

Foundation was originally formed as a charitable trust, which was recognized as a section 501(c)(3) private foundation prior to Year 1. In Year 2, the trust reorganized by forming a corporation in the same state. In Year 3, the corporation sought and received tax-exempt recognition under section 501(c)(3).² In Year 4, the trust transferred all assets to the corporation. Foundation represents that the same person or persons effectively controlled the trust and the corporation during this transfer.

In Year 1, the trust purchased real property for purposes of leasing the land to X, a public charity. The trust and X subsequently entered a lease that year (the Lease). Foundation represents that its support of X is consistent with Foundation's charitable purposes and that X is not controlled by Foundation or its disqualified persons. Under the terms of the Lease, the annual rent is a nominal amount. X must pay real estate taxes (if any), insurance, and other operating expenses. X also has the right of first refusal to purchase the land at a significant discount from Foundation's purchase price, or upon expiration or early termination of the Lease at the same discounted price.

In Year 3, the trust transferred the land subject to the Lease to Y, a wholly owned single member LLC. Y assumed the trust's obligations under the Lease. Foundation represents that Y has been treated as a disregarded entity of the trust and the corporation since Year 3.

In Year 5, X and Y amended the Lease to expand the land subject to the Lease. The Lease as amended remains in effect.

Foundation represents that the Lease, and the additional property added to the Lease in Year 5, were properly treatable as qualifying distributions and such property from then on should have been treated as exempt-use property (disregarded in determining minimum investment return) for purposes of section 4942. Foundation failed to treat the Lease and added property as qualifying distributions and exempt-use property on its Form 990-PF returns for Years 1-5 but now wishes to correct the effects of these errors by re-computing its minimum investment return and qualifying distribution carryforwards beginning in Year 1 for purposes of its Year 6 and Year 7 taxable years (for which returns had not yet been filed as of the filing date of the ruling request).

RULING REQUESTED

- 1) Foundation may take into account understatement of its qualifying distributions and overstatement of its minimum investment return in prior years relating to its property leased to X in computing its minimum investment return and qualifying distribution carryforwards for its Year 6 and Year 7 tax years.

² In compliance with Rev. Proc. 2018-15, Sec. 7.02, which requires a charitable trust that reorganizes as a corporation to file a new Form 1023 to be recognized as exempt under section 501(c)(3).

LAW AND ANALYSIS

Section 4942(a) generally imposes an excise tax on the undistributed income of a private foundation that has not been distributed as qualifying distributions by a certain date.

Section 4942(c) provides that “undistributed income” for a taxable year (or “tax year”) is the amount by which the distributable amount exceeds the qualifying distributions made out of such distributable amount.

Section 4942(d) defines “distributable amount” for a taxable year as the sum of the minimum investment return plus the amounts described in section 4942(f)(2)(C), reduced by the sum of the taxes imposed on the private foundation for the taxable year under subtitle A and section 4940.

Section 4942(e)(1) defines the minimum investment return as five percent of the excess of (A) the aggregate of fair market value of all assets other than those which are used (or held for use) directly in carrying out the foundation’s exempt purposes, over (B) the acquisition indebtedness with respect to such assets.

Section 4942(g)(1) defines the term “qualifying distribution” for purposes of section 4942 generally as any amount paid to accomplish one or more purposes described in section 170(c)(2)(B) (hereafter “exempt purposes”), or any amount paid to acquire an asset used (or held for use) directly in carrying out one or more exempt purposes.

Section 4942(g)(1) further provides that a “qualifying distribution” may not be made to an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in section 4946) with respect to the foundation, except as provided in section 4942(g)(3).

Section 4942(h)(1) provides generally that any qualifying distribution made during a taxable year shall be treated as made—

- (A) first out of the undistributed income of the immediately preceding taxable year (if the private foundation was subject to the tax imposed by this section for such preceding taxable 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.

For purposes of this paragraph, distributions shall be taken into account in the order of time in which made.

Section 4942(h)(2) provides that a private foundation may elect to treat a portion of a qualifying distribution that is not treated as made out of the undistributed income of the

immediately preceding taxable year as made out of the undistributed income of a designated prior taxable year or out of corpus.

Section 4942(i)(1) provides that if, for the taxable years in the adjustment period for which an organization is a private foundation—

(A) the aggregate qualifying distributions treated (under section 4942(h)) as made out of the undistributed income for such taxable year or as made out of corpus (except to the extent section 4942(g)(3)³ with respect to the recipient private foundation or section 170(b)(1)(F)(ii)⁴ applies) during such taxable years, exceed

(B) the distributable amounts for such taxable years (determined without regard to section 4942(i)),

then, for purposes of this section (other than section 4942(h)), the distributable amount for the taxable year shall be reduced by an amount equal to such excess.

Section 4942(i)(2) generally defines the adjustment period as the five immediately preceding taxable years.

Section 6501(a) generally provides that the amount of any tax imposed by Title 26 shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed), and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

Treas. Reg. § 1.507-3(a)(9)(i) provides that if a private foundation transfers all of its net assets to a private foundation effectively controlled, directly or indirectly, by the same person or persons which effectively controlled the transferor private foundation, such a transferee private foundation shall be treated as if it were the transferor for purposes of chapter 42 (section 4940 et seq.) and part II of subchapter F of chapter 1 of the Code (sections 507 through 509).

Treas. Reg. § 53.4942(a)-2(c)(2)(v) excludes from the assets taken into account in determining the minimum investment return any asset used (or held for use) directly in carrying out the foundation's exempt purpose (exempt-use assets).

³ Section 4942(g)(1)(A) and (3) and Treas. Reg. § 53.4942(a)-3(c) allow a private foundation to receive credit for a qualifying distribution to a section 501(c)(3) (non-operating) private foundation or to a controlled section 501(c)(3) organization if the distributee makes a timely re-distribution treated as made out of corpus and the private foundation obtains sufficient evidence from the distributee.

⁴ Section 170(b)(1)(F)(ii) (formerly 170(b)(1)(E)(ii) and 170(b)(1)(D)(ii)) allows a contributor an enhanced charitable contribution to a private foundation that makes qualifying distributions of 100% of its contributions for the foundation's taxable year as out of corpus (after the application of section 4942(g)(3)) by the 15th day of the third month after the end of the year, and with respect to which the contributor obtains sufficient evidence from the foundation. A foundation may use carryovers of excess qualifying distributions from the prior 5 years to satisfy its current-year distribution requirement under section 170(b)(1)(F)(ii)—see Treas. Reg. § 53.4942(a)-3(c)(2)(iv).

Treas. Reg. § 53.4942(a)-2(c)(3)(i) provides that 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 exempt purpose or the foundation establishes that its immediate use for such exempt purpose is not practical and that definite plans exist to commence such use within a reasonable period of time. Assets held for the production of income or for investment are not used (or held for use) directly in carrying out the foundation's exempt purpose.

Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(f) provides as an example of an exempt-use asset any property leased by a foundation in carrying out its exempt purpose at no cost (or at a nominal rent) to the lessee or for a program-related purpose

Treas. Reg. § 53.4942(a)-3(a)(1) provides that the amount of a qualifying distribution of property is the fair market value of such property as of the date such qualifying distribution is made.

Treas. Reg. § 53.4942(a)-3(a)(2)(ii) provides that the term "qualifying distribution" includes any amount paid to acquire an asset used (or held for use) directly in carrying out exempt purposes.

Treas. Reg. § 53.4942(a)-3(a)(5) provides that if an asset not used (or held for use) directly in carrying out exempt purposes is subsequently converted to such a use, the foundation may treat such conversion as a qualifying distribution, valued as of the date of conversion.

Treas. Reg. § 53.4942(a)-3(c)(2)(iv) provides that in order to satisfy distribution requirements under section [170(b)(1)(F)(ii)] or paragraph (c) (relating to section 4942(g)(3)), a donee organization may elect to treat as a current distribution out of corpus any amount distributed in a prior taxable year which was treated as a distribution out of corpus under paragraph (d)(1)(iii) of this section provided that (a) such amount has not been availed of for any other purpose, such as a carryover under paragraph (e) of this section or a redistribution under paragraph (c) for a prior year, (b) such corpus distribution occurred within the preceding 5 years, and (c) such amount is not later availed of for any other purpose.

Treas. Reg. § 53.4942(a)-3(d) provides that a qualifying distribution made during a taxable year is treated as made:

- (i) First, out of the undistributed income (if any) of the immediately preceding taxable year,
- (ii) Second, out of the undistributed income for the taxable year (unless election is made in accordance with Treas. Reg. § 53.4942(a)-3(d)(2) to treat the distribution as made out of corpus or out of undistributed income in earlier taxable years), and
- (iii) Third, out of corpus.

Treas. Reg. § 53.4942(a)-3(e)(1) provides generally that if a private foundation has an excess of qualifying distributions (as determined under paragraph (e)(2)), such excess may be used to reduce distributable amounts in any taxable year of the adjustment period (as defined in paragraph (e)(3)). The distributable amount for a taxable year in the adjustment period shall be reduced to the extent of the lesser of (i) the excess of qualifying distributions made in prior taxable years to which such adjustment period applies or (ii) 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). If during any taxable year of the adjustment period there is created another excess of qualifying distributions, such excess shall not be taken into account until any earlier excess of qualifying distributions has been completely applied against distributable amounts during its adjustment period.

Treas. Reg. § 53.4942(a)-3(e)(2) provides that an excess of qualifying distributions is created for any taxable year if:

- (i) The total qualifying distributions treated (under paragraph (d)) as made out of the undistributed income for such taxable year or as made out of corpus with respect to such taxable year (other than amounts distributed by an organization in satisfaction of section [170(b)(1)(F)(ii)] or paragraph (c) of this section, or applied to a prior taxable year by operation of the elections contained in paragraphs (c)(2)(iv) and (d)(2) of this section), exceeds
- (ii) The distributable amount for such taxable year (determined without regard to paragraph (e)).

Treas. Reg. § 53.4942(a)-3(e)(3) defines the adjustment period as the 5 taxable years immediately following the taxable year in which the excess of qualifying distributions is created. Thus, an excess for any 1 taxable year cannot be carried over beyond the succeeding 5 taxable years.

Treas. Reg. § 301.7701-3(a) provides that an eligible entity with a single owner can elect to be disregarded as an entity separate from its owner for federal tax purposes generally. See also Ann. 99-102, 1999-2 C.B. 545.

Comm'r v. Disston, 325 U.S. 442 (1945), held that the statute of limitations does not purport to preclude an examination into events of prior years for the purpose of correctly determining gift tax liability for years which are still open.

Arrowsmith v. Comm'r, 344 US 6, 8-9 (1952), held that the principle that each taxable year is a separate unit for tax accounting purposes was not breached by considering several liquidation transaction events during 1937–1944 in order properly to classify the nature of a 1944 loss for tax purposes.

State Farming Co. v. Comm'r, 40 T.C. 774 (1963), held that the Service could disallow taxpayer's net operating loss carryovers even though the disallowance was based on a recalculation of the taxpayer's taxable income in closed years.

Unser v. Comm'r, 59 T.C. 528 (1973), held that for purposes of determining the correct amount of taxable income in the current year, the taxpayer must rely on correct taxable income amounts in prior years, even if those prior years were closed by reason of the statute of limitations.

In *H. Fort Flowers Foundation, Inc. v. Comm'r*, 72 T.C. 399 (1979), the Tax Court rejected the taxpayer's classification of a transaction that occurred in a closed year, thereby allowing the imposition of section 4942 tax in open years.

H.R. Rep. 413 (Pt. 1), 91st Cong., 1st Sess. 26 (Aug. 2, 1969), and S. Rep. 552, 91st Cong., 1st Sess. 36 (Nov. 21, 1969), provide, "[a] further exception is provided where a private foundation spends more than the minimum required payout in a given year. Such excess expenditures may be applied against required payouts in the next 5 years."

Rev. Rul. 69-543, 1969-2 C.B. 1, holds that the Service may assess and collect deficiencies owed in open tax years relating to an investment tax credit that was improperly claimed in a closed tax year and subsequently carried forward in part to open tax years.

Rev. Rul. 74-61, 1974-1 C.B. 239, involving repealed income averaging provisions, held that in determining average base period income for income averaging purposes, taxable income for a base period year barred by the statute of limitations must be adjusted, where necessary, to arrive at the correct taxable income for such year.

Rev. Rul. 78-387, 1978-2 C.B. 271, holds that when a private foundation has a carryover of excess qualifying distributions as described in section 4942(i) and transfers all its assets to another private foundation that is controlled by the same person or persons, the transferee foundation may reduce its distributable amount in accordance with the carryover.

Rev. Rul. 79-375, 1979-2 C.B. 389, holds that a private foundation that has made a qualifying distribution equal to the purchase price of an asset and donates the asset to a publicly supported charity will be allowed a second qualifying distribution only to the extent that the fair market value of the asset on the date of contribution exceeds the amount of the first qualifying distribution.

Rev. Rul. 81-88, 1981-1 C.B. 585, holds in part that a taxpayer may apply a net operating loss carryforward to an open year for purposes of reducing its taxable income, even though the taxpayer failed to claim the deduction in a closed year that would have created the carryforward.

Rev. Rul. 82-49, 1982-1 C.B. 5, holds that a taxpayer is entitled to carry over into an open year the unused portion of an investment tax credit (calculated as though the credit had been claimed), even if the taxpayer failed to claim the credit on an income tax return in a closed tax year, or in a timely claim for refund for the year property was placed in service.

Foundation represents that the Lease of property to X furthers Foundation's charitable purposes, that the purchase or Lease in Year 1 and the addition to the Lease in Year 5 were qualifying distributions in accordance with Treas. Reg. § 53.4942(a)-3(a)(2)(ii),⁵, and that the leased property constitutes an exempt-use asset for purposes of Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(f), excludable from Foundation's minimum investment return calculations.

Further, Foundation represents that the same person or persons effectively controlled the trust and the corporation during the transfer of assets in Year 4. Therefore, the corporation may be treated as if it were the trust for purposes of section 4942 under Treas. Reg. § 1.507-3(a)(9)(i) (and therefore the transfer itself cannot be treated as a qualifying distribution but is disregarded for section 4942 purposes). Consistent with Rev. Rul. 78-387, the corporation may apply carryforwards (referred to in the section 4942 regulations as carryovers) in accordance with any excess qualifying distributions made by the trust. In addition, Y as a disregarded entity is treated as part of Foundation, including for purposes of section 4942.

Foundation seeks to reduce its distributable amount in tax years for which returns were not yet filed when its ruling request was filed (Year 6 and Year 7) by carrying forward excess qualifying distributions relating to the Lease of property⁶ despite erroneously failing to treat the purchase or Lease or addition to the Lease as qualifying distributions and failing to treat the leased property as exempt-use property (properly disregarded in determining minimum investment return) in its section 4942 calculations in prior years. Year 1 would be a closed year under the general 3-year limitations period of section 6501(a).

Neither section 4942 nor the regulations thereunder speak directly to this issue. However, the statutory design and legislative history of section 4942 indicate that Congress meant to relieve private foundations from the minimum charitable distribution requirements to the extent that, during the preceding five years, they made excess qualifying distributions.

In other areas of tax law (including analogous situations involving carryovers), the Service and courts have taken the position that adjustments may be made to closed tax years for purposes of determining the correct taxable income in an open year. Most of

⁵ Consistent with Rev. Rul. 79-375, Foundation is generally limited to only one qualifying distribution for a purchase and subsequent charitable lease of property.

⁶ Excess qualifying distributions in Year 1 could not be carried forward beyond Year 6 given the maximum 5-year period for carryovers under Treas. Reg. § 53.4942(a)-3(e)(3).

the relevant authorities appear to hold in favor of the IRS in disputes with taxpayers over tax assessments in open years. See, e.g., *Comm'r v. Disston*, 325 U.S. 442 (1945); *Arrowsmith v. Comm'r*, 344 US 6, 8-9 (1952); *State Farming Co. v. Comm'r*, 40 T.C. 774 (1963); *Unser v. Comm'r*, 59 T.C. 528 (1973); *H. Fort Flowers Foundation, Inc. v. Comm'r*, 72 T.C. 399 (1979); and Rev. Rul. 69-543, 1969-2 CB 1. The IRS has, however, recognized that the principle also applies in favor of taxpayers in appropriate situations. Each example bears similarities to Foundation's fact pattern. In Rev. Rul. 82-49, the Service ruled that a taxpayer may carry into an open year the unused portion of an investment tax credit (calculated as though the credit had been claimed), even if taxpayer failed to timely claim the credit. In Rev. Rul. 81-88, the Service ruled that a taxpayer may apply a net operating loss carryforward to an open year for purposes of reducing its taxable income, even if taxpayer failed to claim the deduction in a closed year that would have created the carryforward. And Rev. Rul. 74-61, 1974-1 C.B. 239, an apparently neutral provision involving the Code's former income averaging provisions, held that in determining average base period income for income averaging purposes, taxable income for a base period year barred by the statute of limitations must be adjusted, where necessary, to arrive at the correct taxable income for such year.

Accordingly, Foundation may recalculate its minimum investment return and qualifying distribution carryovers relating to the Lease in prior years for purposes of applying excess qualifying distribution carryovers in its Year 6 and 7 tax years. By reason of Foundation's additional qualifying distributions relating to the Lease in Year 1, the addition to the Lease in Year 5, and the reduction of Foundation's minimum investment return by treating the leased property as an exempt-use asset in prior years, Foundation has excess qualifying distribution carryovers. Under Treas. Reg. § 53.4942(a)-3(e)(1), excess qualifying distributions may be carried forward to reduce distributable amounts in subsequent years within the five-year adjustment period. The distributable amount for a taxable year in the adjustment period is reduced to the extent of the lesser of (i) the excess of qualifying distributions made in prior taxable years to which such adjustment period applies (with the oldest carryovers applied first) or (ii) 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 § 53.4942(a)-3(e)).

We caution, however, that a private foundation cannot (in effect) apply excess qualifying distribution carryovers in a year in which the foundation has already satisfied its minimum distribution requirements under the ordering rules of section 4942(h) and Treas. Reg. § 53.4942(a)-3(d) and thereby create a new excess qualifying distribution for the current year that can be carried forward for an additional five years. Moreover, making an election under section 4942(h)(2) and Treas. Reg. § 53.4942(a)-3(d)(2) to treat a current-year qualifying distribution as made out of corpus rather than out of current-year undistributed income does not change the result. This caution involves some explanation.

By definition, under Treas. Reg. § 53.4942(a)-3(e)(2), an excess of qualifying distributions is created for a taxable year if:

- (i) The total qualifying distributions treated (under § 53.4942(a)-3(d)) as made out of the undistributed income for such taxable year or as made out of corpus with respect to such taxable year (disregarding certain qualifying distributions) exceeds
- (ii) The distributable amount for such taxable year (determined without regard to § 53.4942(a)-3(e)⁷).

The disregarded qualifying distributions under Treas. Reg. § 53.4942(a)-3(e)(2)(i) are amounts distributed by an organization in satisfaction of section 170(b)(1)(F)(ii) or section 4942(g)(3) (and Treas. Reg. § 53.4942(a)-3(c)), or applied to a prior taxable year by operation of the elections contained in § 53.4942(a)-3(d)(2)⁸ or § 53.4942(a)-3(c)(2)(iv)⁹. The logic of this carve-out under § 53.4942(a)-3(e)(2)(i) is that a qualifying distribution may only be used once; if a current-year qualifying distribution is treated as a distribution out of corpus to qualify the foundation for section 170(b)(1)(F)(ii) status for the benefit of a contributor, to qualify the distribution under section 4942(g)(3) for the benefit of a foundation grantor, or to correct an under-distribution in a prior year, then the qualifying distribution is disregarded in determining whether, for the tax year at issue, the foundation has excess qualifying distributions (that the foundation might use to offset distributable amounts in future years or for other purposes).

Thus, a foundation has an excess of qualifying distributions in a taxable year only to the extent that its qualifying distributions treated as made out of undistributed income for the taxable year or out of corpus for the taxable year (disregarding certain qualifying distributions discussed above) exceed the distributable amount for the taxable year. While carryovers of excess qualifying distributions from prior years may be used to reduce the distributable amount in a taxable year in the five-year adjustment period, such carryovers are disregarded in determining whether a foundation has an excess of qualifying distributions in a taxable year.

⁷ As previously noted, Treas. Reg. § 53.4942(a)-3(e) allows an excess qualifying distribution carryover to reduce the distributable amount for taxable years in the succeeding 5-year adjustment period. Such carryovers are disregarded in determining the distributable amount under Treas. Reg. § 53.4942(a)-3(e)(2)(ii).

⁸ Treas. Reg. § 53.4942(a)-3(d)(2) allows a foundation to elect (pursuant to section 4942(h)(2) to treat any portion of a qualifying distribution (other than the portion treated as made out of the undistributed income of the immediately preceding taxable year) as made out of the undistributed income of a designated prior taxable year (to correct an under-distribution for such year).

⁹ The reference in Treas. Reg. § 53.4942(a)-3(e)(2)(i) to § 53.4942(a)-3(c)(2)(iv) may be in error because that provision only contemplates carryforwards of excess qualifying distributions to comply with the distribution requirements of section 4942(g)(3) or 170(b)(1)(F)(ii), not carrybacks.

RULINGS

Based on the foregoing, and assuming the accuracy of the facts and representations set forth herein, we rule as follows:

- 1) The Foundation may take into account understatement of its qualifying distributions and overstatement of its minimum investment return in prior years relating to its property leased to X in computing its minimum investment return and qualifying distribution carryforwards for its Year 6 and Year 7 tax years.

The rulings contained in this letter are based upon information and representations submitted by or on behalf of Foundation and accompanied by a penalty of perjury statement executed by an individual with authority to bind Foundation, and upon the understanding that there will be no material changes in the facts. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination. The Associate office will revoke or modify a letter ruling and apply the revocation retroactively if there has been a misstatement or omission of controlling facts; the facts at the time of the transaction are materially different from the controlling facts on which the ruling was based; or, in the case of a transaction involving a continuing action or series of actions, the controlling facts change during the course of the transaction. See Rev. Proc. 2026-1, section 11.05.

This letter does not address the applicability of any section of the Code or Regulations to the facts submitted other than with respect to the sections specifically described, and, except as expressly provided in this letter, no opinion is expressed or implied concerning the tax consequences of any aspects of any transaction or item of income discussed or referenced in this letter.

Because it could help resolve questions concerning federal tax status, this letter should be kept in Foundation's permanent records.

A copy of this letter must be attached to any tax return to which it is relevant. Alternatively, if Foundation files a return electronically, this requirement may be satisfied by attaching a statement to the return that provides the date and control number of this letter.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Foundation's authorized representatives.

This ruling letter is directed only to Foundation. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Ward L. Thomas
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cc: