the taxable year in which the failure to distribute took place won't be treated as a qualifying distribution unless it is approved under the suitability test.
- (2) So, in this situation a deficiency may be assessed under Section 4942(a). In addition, Section 6501(l)(3) has a special rule for the period within which a deficiency may be assessed.
- (3) However, Treas. Reg. 53.4942(a)-3(b)(6)(ii) notes that if the failure to distribute the full-payment period minimum amount was not willful and was due to reasonable cause, the foundation is allowed to correct the failure to distribute. Correction by distribution of cash must occur during the correction period as defined in Section 4963(e), determined for the earliest taxable event (Section 4963(e)(2)(A)) that would result if the failure to distribute were not corrected. This distribution to correct is treated as made during the taxable year in which the failure to distribute occurred. If the failure to distribute is because the full-payment period minimum amount could only be determined after the end of the taxable year, no "willful failure to distribute" will occur if the foundation makes an additional distribution within 5 1/2 months after the end of the taxable year.

## **S.8. Cash Distribution Test**

- (1) Approval and Information Requirements. Prior approval of a set-aside under the cash distribution test isn't required. Instead, for taxable years ending after April 2, 1984, Treas. Reg. 53.4942(a)-3(b)(7)(ii) provides that the foundation must attach the following information to its annual information return for the taxable year in which the set aside is made:
  - a. A statement describing the nature and purposes of the specific project for which amounts are to be set aside;
  - b. A statement that the amount set aside will be paid for the specific project within a specified period not to exceed 60 months;
  - c. A statement that the project will not be completed before the end of the taxable year in which the set-aside is made;
  - d. A statement showing the distributable amounts determined under Section 4942(d) for any past taxable years in the private foundation's start-up and full-payment periods; and
  - e. A statement showing the aggregate amount of actual payments made in cash for charitable purposes during each taxable year in the foundation's start-up and full-payment period. This statement should include a detailed description of any payments that are to be treated as distributed during a taxable year before the taxable year in which those payments were actually made (under Treas. Reg. 53.4942(a)-3(b)(4)(iv) and (6)(ii)) and, in addition, should explain the circumstances that justify the application of those rules.



**Note:** For the five taxable years following the year in which the amount is set-aside, this attachment must include the statements required in (d) and (e).

### **S.9. Evidence of Set-Asides**

- (1) A set-aside that is approved under the suitability test or which satisfies the cash distribution test need only be noted as a bookkeeping entry on the foundation's books of account signifying a pledge or obligation to be paid at a future date(s). See Treas. Reg. 53.4942(a)-3(b)(8). Rev. Rul. 78-148, 1978-1 C.B. 380, held that a foundation, that otherwise meets the requirements for a set-aside under the suitability test, may make a set-aside by means of a bookkeeping entry, consisting of the amount by which its minimum investment return for its immediately preceding taxable year exceeds its adjusted net income for that year.
- (2) If the suitability test is otherwise satisfied, the 60-month period for paying the amount set-aside may, for good cause shown, be extended.

### **S.10. Contingent Set-Asides**

- (1) If a foundation is involved in litigation and can't distribute assets or income because of a court order, the foundation may seek and obtain a contingent set-aside. The amount of the set-aside will be limited to that portion of the foundation's distributable amount which is attributable to the assets or income that are held pursuant to court order and which, but for the court order precluding the distribution, would have been distributed. If the litigation encompasses more than one taxable year, the foundation may seek additional contingent set-asides. These amounts must be distributed by the last day of the taxable year following the taxable year in which the litigation is terminated. See Treas. Reg. 53.4942(a)-3(b)(9).

### III. Other Considerations

- (1) There are other considerations to analyze when examining a transaction that may fall within the definition of Section 4942.

#### A. Twelve-Month Pass-Through

- (1) Under Treas. Reg. 53.4942(a)-3(c)(1), a contribution to a controlled Section 501(c)(3) organization or to a private foundation which is not an operating foundation will be treated as a qualifying distribution in the year in which it is made, if:
  - a. The donee organization, in turn, makes a distribution equal to the full amount of such contribution not later than the close of the first taxable year after the taxable year in which it received the contribution,
  - b. The donee organization's distribution of the contribution is a qualifying distribution which is treated under Section 4942(h) as a distribution out of the donee's corpus (or would be so treated if the donee were a private foundation which is not an operating foundation) and
  - c. The private foundation making the contribution obtains adequate records or other sufficient evidence from the donee organization which: shows that the donee organization has made a qualifying distribution of the contribution; shows the names and addresses of the recipients thereof; and shows that as to the donee the distribution is treated as made out of corpus under Section 4942(h) or would be so treated if the donee were a private foundation which is not an operating foundation. This condition in effect generally requires that the donee organization have no undistributed income with respect to the taxable year preceding its compensatory qualifying distribution since, under Section 4942(h), distributions may be allocated to corpus only after undistributed income of the preceding taxable year has been distributed. See Section 4942(h)(2) and Treas. Reg. 53.4942(a)-3(d)(2).
- (2) Use of pass-through for administrative expense. "Qualifying distributions" include expenditures for reasonable administrative expenses. If the donee expends the contribution for an administrative expense which is part of a Section 170(c)(1) or 170(c)(2)(B) expenditure and can't reasonably account separately for the contribution, the donee's statement setting forth the purpose for which the expenditure was made and that the amount was distributed as a corpus distribution will satisfy the requirements of (1)(c) above.
- (3) Distribution requirements. Not later than the close of the first taxable year after the taxable year of receipt of any contribution described in this section, the donee organization must distribute an amount equivalent in value to such contribution. The compensating distribution must be attributable to the donee's corpus; so, the donee must first distribute any undistributed income for the prior taxable year. See Treas. Reg. 53.4942(a)-3(c)(2)(i).

- (4) Failed pass-through. If a donee organization fails to entirely redistribute pass-throughs of a prior taxable year by the close of the succeeding taxable year, any redistributions are deemed made pro rata out of all pass-throughs received in the prior taxable year regardless of any earmarking by the donee. A failed pass-through is taken back into gross income of the donor foundation in the first taxable year succeeding the donee's first taxable year following donee's taxable year of receipt. See Treas. Reg. 53.4942(a)-3(c)(2)(i).
- (5) Value of contribution. The fair market value of contributed property is determined as of the date of the contribution. Such fair market value must be used in determining whether an amount equal in value to the contribution has been redistributed. See Treas. Reg. 53.4942(a)-3(c)(2)(i).
- (6) Characterizing donee's qualifying distribution. In determining whether the donee of a pass-through has made compensating distributions out of its corpus in the taxable year succeeding the contribution, characterization of the origin of the donee's qualifying distributions in those succeeding taxable years is made at the end thereof. Unless the donee organization has made an election under either Treas. Reg. 53.4942(a)-3(d)(2) or Treas. Reg. 53.4942(a)-3(c)(2)(iv) to vary the normal treatment of qualifying distributions, amounts distributed in the succeeding taxable year are allocated first to undistributed income of the donee's prior taxable year, then to undistributed income of its current taxable year, and then to corpus. When a qualifying distribution is determined to be attributable to corpus, that distribution is charged to pass-through contributions received in the donee's immediately preceding taxable year. See Treas. Reg. 53.4942(a)-3(c)(2)(ii).

## **B. Applying Prior Corpus Distributions**

- (1) The pass-through distribution requirement may be satisfied under an election to treat distributions out of corpus in certain prior taxable years as a current distribution out of corpus. See Treas. Reg. 53.4942(a)-3(c)(2)(iv). This treatment of prior distributions from corpus may be applied, at the election of the foundation, in satisfaction of pass-through requirements both for a contribution from another foundation and a contribution from an individual made under the provisions of Section 170(b)(1)(F)(ii). To be available for treatment as a current distribution out of corpus, the prior distribution out of corpus:
  - a. Must have been distributed as a distribution out of corpus under the provisions of Section 4942(h),
  - b. Must not have been availed of for any other purpose, for example, in satisfaction of redistribution requirements on some other contribution,
  - c. Must have occurred within the preceding five years, and
  - d. May not be later availed of for any other purpose.
- (2) The election to treat a prior distribution out of corpus as a current distribution out of corpus is made by attaching a statement to the return the foundation is required to file under Section 6033 with respect to the taxable year for which the

election is to apply. The statement must contain a statement by an appropriate foundation manager, within the meaning of Section 4946(b)(1), that the foundation is making an election under the provisions of Treas. Reg. 53.4942(a)-3(c)(2)(iv), and that the distribution is made out of the undistributed income of a prior taxable year(s) which was treated under Treas. Reg. 53.4942(a)-3(d)(1)(iii) as a distribution out of corpus. See Treas. Reg. 301.9100-1 regarding an extension of time for making certain elections.

- (3) Treas. Reg. 53.4942(a)-3(c)(3) illustrates the pass-through requirements with the following examples.

**Example 1:** In 1972 M, a private foundation, contributes out of 1971 income to X, a private non-operating foundation. The contribution is the only one received by X in 1972. In 1973, X makes a qualifying distribution to an art museum maintained by an operating foundation in an amount equal to the amount of the contribution received from M. X also distributes all its undistributed income for 1972 and 1973 for other purposes described in Section 170(c)(2)(B). Under Treas. Reg. 53.4942(a)-3(d), the distribution to the museum is treated as a distribution out of corpus. Thus, M's contribution to X is a qualifying distribution out of M's 1971 income provided M obtains adequate records or other sufficient evidence from X showing the nature and amount of the distribution made by X, the identity of the recipient, and the fact that the distribution is treated as made from corpus. If X's qualifying distributions during 1973 had been equal only to M's contribution to X and X's undistributed income for 1972, X could have made an election under Treas. Reg. 53.4942(a)-3(d)(2) to treat the amount distributed in excess of its 1972 undistributed income as a distribution out of corpus and in that manner satisfied the pass-through distribution requirements.

**Example 2:** Assume the facts stated in example 1, except that X is a private college described in Section 170(b)(1)(A)(ii) which is controlled by disqualified persons with respect to M and that the records which X furnishes to M show that the distribution would have been treated as made out of corpus if X were a private non-operating foundation. Under these circumstances, the result is the same as in example 1.

**Example 3:** Assume the facts stated in example 1, except that X makes a distribution to the museum equal only to one-half of the contribution from M, that the remainder of such contribution is added to X's funds and used to pay charitable administrative expenses, and that the records obtained by M from X are not sufficient to show the amounts distributed or the identities of the recipients of the distributions. The contribution by M to X will be a qualifying distribution only to the extent that M can obtain (i) other sufficient evidence (such as statements from officers or employees of X or from the museum) showing the facts required by Treas. Reg. 53.4942(a)-3(c)(1) and (ii) a statement from X setting forth that the remainder of the contribution was used for charitable administrative expenses which constituted qualifying distributions described in Treas. Reg. 53.4942(a)-3(a)(2)(i).

**Example 4:** X and Y are private non-operating foundations. A is an exempt organization which is not described in Section 501(c)(3) but which supervises and conducts a program described in Section 170(c)(2)(B). Y, but not X, controls A within the meaning of Treas. Reg. 53.4942(a)-3(a)(3). In 1972, X and Y each makes a grant to A of \$100, specifically designated for use in the operation of A's Section 170(c)(2)(B) program. X has made a qualifying distribution to A because the distribution is one described in Treas. Reg. 53.4942(a)-3(a)(2)(i). However, because A is controlled by Y, Y's grant of \$100 to A does not constitute a qualifying distribution. Furthermore, because A is not an exempt organization described in Section 501(c)(3), Y's grant to A does not constitute a qualifying distribution.

**Example 5:** N, a private non-operating foundation, had distributable amounts of \$100 in 1970 and \$125 in 1971. In 1970 N received total contributions of \$540: \$150 from Y, a public charity; \$70 from Z, a private foundation; \$140 from Q, a private foundation, subject to the requirement that N earmark the amount and distribute it before distributing Z's contribution; and, \$180 from R, also a private foundation. However, R specifically instructed N that such contribution did not have to be redistributed because R already had made enough qualifying distributions to avoid all Section 4942 taxes. N is not controlled by Y, Z, Q, or R and N made no qualifying distributions in 1970. By the close of 1971, N had made qualifying distributions of \$420, earmarking \$140 as having been a distribution of Q's contribution, but had made no election under Treas. Reg. 53.4942(a)-3(d)(2) to have any amount distributed which was in excess of N's 1970 undistributed income treated as distributed out of corpus. Therefore, the first \$225 of qualifying distributions made in 1971 (the sum of \$100 and \$125, N's distributable amounts for 1970 and 1971, respectively) are treated as amounts described in Treas. Reg. 53.4942(a)-3(d)(1)(i) and (ii). Since Y's contribution is a contribution from a public charity and does not have to be "redistributed" and since R specifically instructed N that its contribution need not be "redistributed", the remaining \$195 of qualifying distributions will be treated as distributed pro rata from Z's and Q's contributions, regardless of N's earmarking. Accordingly, of Z's original qualifying distribution of \$70 only \$65 (\$195 multiplied by \$70, Z's contribution, over \$210, the total (\$70 plus \$140) of Z's and Q's contributions) will be treated as redistributed by N. Similarly, of Q's original qualifying distribution of \$140 only \$130 (\$195 multiplied by \$140 over \$210) will be treated as redistributed by N. Thus, Z's gross income for 1972 will be increased by \$5 (\$70 less the \$65 redistributed), and Q's gross income for 1972 will be increased by \$10 (\$140 less the \$130 redistributed).

### **C. Transfer by Donee to Secondary Recipient**

- (1) Treas. Reg. 53.4942(a)-3(c)(4) states that where a private foundation makes a distribution to organization X which in turn uses that distribution to make a distribution to organization Y, the latter distribution is not considered a contribution by the private foundation to organization Y if the private foundation doesn't earmark the use of the contribution for any named secondary recipient

and doesn't retain power to cause the selection of the secondary recipient by organization X. This rule of non-attribution applies even though the contributing foundation has reason to believe that certain organizations will benefit from its contribution so long as the original donee organization exercises control in fact over the selection process and makes the selection completely independently of the contributing foundation.

#### **D. Set-Aside by Donee**

- (1) An amount contributed by a private foundation to another private foundation that, in the taxable year following the year in which it received the contribution, established an approved set-aside in the amount of the contribution and made a valid election to treat the entire amount of the set-aside as a distribution out of corpus may be treated by the donor foundation as a qualifying distribution. Rev. Rul. 78-45, 1978-1 C.B. 378.

#### **E. Treatment of Qualifying Distributions**

- (1) Whenever a qualifying distribution is made, it becomes necessary to determine the taxable year against which the amount involved is to be credited, since a private foundation may have undistributed income from one or more years or may have no undistributed income. Section 4942(h) and Treas. Reg. 53.4942(a)-3(d)(1) state that the amount of any qualifying distribution is treated as made of:
  - a. First, any undistributed income of the immediately preceding taxable year (if the private foundation was subject to the initial excise tax of Section 4942(a) for such year) to the extent thereof;
  - b. Second, out of the undistributed income for the taxable year to the extent thereof; and
  - c. Then, out of corpus.
- (2) Treas. Reg. 53.4942(a)-3(d)(3) illustrates the treatment of qualifying distributions.

#### **F. Election as to Treatment of Certain Qualifying Distributions**

- (1) If a private foundation has no undistributed income for the immediately preceding taxable year, a qualifying distribution made in its current taxable year would normally be treated as made from the undistributed income of the current taxable year, and then out of corpus. If no undistributed income remains for the preceding taxable year, a private foundation may elect to vary the normal crediting sequence to credit a qualifying distribution in the current taxable year to a taxable year or years prior to the immediately preceding taxable year, or to corpus. See Treas. Reg. 53.4942(a)-3(d)(2).
- (2) This election's availability is significant where an under-distribution has occurred for a prior taxable year and the taxable period remains open for that year.

- (3) Treas. Reg. 53.4942(a)-3(d)(3) illustrates the effect of an election with the following example: M, a private foundation which uses the calendar year as the taxable year, has undistributed income of \$300 for 1981, \$200 for 1982, and \$400 for 1983. On January 14, 1983, M makes its first qualifying distribution in 1983 when it makes an approved set-aside of \$700 for construction of a hospital. On February 24, 1983, a notice of deficiency with respect to the excise taxes imposed by Section 4942(a) and (b) regarding M's undistributed income for 1981 is mailed to M under Section 6212(a). M notifies the IRS in writing on March 24, 1983, that it is making an election under Treas. Reg. 53.4942(a)-3(d)(2), and that its distribution of January 14th (to the extent it exceeds undistributed income for 1982) is to be applied first against undistributed income for 1981. Thus, under these facts and circumstances, an initial excise tax of \$45 (15% of \$300) is imposed by Section 4942(a). Since M made the election described above, the \$300 of undistributed income for 1981 is treated as distributed during the correction period (as defined in Treas. Reg. 53.4942(a)-1(c)(3)), and therefore no additional excise tax will be imposed. In addition, \$200 (\$700 minus \$500) of the \$700 qualifying distribution is treated as made of undistributed income for 1983.

**Note:** The above example uses the outdated 15% tax rate for the initial excise tax. The current initial excise tax rate is 30%.

## G. Method of Making Election

- (1) Treas. Reg. 53.4942(a)-3(d)(2) notes that an election to vary the normal sequence for treatment of qualifying distributions is made by filing a statement with the IRS during the taxable year in which such qualifying distribution is made or by attaching a statement to the return required to be filed by the foundation with respect to the taxable year in which the qualifying distribution was made. See also Rev. Proc. 74-41, 1974-2 C.B. 495. The statement must contain a foundation manager's declaration that the foundation is making a Section 4942(h) election and must specify whether the distribution is made of the undistributed income of a designated prior taxable year (or years) or is made from corpus. An election made during the taxable year in which the qualifying distribution is made may be revoked in whole or in part by the filing of a revocation statement with the foundation's annual return for the taxable year in which the qualifying distribution was made.

## H. Carryover of Excess Qualifying Distributions

- (1) Under Section 4942(i) and Treas. Reg. 53.4942(a)-3(e), if a private foundation makes excess qualifying distributions in any taxable year in which it is subject to Section 4942(a) initial tax, the excess distribution may be used to reduce distributable amounts in any taxable year of the adjustment period which is the five taxable years immediately following the taxable year in which the excess distribution occurred.
- (2) GCM 39808 (Jan. 16, 1990). The IRS can adjust the excess distribution carryover applicable for years not barred by the statute of limitations by



recalculating the distributable amount or the amount of qualifying distributions for years that are closed.

## **I. Reduction of Distributable Amount**

- (1) Under Section 4942 (g)(2)(D) and Treas. Reg. 53.4942(a)-3(e)(1), the distributable amount for a taxable year in the adjustment period is reduced to the extent of the lesser of:
  - a. the excess of qualifying distributions made in prior taxable years to which such adjustment period applies, or
  - b. the remaining undistributed income at the close of such taxable year after applying any qualifying distributions made in such taxable year to the distributable amount for such taxable year (determined without regard to this paragraph).
- (2) If during any taxable year of the adjustment period there is created another excess of qualifying distributions, such excess isn't considered until any earlier excess of qualifying distributions has been completely applied against distributable amounts during its adjustment period.

## **J. Excess Qualifying Distributions**

- (1) An excess qualifying distribution is a distribution of either undistributed income or corpus with respect to a taxable year beginning after December 31, 1969, that exceeds the distributable amount for that taxable year. See Treas. Reg. 53.4942(a)-3(e)(2).

## **K. Adjustment Period**

- (1) The taxable years in the adjustment period are the five taxable years immediately following the taxable year in which an excess of qualifying distributions is created. Section 4942(g)(2)(E) and Treas. Reg. 53.4942(a)-3(e)(3). So, an excess can't be carried over beyond five succeeding taxable years. If at the time when it is carrying an excess of qualifying distributions, a foundation ceases to be subject to the Section 4942(a) excise tax, for example, by qualifying as an operating foundation, the excesses are extinguished for purposes of this section even if the organization again becomes subject to Section 4942(a) tax. See Treas. Reg. 53.4942(a)-3(e)(4) which gives examples on applying the carryover provisions.
- (2) Rev. Rul. 78-387, 1978-2 C.B. 270 describes a private foundation that transferred all its assets to another private foundation controlled by the same persons who controlled the transferor foundation. The transferor had a carryover of excess qualifying distributions. Under Treas. Reg. 1.507-3(a)(9)(i) the controlled transferee is treated as if it were the transferor. Accordingly, it may reduce its distributable amount by the transferor's carryover.



## IV. Examination Techniques

- (1) This section focuses on how to calculate and assert the excise tax once it has been determined that the foundation has failed to meet its distribution requirements. It also contains information relevant to examinations of private foundations in general.

### A. Introduction

- (1) Section 4942 taxes don't pyramid like continuing acts of self-dealing, but a failure to distribute in a given year may give rise to tax in multiple years in the taxable period similar to discrete acts of self-dealing. Also, if there is a failure to distribute in one year, there may be a failure to distribute in subsequent years. Section 4942 may be triggered when an otherwise "qualifying distribution" is disqualified.

### 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 (former Section 4940(e)). The changes are effective for taxable years beginning after December 20, 2019.

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

4945(a)(1)	PF	10%	20%	None	None	No change
4945(a)(2)	FM	2.5%	5%	\$5,000 per act	\$10,000 per act	No change
*The tax rate changes are effective for full tax years that begin after August 17, 2006.						
**The tax rate changes are effective for full tax years after December 20, 2019.						

- (3) If an organization or individual incurs an excise tax under Sections 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).

**Note:** If a foundation has undistributed income under Section 4942 for its first taxable year that remains undistributed as of the end of its second taxable year, then the Form 4720 instructions treat the Section 4942 tax on the undistributed income as imposed as of the end of its second taxable year and reportable on Form 4720 for its second taxable year (normally due May 15 of its third taxable year for a calendar year filer).

- (4) For Sections 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.

- (5) 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)).

- (6) Under Section 4945, there is only one first tier tax in the taxable period (unlike Sections 4941-4944).
- (7) 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 4942-4945, and the tax year of the foundation manager for foundation manager taxes under Sections 4941, 4944 and 4945.
- (8) Except for Section 4940, excise taxes are reported on Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Code. Previously, for years prior to 2020, if the taxpayer was a self-dealer, disqualified person,

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

**Note:** Electronic filing of the Form 4720 is required for private foundations for Form 4720 returns due on or after July 15, 2021. A limited exception applies for 2020 Form 4720 returns with a due date on or after July 15, 2021, that are submitted on paper and bear a postmark date on or before June 16, 2021.

- (9) 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.
- (10) 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, and
  - d. Form 870-E, Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment.

## C. Qualifying Distributions

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

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

- (3) A taxpayer generally can't make any elections with respect to qualifying distributions during the examination. Taxpayers must make the elections before

filing the Form 990-PF. If the taxpayer properly made a pre-filing election, verify it. If there is a valid election, consider that when revising Part XIII. (The election might be in another part of the form.)

- (4) Refer to the Correction section for a discussion of acceptable correction.
- (5) Complete Forms 4883, 4621, 886-A and 870-E. See Exhibits below showing how to compute and propose the tax.

**Note:** To incur the Section 4942 excise tax requires two years of failing to distribute; in other words, a foundation has until the end of Year 2 to make qualifying distributions of its distributable amount for Year 1. Consider opening all periods with open statutes when dealing with possible disqualified distributions.

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

- (6) The Section 4942 tax is reported on Form 4720 and assessed against the private foundation. See IRM 4.70.13, Executing the Examination, to set up a substitute for return or secure a delinquent return.

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

- (1) The structure of Chapter 42 permits the assessment of excise taxes under different statutes for the same transaction. For instance, a self-dealing transaction (Section 4941) is frequently also a taxable expenditure (Section 4945), that may also affect the net investment income (Section 4940) and the qualifying distributions (Section 4942). See Treas. Reg. 53.4944-1(a)(2)(iv); Rev. Rul. 77-161, 1977-1 C.B. 358; Kermit Fisher Foundation v. Commissioner, T.C. Memo. 1990-300.
- (2) Section 4940 and Section 4942 are closely related. Expenses must be allocated between Section 4940 (investment activities) and Section 4942 (charitable activities). See Treas. Reg. 53.4940-1(e)(1); Rev. Rul. 75-410, 1975-2 C.B. 446; Julia R. & Estelle L. Foundation, Inc. v. Commissioner, 598 F.2d 755 (2d Cir. 1979); Kermit Fisher Foundation v. Commissioner, *supra*. 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 more than the income derived from the property may be treated as a qualifying distribution. See Treas. Reg. 53.4942(a)-2(d)(4)(i).
- (3) For taxable years beginning before December 21, 2019, Section 4940(e) and Section 4942 were especially inseparable. Adjustments to the net value of non-

charitable use assets impact the investment tax calculations (under former Section 4940(e)) and the minimum investment return (Section 4942). Both taxes rely on determining qualifying distributions; Section 4942 applies them against undistributed income to compute the tax liability. The following examples illustrate several outcomes when changes are made to the first page of the Form 990-PF.

- (4) Note that the examples below regarding Section 4940, which imposes an excise tax on the net investment income of most domestic tax-exempt private foundations, including private operating foundations, are for tax years beginning on or before December 20, 2019. For those tax years, the excise tax is 2% of net investment income, but is reduced to 1% in certain cases. For tax years beginning after December 20, 2019, the excise tax is 1.39% of net investment income, and there is no reduced 1% tax rate.

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

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

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

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

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

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

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

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

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

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

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

and vice-versa. See Rev. Rul. 77-161, 1977-1 C.B. 358. Remember to apply the appropriate 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.

## E. Procedural 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 Code subsection.



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

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

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

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

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

- (9) The taxable event appears to be an isolated occurrence, and it appears unlikely that similar taxable events will occur in the future. See Treas. Reg. 53.4963-1(e)(3).

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

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

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

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

- (11) See Treas. Reg. 53.4963-1(e)(5) for extensions of the correction period where a claim for refund is filed with respect to payment of the full amount of the first tier tax imposed with respect to the taxable event or when a suit or proceeding with respect to the claim is filed.
- (12) If there has been a waiver of the restrictions on assessment and collection of the deficiency or if the deficiency is paid, and therefore no notice of deficiency is mailed, the correction period will end with the end of the collection prohibition period described in Treas. Reg. 53.4961-2(e)(5). See Treas. Reg. 53.4963-1(e)(6).

## F. Correction Period

- (1) Section 4942(g)(2)(C) provides that if, for any taxable year to which clause (ii)(II) of subparagraph (B) applies, the private foundation fails to distribute in cash or its equivalent amounts not less than those required by such clause and—
- a. The failure to distribute such amounts was not willful and was due to reasonable cause, and
  - b. The foundation distributes an amount in cash or its equivalent which is less than the difference between the amounts required to be distributed under clause (ii)(II) of subparagraph (B) and the amounts actually distributed in cash or its equivalent during that taxable year within the correction period (as defined in Section 4963(e)), such distribution in cash or its equivalent shall be treated for the purposes of this subparagraph as made during such year.

- (2) Under Section 4963(e), the correction period is the period beginning on the first day on which there is undistributed income and ending 90 days after the date of mailing under Section 6212 of a notice of deficiency with respect to the additional tax, extended by:
  - a. any period in which a deficiency cannot be assessed under Section 6213(a) (determined without regard to the supplemental proceeding provided for under Section 4961(b), and
  - b. any other period which the IRS determines is reasonable and necessary to bring about correction.
- (3) Section 4942(h)(2) provides that in the case of any qualifying distribution which (under paragraph (h)(1)) isn't treated as made out of the undistributed income of the immediately preceding taxable year, the foundation may elect to treat any portion of such distribution as made out of the undistributed income of a designated prior taxable year or out of corpus. The election shall be made by the foundation at such time and in such manner as the IRS shall by regulations prescribe.

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

- (1) Taxpayers may request advance approval of a proposed correction. If granted, the advance approval provides assurance to taxpayers and organizations that IRS will view an intended remedial action favorably as correction.
- (2) Advance approval is **only** available when:
  - a. The only barrier is the reluctance to correct because the taxpayer is uncertain of final IRS approval, and
  - b. The other aspects of the issue aren't disputed.
- (3) For all other cases, treat the case as unagreed if the taxpayer is unwilling to make correction.
- (4) To grant advance approval, all the following conditions must be met:
  - a. The taxpayer indicates acceptance of initial tax liability (Sections 4941 through 4945).
  - b. Correction will be very difficult or costly, requiring the exercise of sound judgment on a broad scale.
  - c. The taxpayer should be able to complete the proposed correction within 90 days from the date of approval.
  - d. The taxpayer submits a written request for advance approval, attention of the Area Manager.
- (5) The written request must:
  - a. Fully describe the surrounding circumstances giving rise to the initial tax liability.

- b. Outline in detail the nature and method of the proposed correction.
  - c. Accept an initial tax liability for the act or failure to act in question.
  - d. Include the date by which the taxpayer will complete the correction.
- (6) When such a written request is received, suspend further action on the issue, and continue all other aspects of the examination. Send a copy of the request to the Area Manager (scanned and secured e-mail if possible). Consult with Area Counsel if complex correction situations arise from the written request. Schedule and hold a conference call with the Group and Area Managers.
- (7) If the Area Manager approves the request, prepare, and issue a draft correction approval letter. See Letter 5305, Private Foundation Correction Approval Letter. The letter must:
- a. Explain in detail the proposed corrective action.
  - b. Specify the due date for correction completion.
  - c. Require the taxpayer to notify the area manager upon completion.
  - d. Clarify that the taxpayer's reliance on the letter is conditioned on the taxpayer meeting the conditions specified for correction.
- Reminder:** Monitor the time remaining on the statute of limitations. Consider requesting a statute extension as needed.
- (8) If the Area Manager denies the request, prepare, and issue a draft correction rejection letter. See Letter 5306, Private Foundation Correction Rejection Letter. In the letter:
- a. Outline the taxpayer's proposal.
  - b. Explain why it doesn't constitute correction.
  - c. Clarify that other methods of correction are still available.
  - d. Suggest a correction action (or actions) that would be acceptable.
- (9) If the Area Manager accepts the request, keep the case in the group, and continue to work other issues on the case. When the Area Manager provides notification that the taxpayer corrected, secure proof. Secure the taxpayer's agreement to the first tier tax on Form 870-E. Collect the first tier tax or secure an installment agreement request (Form 9465, Installment Agreement Request).
- (10) If notification or proof isn't received by the due date for correction, contact the taxpayer to confirm correction. Ask the taxpayer to send proof right away (via express mail, or fax).
- (11) If proof of correction isn't promptly received after contacting the taxpayer, close the case as unagreed. See IRM 4.70.14, Resolving the Examination.

## H. All Chapter 42 Second tier Excise Taxes

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

Code Section	Liable Party	Tax Rate	Limit? (PPA 2006*)	
			Before	After
4941(b)(1)	Self-dealer	200%	None	None
4941(b)(2)	FM	50%	\$10,000 per act	\$20,000 per act
4942(b)	PF	100%	None	None
4943(b)	PF	200%	None	None
4944(b)(1)	PF	25%	None	None
4944(b)(2)	FM	5%	\$10,000 per act	\$20,000 per act
4945(b)(1)	PF	100%	None	None
4945(b)(2)	FM	50%	\$10,000 per act	\$20,000 per act
*The limit changes are effective for the first full tax years that begin after August 17, 2006.				

- (2) Second tier taxes are:

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

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

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

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

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

**Example:** M, a private foundation which uses the calendar year as its taxable year, has at the end of 1981, \$50,000 of undistributed income for 1981. As of January 1, 1983, \$40,000 is still undistributed. On August 15, 1983, a notice of deficiency with respect to the excise taxes imposed by Section 4942(a) and (b) is mailed to M under Section 6212(a) and the taxable period ends. Thus, under these facts, an initial excise tax of \$12,000 (30% of \$40,000) is imposed upon M. An additional excise tax of \$40,000 (100% of \$40,000) is imposed by Section 4942(b). Under Section 4961(a), however, if the undistributed income is reduced to zero during the correction period, this latter tax will not be assessed, and if assessed, it will be abated, and if collected, it will be credited or refunded as an overpayment.

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

## I. Termination Tax

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



- d. The foundation becomes a public charity. (See Section 507(b)(1)(B).)

**Note:** Transfer under Section 507(b)(2) of all a foundation's net assets to one or more other foundations doesn't, by itself, terminate private foundation status. The foundation must separately terminate, whether voluntarily (Sections 507(a)(1), 507(b)(1)(A), or 507(b)(1)(B)) or involuntarily (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 its net assets before providing notice of termination). The foundation follows the instructions to the Form 990-PF as to the method of notification.
- (4) Consider a Section 507(a)(2) involuntary termination when there have been multiple willful repeated acts committed under Chapter 42. Also consider Section 507(a)(2) if there has been one willful flagrant act committed triggering Chapter 42 treatment. If proposing involuntary termination, you can propose revocation at the same time.

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

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

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

The Termination Tax is the Smaller of:	
A) The aggregate tax benefit - the sum of:	B) The value of the net assets as of the date the foundation first committed

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))	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 Generation System NT (RGS NT) or Integrated Data Retrieval System (IDRS) command code INTST. (See Section 507(d)(1)(C))	

\*For purposes of this calculation, the charitable contribution deduction allowed a trust is deemed to have been limited to 20% of taxable income. See Section 507(d)(1)(B)(ii).

\*\* 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.

- (6) Aggregate tax benefit is used as the amount of the termination tax only if the foundation substantiates the amount by adequate records or other corroborating evidence. See Section 507(c)(1). As the IRS retains records for a limited period, it may not be feasible to compute the tax from the date of inception. Obtain what information is available via IDRS, return requests, and Online Statistics of Income EO Image Net (SEIN). Establish Audit Information Management System (AIMS) controls via the Reporting Compliance and Case

Management System (RCCMS) using source code 45 to retrieve the returns of the substantial contributors.

- (7) See IRM 4.70.14, Resolving the Examination, for guidance on converting the Form 990-PF to Forms 1120 or 1041. Use the RGS NT to determine the increase in income tax from the disallowance of charitable contributions deductions.
- (8) Propose the tax using Forms 4883 and 4621. Use Form 990-PF to assess the tax in lieu of Form 4720.
- (9) Imposition of the termination tax doesn't eliminate liability for the underlying Chapter 42 taxes that initiated the termination process. See Treas. Reg. 1.507-1(b)(2).
- (10) When you close the case as a termination, prepare Form 2363-A, Request for IDRS Input for BMF/EO Entity Change, to update the status code, indicating the effective date in YYYYMM format:
  - a. Status 23: 507(a)
  - b. Status 24: 507(b)(1)(A) (No termination tax applies)
  - c. Status 25: 507(b)(1)(B) (No termination tax applies)
- (11) Termination of private foundation status under Section 507 results in the foundation being treated as an organization created on the day after termination. See Section 509(c).

## **J. Revocation**

- (1) Propose to revoke exemption if the foundation ceases to be operated exclusively for exempt purposes but the circumstances don't warrant involuntary termination of private foundation status under Section 507(a)(2). A Section 501(c)(3) foundation must engage primarily in activities that accomplish Section 501(c)(3) purposes. If more than an insubstantial part of its activities doesn't 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 (See 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.
- (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 (Forms 4883 and 4621) with Letter 3614, 30-day letter package for Chapter 42 excise taxes. Form 870-E shows all tax deficiencies of the foundation.
- (5) In revocations of private foundations, the foundation becomes a taxable foundation and must file an income tax return as well as Form 990-PF. See Section 509(b) and Treas. Reg. 1.509(b)-1(b). Use status codes 18 (for trusts) and 19 (for corporations) in lieu of status code 22. Status codes 18 and 19 set the Form 990-PF and Form 1041 or Form 1120 filing requirements. Prepare Form 2363-A with status code change and indicate the effective date of revocation in YYYYMM format. Leave the Form 2363-A in the case file for processing following review.
- (6) All revocations are subject to Mandatory Review.

## K. Statute of Limitations

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

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

4941(a)(2)	FM	*4720	Form 1040 year in which transaction occurs.
4942(a)	PF	4720	Same year of Form 990-PF
4943(a)(1)	PF	4720	Same year of Form 990-PF
4944(a)(1)	PF	4720	Same year of Form 990-PF
4944(a)(2)	FM	*4720	Form 1040 year in which transaction occurs.
4945(a)(1)	PF	4720	Same year of Form 990-PF
4945(a)(2)	FM	*4720	Form 1040 year in which transaction occurs.
*Contact Area Counsel if considering asserting tax on indirect self-dealing against a disqualified person partner or other owner of the disqualified person entity (in addition to asserting tax on self-dealing against the entity).			

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

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

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

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

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

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

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

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

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

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

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

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

## **L. Applicable Penalties**

- (1) For a complete overview of the penalties that apply to private foundations, see IRM 20.1.8, Employee Plans and Exempt Organizations Miscellaneous Civil Penalties.
- (2) As the Form 990-PF is both an information return and an excise tax return for purposes of Section 4940, foundations are subject to several sets of penalties:
  - a. Section 6652(c) - daily delinquencies (Section 6652(c)(1)(A) - failure to file return or show correct information), public inspections (Section 6652(c)(1)(C) and (D)) and prohibited tax shelters (Section 6652(c)(3)).



- b. Section 6651(a), Section 6655, and Section 6662(c) - failure to file, failure to pay, estimated tax (Section 6655(g)(3)(B)), and accuracy-related due to negligence penalties. See IRM 20.1.2, Failure To File/Failure To Pay Penalties, IRM 20.1.3, Estimated Tax Penalties and IRM 20.1.5, Return Related Penalties.

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

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

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

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

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

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

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

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

- (1) Taxable private foundations are former tax-exempt private foundations whose exemptions were revoked. Unless terminated under Section 507, they remain private foundations, and under TE/GE jurisdiction. See Section 509(b) and Treas. Reg. 1.509(b)-1(b).
- (2) Taxable private foundations are required to file Form 990-PF in addition to either the Form 1120 or Form 1041.
- (3) Taxable foundations remain subject to Chapter 42 taxes.

- (4) A taxable foundation owes Section 4940 tax to the extent that this tax (plus unrelated business income tax, computed as if it were still exempt), exceeds its income tax liability. See Section 4940(b). The foundation isn't subject to the Form 990-T filing requirement, but may attach the Form 990-T, Exempt Organization Business Income Tax Return, to the Form 990-PF to show the computations.
- (5) When computing the Section 4940 tax:
  - a. Compute the 1% or 2% tax via Form 990-PF Part V.
  - b. Add the tax computed via Form 990-T.
  - c. Subtract the tax determined via Form 1120 or Form 1041.

**Note:** Taxable private foundations can't qualify as Section 4940(d)(2) exempt operating foundations.
- (6) Taxable foundations are subject to the penalty of Section 6710 for failure to make the required disclosures under Section 6113 of non-deductibility of contributions for the first five years after revocation. See IRM 20.1.8, Employee Plans and Exempt Organizations Miscellaneous Civil Penalties.
- (7) If you find acts/failures to act that give rise to Chapter 42 taxes, consider proposing involuntary termination under Section 507(a)(2).

## N. Abatement of Excise Taxes

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

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

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

- (3) The correction period begins on the date the event occurs and ends 90 days after the mailing date of a notice of deficiency in connection with the second tier tax imposed on that taxable event (See Section 4963 and Section 6212). That time is extended by:
- a. Any period in which a petition to the Tax Court for redetermination of the deficiency is pending. (See Section 6213(a).)
  - b. Any other period the IRS determines is reasonable and necessary to correct the taxable event.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## O. Pre-Examination Considerations

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

- c. Did the organization request advance approval of individual grant making under Section 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 haven't 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 audit in the following sequence:

Review Form 990-PF:	
<b>Verify the Statute of Limitations</b>	
1	Find the date stamped received.
2	Determine the date mailed, if possible.
3	Apply the rules of Section 7502 (timely mailing treated as timely filing).
<b>Analyze the first page, Letters A through J (in the top third of the page)</b>	
1	Note the accounting method.
2	Note whether this is an initial, amended, or final return.
3	Determine whether there has been a name or address change.
4	Check whether a foreign foundation and percentage of foreign support (for purposes of Section 4948(b)).
5	Check for unusual events: prospective exemption, 507(b)(1)(A) termination, 507(b)(1)(B) conversion.
6	Note the type of entity.
<b>Review Parts VII-A and VII-B, Statements Regarding Activities</b>	
1	Verify the presence of all required schedules. Note any missing documents.
2	Check for an FBAR, if indicated.



3	Determine the liability for Form 4720.
4	Note any private benefit disclosures.
<b>Review Part VIII, Information About Officers, Directors, Trustees, Foundation Managers, Highly Paid Employees, and Contractors</b>	
1	Match the amounts reported to the Forms W-2. (Use command code IRPTRR to retrieve the Forms W-2.)
2	Note the top paid individuals and contractors. Match to the list of founders, substantial contributors, and foundation managers reported in the determination application and in Part XV. (May be subject to Section 4941.)
<b>Review XVII, Information Regarding Transfers to and Transactions and Relationships With Noncharitable Exempt Organizations</b>	
1	Identify any large, unusual, or questionable items.
2	Verify the non-charitable entities exemptions on IDRS.
3	Print the INOLES/BMFOLO information for each non-charitable entity.
4	Use Online SEIN to obtain copies of the Forms 990 or 990-EZ for each entity.
5	Check EO Select Check for electronic postcard information.
6	See if there are any related parties on the board of each entity.
<b>Review Part XV, Supplementary Information</b>	
1	Identify any large, unusual, or questionable items.
2	Compare any entries to information from the determination application.
<b>Review Part IV, Capital Gains and Losses for Tax on Investment Income</b>	
1	Verify the math. Note any errors.
2	Identify any large, unusual, or questionable items.
3	Note the type of asset(s) for future reference in the interview and IDR.
<b>Review Part I, Analysis of Revenue and Expenses</b>	
1	Verify the math. Note any errors.
2	Identify any large, unusual, or questionable items.
<b>Review Part XVI-A, Analysis of Income-Producing Activities and Part XVI-B, Relationship of Activities to the Accomplishment of Exempt Purposes</b>	
1	Verify the math. Note any errors.

2	Identify any large, unusual, or questionable items.
3	Compare to Part I. Note any differences.
4	Compare to any filed Forms 990-T. Note any differences.
<b>Review Part II, Balance Sheets **</b>	
1	Verify the math. Note any errors.
2	Identify any large, unusual, or questionable items.
3	Check for any attached schedules. Note any missing schedules.
4	Compare any amounts on the attached schedules to Part II. Note any differences.
<p>**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.</p>	
<b>Review Part III, Analysis of Changes in Net Assets or Fund Balances</b>	
1	Verify the math. Note any errors.
2	Note any increases or decreases not included in Part I, Line 27a. Determine whether such amounts should be included in Part I.
<b>Review Part IX, Summary of Direct Charitable Activities, Summary of Program-Related Investments</b>	
1	Identify any large, unusual, or questionable items.
2	Compare the expenses reported to the amounts listed in Part I.
3	If applicable, compare the investment amounts to the amounts listed in Part II.
<b>Review Part X, Minimum Investment Return</b>	
1	Verify the math. Note any errors.
2	Note the existence of any acquisition indebtedness for Section 514 purposes.
<b>Review Part XI, Distributable Amount</b>	
1	Verify the math. Note any errors.
2	Note whether there was any income tax. Check the amount against Form 990-T (or Form 1120/Form 1041 if a taxable foundation).
3	Note any recoveries of qualifying distributions for inclusion in the IDR.
<b>Review Part XII, Qualifying Distributions</b>	

1	Verify the math. Note any errors.
2	For set asides, note whether claiming prior IRS approval or look for an attached schedule. If prior approval, or schedule is missing, note for inclusion in the IDR.
<b>Review Part XIII, Undistributed Income</b>	
1	Verify the math. Note any errors.
2	Note any excess distributions. Compare the amounts reported to the prior years' Forms 990-PF.
3	For entries indicating election required, check for the attached statement. If none present, include in the IDR a request of the election.
4	Verify that the foundation has not elected to treat a qualifying distribution as made out of corpus to "refresh" an expiring excess distribution "carryover."
<b>Review Part V, Qualification Under Section 4940(e) for Reduced Tax on Net Investment Income (for taxable years beginning on or before December 20, 2019)</b>	
1	Verify the math. Note any errors.
2	Compare the entries in Line 1 to the prior years' Forms 990-PF Parts X through XII. Note any differences.
<b>Review Part VI, Excise Tax Based on Investment Income</b>	
1	Verify the math. Note any errors.
2	Note the tax rate used. Verify whether the correct rate was used.
3	Note any additional taxes reported. Verify whether properly entered. (If tax-exempt, UBTI 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.)
<b>Review Part XIV, Private Operating Foundations</b>	
1	Verify the math.
2	Note which operating foundation status was claimed. (Section 4942(j)(3) vs. Section 4942(j)(5)). If Section 4942(j)(5), compare the charitable activities to the Code and regulation requirements. See Instructions to the Form 990-PF.
3	Note the letter date. Request a copy via the initial IDR.

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

- (7) Review any information in the case file from Classification. Prepare to start an administrative record if there are indicators of potential exemption issues. See IRM 4.70.14, Resolving the Examination.
- (8) Modify the initial interview/questionnaire to incorporate any items identified during the review of the application and tax returns. Additional questions to ask:
  - a. Please describe the relationship, if any, between the foundation manager(s), founder(s), and any substantial contributor(s). (If all the same person, don't ask.)
  - b. Please explain your understanding of the Chapter 42 provisions/prohibitions.
- (9) Incorporate the items noted from analyzing the application and the tax returns. When asking for financial information, you can ask for the supporting source documents, such as bank statements and cancelled checks, for up to five years back. For private operating foundations, Form 990-PF Part XIV supports the request of records for the three prior years.

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

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

- (10) Consider requesting these additional items in the IDR:
  - a. A list of all disqualified persons with respect to the foundation, including government officials with which the foundation had any interactions, and a brief explanation of why each is a disqualified person (for example "daughter of substantial contributor (Mr. X)").
  - b. A list of all business enterprises owned in whole or in part by the foundation and percentage of ownership for the foundation and disqualified persons. See Part XV of the Form 990-PF.
  - c. The list of all scholarship and grant recipients who were awarded a grant or received a payment.
  - d. Relationship information of the scholarship/grant recipients to the founder(s), substantial contributor(s), foundation manager(s) and any other disqualified persons.
  - e. Copies of the scholarship/grant criteria and any application forms.
  - f. Copies of any such applications and other grant request forms received.
  - g. Title documents to any foundation-owned real property.

- h. Compensation contracts for the foundation manager(s).
- i. Notes and other loan documents involving disqualified persons.
- j. Review of the general ledger and bank statements for transactions with disqualified persons.
- k. Leases, partnership agreements, and all contracts between the foundation and disqualified persons.
- l. Credit card statements of the foundation as well as credit card statements of the disqualified persons, if applicable.
- m. Travel expenses incurred by the foundation on behalf of disqualified persons.

## P. Field/Office Correspondence Exam Information

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

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

Financial Statement and Financial Record Analysis:	
1	Compute the average fair market value of the securities using the twelve monthly ending values.
2	Do the same for the bank statements.
3	Compare the amounts to Form 990-PF Part X Line 1.
4	Identify the program-related investments, if reported on Form 990-PF Part IX-B, and determine whether they qualify as such.
5	Determine if there is any overlap between program-related investments and non-charitable use investments.
6	Identify any assets purchased in the year(s) under examination.
7	Compare the asset purchase amounts to the amount reported in Part XII Line 2.
8	Determine any differences, verify whether any amounts are for non-charitable use.
9	Identify any amounts listed as set aside.
10	Verify that the set aside was appropriate.
11	Identify any acquisition indebtedness.

12	Determine whether Section 514 applies. If so, verify that a Form 990-T was filed and that it included the debt financed income.
13	Determine whether the acquisition indebtedness triggers Section 4941 as a loan with a disqualified person (or as a deemed sale or exchange with a disqualified person because the foundation received property subject to a mortgage or similar lien as described in Section 4941(d)(2)(A)).
14	Determine whether any of the asset purchases trigger Section 4941 as a sale with a disqualified person.
15	Review the other assets of the organization.
16	Look at the title documents. Review for any questionable elements involving disqualified persons.
17	Inquire and verify whether the assets are being used by any disqualified persons.
18	Review the cancelled checks and check registers. Request explanations for questionable expenditures.
19	Inspect any receipts provided for the questionable expenditures.
20	Identify all payments that are grants or scholarships to disqualified persons.
21	Determine whether the payments meet the exceptions to Section 4941 and Section 4945.
22	Compare the Forms W-2/1099 to the amounts reported on Form 990-PF Part VIII and to the amounts reported in the register.
23	Determine whether there are any missing or incorrectly reported Forms W-2/1099.

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

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

- (4) 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.
- (5) If amounts reported in Part I Column d aren't charitable expenditures, remove the amounts in the 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.

- (6) 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.
- (7) 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.
- (8) For any Chapter 42 taxes, prepare a report of examination for each liable party. Ensure there aren't 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.
- (9) 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.
- (10) See IRM 4.70.14, Resolving the Examination, for information on the necessary letters and forms to complete. However, before issuing a 30-day letter to a foundation manager proposing the second tier tax, you must first issue a Thorne letter. For help in drafting a Thorne letter, with your manager's authorization, contact Area Counsel. A sample Thorne letter can be found in other Technical Guides, such as those for Sections 4941 and 4945.
- (11) For egregious cases, consider involuntary termination and revocation. Discuss these possibilities with your group manager and Area Counsel before pursuing these actions. See IRM 4.70.14, Resolving the Examination, for information on preparing an administrative record.

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

- (1) Resolve the following types of related cases:
  - a. Employment tax cases such as worker reclassification, fringe benefit treatment, and unreported amounts.
  - b. Income tax cases (Forms 990-T for tax-exempt foundations, Forms 1120 or 1041 for taxable foundations).
  - c. Excise tax cases (gaming and/or Chapter 42 taxes).



- (2) Discuss with your group manager whether to close the related cases separately from the Form 990-PF.
- (3) Close Form 990-PF as a no change/no change with advisory if there is no modification to the Section 4940 tax, foundation status, or exempt status. See IRM 4.70.14, Resolving the Examination, for case file assembly and other common closing information.
- (4) For agreed cases involving employment, income, or gaming excise taxes:
  - a. Issue report of examination.  
**Note:** Remember 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. IRM 4.70.14, Resolving the Examination.
  - d. Prepare the appropriate closing letter. 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 requirements below:
  - a. If correction is acceptable, issue the acceptance letter. Letter 5305.
  - b. If correction is inadequate or unacceptable, issue the rejection letter. Letter 5306.

- c. If uncorrected, determine whether additional time is needed for correction.
  - d. Grant an extension of time with managerial approval for the correction to be made.
  - e. If uncorrected as of the end of the extension date, **close as unagreed**, even if the taxpayer previously signed an agreement to the first tier tax on Form 870-E.
- (7) For agreed cases involving revocation or foundation status modification:
- a. Secure Form 6018, Consent to Proposed Action.
  - b. Obtain a statute extension, if less than 270 days remaining on the statute of limitations.
  - c. Prepare a Form 3198-A, completing the Mandatory Review/Operations, Planning & Review section.
  - d. Close the case to your manager, who closes the case to Mandatory Review.
- (8) For unagreed cases, regardless of the type of tax or action (revocation, termination, foundation status modification):
- a. Issue a Thorne letter before issuing the 30-day letter if proposing second tier excise taxes on the foundation manager(s).
  - b. Obtain a full copy of the tax form under protest showing the date received, if not already in the file or on RCCMS. Use Online SEIN if obtaining a Form 990-PF or a filed Form 4720.
  - c. Issue a formal report of examination with the appropriate waiver/agreement form(s).
  - d. Ensure that there are 425 days remaining on the statute of limitations when closed from the group.
- Note:** All cases received in Appeals require 365 days remaining on the assessment statute of limitations.
- e. Prepare a Form 3198-A, completing the applicable sections.
  - f. Verify that a formal protest to Appeals is valid. If invalid, secure a valid protest.
  - g. Prepare and issue a full rebuttal to any protests.
  - h. Close the case to your manager as unagreed (with or without protest.)
- Note:** If applicable, consider offering a Fast Track Settlement before issuing the formal report of examination. Both agent and manager must approve a request to enter 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 does not know) that the statement of facts in the protest and any accompanying documents are true and correct. Organization officers or representatives may sign the protest. (Pub 892, How to Appeal an IRS Decision on Tax Exempt Status.)
- (12) For cases subject to Section 7428 declaratory judgment information, prepare an administrative record. IRM 4.70.14, Resolving the Examination.

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

- (1) This section provides for possible issue indicators and examination tips when reviewing a private foundation issue, particularly with respect to a foundation's failure to make distributions of its income.

### **A. Issue Indicators**

- (1) Undistributed income by the foundation but no Form 4720 filed.
- (2) Set-asides claimed as qualifying distributions under the suitability test in Form 990-PF, Part XII are not substantiated by proof of advance IRS approval.
- (3) Set-asides claimed as qualifying distributions under the cash distribution test in Form 990-PF, Part XII, are not substantiated by detailed return information.
- (4) Prior and subsequent year returns don't reconcile to amounts in Part XIII of the Form 990-PF to ensure undistributed amounts and excess contributions are properly carried forward.
- (5) Look to other Chapter 42 Code sections as well. Chapter 42 permits the assessment of excise taxes under different statutes for the same transaction.

### **B. Examination Tips**

- (1) Review Parts X, XI, XII, and XIII of the Form 990-PF for accuracy.
- (2) Examine supporting documents to confirm validity of qualifying distributions.
- (3) Reconcile amounts in Part XIII of the Form 990-PF to ensure undistributed amounts and excess contributions are properly carried forward for prior and subsequent year returns.
- (4) Qualifying distributions also include that portion of reasonable and necessary expenses, direct and indirect, that a foundation incurs in implementing exempt purposes.
  - a. Direct expenses are those which can be specifically identified with a particular activity and include compensation and travel expenses of employees and officers; the cost of materials and supplies; and fees paid to outside firms and individuals.
  - b. Indirect (overhead) expenses aren't specifically identifiable with a particular activity. They relate to the direct costs incurred in conducting the activity. Examples of indirect expenses are occupying expenses (except depreciation), supervisory and clerical compensation, repair, rental and maintenance of equipment, expenses of other departments, such as accounting, personnel, and payroll that serve the department or function that incurs the direct expenses of conducting an exempt activity.

- (5) Administrative expenses are allocated from total foundation expenses stated in Form 990-PF, Part I, Column (a), Lines 13-24, and listed on the same lines in Column (d).
- a. Although there aren't current limits on the amount of administrative expenses that can be treated as qualifying distributions, expenses must be reasonable and necessary for the accomplishment of the private foundation's exempt purposes. If the payment isn't reasonable and necessary, it'll be a taxable expenditure under Section 4945.
  - b. Even reasonable and necessary expenses may be improperly allocated between Revenue and Expenses (Part I, (a)), Net Investment Income (Part I, (b)), and Disbursements for Charitable Purposes (Part I, (d)). Allocations may be used to improperly minimize net investment income or maximize qualifying distributions.
- (6) Confirm that set-asides claimed as qualifying distributions under the suitability test in Form 990-PF, Part XII are substantiated by proof of advance IRS approval.
- (7) Confirm that set-asides claimed as qualifying distributions under the cash distribution test in Form 990-PF, Part XII are substantiated by detailed return information.
- (8) For private operating foundations, examine Form 990-PF, Part XIV computations to ensure the organization meets private operating foundation status. If a private foundation isn't an operating foundation, then consider whether it has distributed sufficient amounts in qualifying distributions. If not, then assert the Section 4942 excise tax for failure to distribute income.
- (9) Part XV of Form 990-PF should list the name, address, and foundation status of all grant recipients. Review the grantees for any that may have foreign addresses. The tax-exempt status of an organization can be verified by using EO Select Check.
- (10) If the foreign organization doesn't have a determination letter, then ask the private foundation if it has an equivalency determination for the foreign organization. If provided, verify that the equivalency determination was prepared by a qualified tax practitioner, that it contains current information, and that it appears reasonable.
- (11) If the private foundation was required to exercise expenditure responsibility, Treas. Reg. 53.4945-5(d) requires the private foundation to include certain reports with the Form 990-PF. Form(s) 990-PF for the tax period(s) under examination should be reviewed for compliance.
- (12) If a private foundation fails to establish that grants or amounts set aside are qualifying distributions, consider whether it has distributed sufficient amounts as qualifying distributions. If not, examine whether Section 4942 excise taxes should be imposed for failure to distribute income.

## VI. Examples Worksheets / Exhibits

- (1) This section provides worksheets as well as exhibits focusing on practical applications when calculating undistributed income and asserting Section 4942 excise taxes for a private foundation's failure to distribute its income. This section also provides an example of a statute extension (modified Form 872) extending the time for assessment of Section 4942 tax.

### A. Section 4942: First tier Example

- (1) Private Foundation Lima is under examination for three years: 200912, 201012, 201112. Agent Garcia is conducting the examination in March of 2013. PF Lima reports on Form 990-PF Part XIII the following information:

Description	Amount Reported
2009 Distributable amount	85,071
2010 Distributable amount	77,553
2011 Distributable amount	72,260
2009 Qualifying distributions	320,000
2010 Qualifying distributions	270,000
2011 Qualifying distributions	70,000
2004 Excess distributions	0
2005 Excess distributions	0
2006 Excess distributions	0
2007 Excess distributions	10,469
2008 Excess distributions	0
2009 Excess distributions	234,929
2010 Excess distributions	192,467

- (2) Agent Garcia determines that for 2009, PF Lima made only \$4,525 in qualifying distributions, for 2010 only \$2,425 in qualifying distributions, and for 201112 only \$3,750 in qualifying distributions. No qualifying distributions were made in 2012. Agent Garcia finds no issues with Parts X or XI of the Form 990-PF. The following tables shows how to redo Part XIII. (When completing Part XIII, use the PDF version of the Form 990-PF to see the fields to complete. Much of the page is grayed out, limiting the possible entries.)

2009 Form 990-PF Part XIII			
Line #	Title (abbreviated/paraphrased)	Amount as Reported	Amount as Corrected
1	Distributable amount for 2009	85,071	85,071
2a	2008 undistributed income	0	0
2b	Prior years undistributed income	0	0
3a	Excess distributions carryover from 2004	0	0
3b	Excess distributions carryover from 2005	0	0
3c	Excess distributions carryover from 2006	0	0
3d	Excess distributions carryover from 2007	10,469	10,469
3e	Excess distributions carryover from 2008	0	0
3f	Total excess distributions carryover to 2009	10,469	10,469
4	2009 qualifying distributions	320,000	4,525
4a	Applied to 2008	0	0
4b	Applied to prior years	0	0
4c	Treated as distributions out of corpus (election)	0	0
4d	Applied to 2009 distributable amount	85,071	4,525
4e	Remaining amount out of corpus	234,929	0
5	Excess distributions carryover applied to 2009	0	10,469
6a	Corpus	245,398	0
6b	Prior years undistributed income	0	0
6c	Stat notice/previously taxed undistributed income	0	0
6d	Taxable amount	0	0
6e	Undistributed income for 2008 (taxable)	0	0
6f	Undistributed income for 2009 (must be distributed in 2010)	0	70,077
7	170(b)(1)(E)/4942(g)(3) corpus distributions	0	0
8	2004 excess distributions carryover not applied	0	0
9	Excess distributions carryover to 2010	245,398	0
10a	Excess distributions from 2005	0	0



10b	Excess distributions from 2006	0	0
10c	Excess distributions from 2007	10,469	0
10d	Excess distributions from 2008	0	0
10e	Excess distributions from 2009	234,929	0

2010 Form 990-PF Part XIII			
Line #	Title (abbreviated/paraphrased)	Amount as Reported	Amount as Corrected
1	Distributable amount for 2010	77,553	77,553
2a	2009 undistributed income	0	70,077
2b	Prior years undistributed income	0	0
3a	Excess distributions carryover from 2005	0	0
3b	Excess distributions carryover from 2006	0	0
3c	Excess distributions carryover from 2007	10,469	0
3d	Excess distributions carryover from 2008	0	0
3e	Excess distributions carryover from 2009	234,929	0
3f	Total excess distributions carryover to 2010	245,398	0
4	2010 qualifying distributions	270,000	2,425
4a	Applied to 2009	0	2,425
4b	Applied to prior years	0	0
4c	Treated as distributions out of corpus (election)	0	0
4d	Applied to 2010 distributable amount	77,553	0
4e	Remaining amount out of corpus	192,447	0
5	Excess distributions carryover applied to 2010	0	0
6a	Corpus	437,845	0
6b	Prior years undistributed income	0	0
6c	Stat notice/previously taxed undistributed income	0	0
6d	Taxable amount	0	0
6e	Undistributed income for 2009 (taxable)	0	67,652

6f	Undistributed income for 2010 (must be distributed in 2011)	0	77,553
7	170(b)(1)(E)/4942(g)(3) corpus distributions	0	0
8	2004 excess distributions carryover not applied	0	0
9	Excess distributions carryover to 2011	437,845	0
10a	Excess distributions from 2006	0	0
10b	Excess distributions from 2007	10,469	0
10c	Excess distributions from 2008	0	0
10d	Excess distributions from 2009	234,929	0
10e	Excess distributions from 2010	192,447	0

2011 Form 990-PF Part XIII			
Line #	Title (abbreviated/paraphrased)	Amount as Reported	Amount as Corrected
1	Distributable amount for 2011	72,260	72,260
2a	2010 undistributed income	0	77,553
2b	Prior years undistributed income	0	67,652
3a	Excess distributions carryover from 2006	0	0
3b	Excess distributions carryover from 2007	10,469	0
3c	Excess distributions carryover from 2008	0	0
3d	Excess distributions carryover from 2009	234,929	0
3e	Excess distributions carryover from 2010	192,447	0
3f	Total excess distributions carryover to 2011	437,845	0
4	2011 qualifying distributions	70,000	3,750
4a	Applied to 2010	0	3,750
4b	Applied to prior years	0	0
4c	Treated as distributions out of corpus (election)	0	0
4d	Applied to 2009 distributable amount	70,000	0
4e	Remaining amount out of corpus	0	0
5	Excess distributions carryover applied to 2011	2,260	0
6a	Corpus	435,585	0
6b	Prior years undistributed income	0	67,652

6c	Stat notice/previously taxed undistributed income	0	0
6d	Taxable amount	0	67,652
6e	Undistributed income for 2010 (taxable)	0	73,803
6f	Undistributed income for 2011 (must be distributed in 2012)	0	72,260
7	170(b)(1)(E)/4942(g)(3) corpus distributions	0	0
8	2006 excess distributions carryover not applied	0	0
9	Excess distributions carryover to 2012	435,585	0
10a	Excess distributions from 2007	8,209	0
10b	Excess distributions from 2008	0	0
10c	Excess distributions from 2009	234,929	0
10d	Excess distributions from 2010	192,447	0
10e	Excess distributions from 2011	0	0

- (3) Before Agent Garcia prepares a report, PF Lima makes full correction by making qualifying distributions of \$213,715 (\$67,652 + \$73,803 + \$72,260) to an independent public charity described under Section 170(b)(1)(A)(vi). Agent Garcia determines that abatement under Section 4962 doesn't apply in this case. Agent Garcia would issue the following initial report when soliciting correction, or as part of the formal report of examination after the foundation has made full correction.

**Exempt Organizations Excise Tax Audit Changes**

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

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

Name of Exempt Organization (*if different from*  
Taxpayer)

		Taxable Years Ended		
		12/31/2010	12/31/2011	12/31/2012
Internal Revenue Code Section for Proposed Adjustment		4942(a)	4942(a)	4942(a)
1. Adjustments	Failure to distribute 2009 income	67,652.00	67,652.00	67,652.00
	Failure to distribute 2010 income		73,803.00	73,803.00
	Failure to distribute 2011 income			72,260.00
2.	Total Adjustments	67,652.00	141,455.00	213,715.00
3.	Amount reported on return or as Previously adjusted	0	0	0
4.	Total amount as corrected	67,652.00	141,455.00	213,715.00
5.	Applicable tax rate %	30%	30%	30%
6.	Initial tax liability as corrected (line 4 x Line 5)*	20,295.60	42,436.50	64,114.50
7.	Initial tax liability reported	0	0	0
8.	Increase (or decrease) in tax	20,295.60	42,436.50	64,114.50
9.	Additional tax (minimum)			
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]	
4. Name and Address of Taxpayer  Private Foundation Lima [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	7. Tax Period(s) Ended		8. Private Foundation's or other Exempt Organization's Employer Identification Number (If different from Item 6)
	12/31/2011		
9. Tax Period(s) Ended			
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]	
<b>14a. Summary of Proposed Adjustments</b>			
Internal Revenue Code Section (1)	Period Covered by Examination (2)	Amount of Tax (3)	Additional Tax (4)
4942(a)	12/31/2009	20,295.60*	
4942(a)	12/31/2010	42,436.50*	
4942(a)	12/31/2011	64,114.50*	
15. Remarks *The amount of tax is due for the years following those examined due to the foundation having distributable income in the years examined that was not distributed. See Form 4883, which shows the undistributed income as being taxed in 2010, 2011 and 2012, respectively. See attached Explanation of Items.			
16. Attachments			

## **B. Section 4942: Second tier Tax Example**

- (1) Using the example in section VI.A., assume no correction was made. See the following Form 4883 for how to propose the second tier tax. Note that under Section 4942(b), the second tier tax is on the remaining undistributed amount at the end of the taxable period. This tax is imposed once for the undistributed amount. Report the second tier tax on the last year in which an adjustment has been made showing initial tier tax liability.
- (2) Without correction, a formal report of examination that includes the second tier tax would be issued with a 30-day letter (Letter 3614).

**Exempt Organizations Excise Tax Audit Changes**

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

Name of Taxpayer Private Foundation Lima		Employer ID No. [Insert EIN]	Schedule or Exhibit 1	
Name of Exempt Organization ( <i>if different from</i> Taxpayer) Private Foundation Lima				
		<b>Taxable Years Ended</b>		
		12/31/2010	12/31/2011	12/31/2012
Internal Revenue Code Section for Proposed Adjustment		4942(a)	4942(a)	4942(a)
1. Adjustments	Failure to distribute 2009	67,652.00	67,652.00	67,652.00
	Failure to distribute 2010		73,803.00	73,803.00
	Failure to distribute 2011			72,260.00
2.	Total Adjustments	67,652.00	141,455.00	213,715.00
3.	Amount reported on return or as previously adjusted	0	0	0
4.	Total amount as corrected	67,652.00	141,455.00	213,715.00
5.	Applicable tax rate %	30%	30%	30%
6.	Initial tax liability as corrected (line 4 x Line 5)*	20,295.60	42,436.50	64,114.50
7.	Initial tax liability reported	0	0	0
8.	Increase (or decrease) in tax	20,295.60	42,436.50	64,114.50
9.	Additional tax (minimum) at 100% (4942(b))			213,715.00
10.	Penalties (Code section)			
Explanation of Adjustments				
See attached Explanation of Items				
Form 4883 (Rev. 1-2004)		Catalog Number 42083F	Department of the Treasury <b>Internal Revenue Service</b> 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]		
4. Name and Address of Taxpayer  Private Foundation Lima [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	
	12/31/2011				
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)
4942(a)	12/31/2009	20,295.60*			
4942(a)	12/31/2010	42,436.50*			
4942(a)	12/31/2011	64,114.50*	213,715.00		
15. Remarks *The amount of tax is due for the years following those examined due to undistributed amounts of income arising in the years examined. See Form 4883, which shows the undistributed income for the examined periods as being taxed in 2010, 2011 and 2012, respectively. See attached Explanation of Items					
16. Attachments					

## C. Statute Extension Example

- (1) Extensions for Sections 4941 through 4945 taxes require modification of the Form 872. The example shown is not an official Form, but a modified Form 872. The modified Form replaces the phrase “on any returns made by or for the above taxpayer(s) for the period(s) ended with” with “from the above taxpayer(s) for the years that are fully or partially within the taxable period(s) that began”. As a general rule for extending statutes for assessment of Chapter 42 excise taxes, use the date of the first act or failure to act (or taxable event) for the start of the taxable period.

**Note:** The statute must be protected for an act or acts in each separate year (including continuing acts), preferably by separate consents noting the date(s) of the act and year.

- (2) Consult with Area Counsel when preparing Form 872 for excise taxes, particularly in situations where a private foundation may be liable for several different types of excise taxes arising in a particular year or years.
- (3) The example shown can be used when extending the statute of limitations for assessing excise taxes under Section 4942.



## **D. Section 4942 Taxes on Failure to Distribute Income Lead Sheet**

**Taxpayer Name:**

**Examiner:**

**TIN:**

**Date:**

**Tax Form:**

**Tax Year:**

IRC 4942 Taxes on Failure to Distribute Income Lead Sheet				
Tax Period	Per Return	Per Exam	Adjustment	Reference
<b>Conclusion:</b> <i>(Reflects the final determination on the issue.)</i>				
<p><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></p>				
<b>Audit Steps:</b> <i>(Document audit steps taken or to be taken.)</i>				<b>Workpaper Reference</b>
1. Determine the type of private foundation. Operating foundations are not subject to the tax imposed on the undistributed income of a private foundation under IRC 4942(a) and 4942(b). Determine if the private foundation is liable for filing Form 4720, and review if filed.				
2. Determine if the foundation is in a start-up period; Treas. Reg. 53.4942(a)-3(b)(4).				
3. Identify the foundation's investment assets and determine which assets are exempt function assets and/or future interests or expectancies. IRC 4942(j)(4)				
4. Determine the foundation's debt and cash reserves.				
5. Calculate the foundation's minimum investment return pursuant to IRC 4942(e).				
6. Calculate the foundation's distributable amount pursuant to Treas. Reg. 53.4942(a)-2(b).				
7. Verify that the distributions are qualifying distributions pursuant to IRC 4942(g).				
8. Review if any amounts have been approved set-asides; Treas. Reg. 53.4942(a)-3(b)(1).				
9. Calculate the undistributed income of the taxable year.				
10. Determine if initial 30% excise tax should be imposed; Treas. Reg. 53.4942(a)-1(a).				
11. Determine, if after imposition of the initial excise tax on undistributed income of a specific taxable year, whether remedial distributions have been made. Additional excise taxes (100% of undistributed income) are imposed on any undistributed income of the pertinent taxable year remaining at the close of the correction period.				

**Taxpayer Name:**

**Examiner:**

**TIN:**

**Date:**

**Tax Form:**

**Tax Year:**

<b>Facts:</b> <i>(Document the relevant facts.)</i>
<b>Law:</b> <i>(Tax Law, Regulations, court cases, and other authorities.)</i>
IRC Section: 4942, 53.4942(a)-1, 53.4942(a)-3
Specific citations:
<b>Taxpayer Position:</b> <i>(If applicable)</i>