KNOW GREATER VALUE™

PKF O'CONNOR DAVIES
ACCOUNTANTS AND ADVISORS

September 2018

Private Foundations Bulletin

Private Foundations and the 5% Minimum Distribution Rule – A Synopsis

Aside from paying excise tax on net investment income, another important distinction between a private foundation and a public charity is that a private foundation is **required** to spend money. In this bulletin, we will walk you through the rule and calculations attributable to non-operating private foundations.

The "Rule"

Generally speaking, a private foundation that is not a private operating foundation is required to distribute annually – through grants and grant-related expenses – at least 5% of the total fair market value of its noncharitable-use assets from the preceding year. Newly-created foundations have until the end of their second year of existence to make this distribution. The purpose of this requirement is to force private foundations to distribute money for charitable purposes.

The Calculation

Calculating the amount of such distribution is complex, and we have simplified various scenarios as follows:

Securities

When performing the calculation and assuming market quotations are readily available, a foundation may use any reasonable method to determine the average monthly fair market value of securities – such as common and preferred stocks, bonds and mutual funds – as long as the method used is consistent. For example, the value for a particular month might be determined by the closing price on the first or last day of the month or on the average of the closing price on the first and last trading day of the month.

Cash

A foundation can compute cash balances on a monthly basis by averaging the amount of cash on hand on the first and last day of each month.

Real Estate and Other Assets

The fair market value of all other assets is determined annually with the exception of real estate. The fair market value of real estate, including improvements, can be obtained using an independent appraisal on a five-year basis. You can rely on the same independent appraisal report for the tax year for which the valuation was made and for each of the four following tax years. To determine the value of an asset held less than one tax year, divide the number of days the foundation held the asset by the number of days in the tax year. Multiply the result by the fair market value of the asset.

Dual-Use Property

If property is used for both charitable and noncharitable activities, a reasonable allocation of the valuation must be used (for example, square footage of building used as office space for employees who manage endowment, as a percentage of total square footage of building). It is important to note that the property is considered used entirely for charitable purposes if 95% or more of its total use is for that purpose.

Short Tax Periods

If the foundation's tax period is less than 12 months (due to being its first year, last year or an accounting period change), the calculation is adjusted by multiplying the net value of noncharitable-use assets as calculated per above by the number of days in the tax period, divided by the number of days in the year, and then multiplied by 5%.

Exclusions

Pledges of grants and contributions to be received in the future and future interests in estates and trusts are excluded from the calculation.

A foundation is allowed to exclude 1.5% of the fair market value of all assets (minus any acquisition indebtedness) in performing the calculation. After the calculation is performed, a credit for the excise tax expense as well as unrelated business income tax expense (if applicable) is applied to this amount to arrive at the final distribution amount before adding any recoveries.

Recoveries

Recoveries received during the tax year of amounts previously treated as qualifying distributions are added to the distributable amount. Some examples are: refunds of grants previously made, proceeds from the sale or other disposition of property whose cost was treated as a qualifying distribution when the property was acquired, and recoveries of program-related investments.

The Carry Forward

A foundation that distributes in excess of the 5% amount (minimum distribution requirement) may carry forward the excess for up to five future years to fund any shortfall.

The Penalty

A foundation that fails to meet the minimum distribution requirement is subject to an excise tax payment of 30% on the undistributed amount. Further, the private foundation will not be allowed to qualify for the reduction of excise tax from the 2% to the 1% rate for the following five tax years.

Contact Us

We welcome the opportunity to speak with you concerning any questions you may have about this bulletin or any other accounting, auditing, tax or other business and financial matters of interest to your private foundation. Please contact us.

Thomas F. Blaney, CPA, CFE
Partner, Co-Director of Foundation Services
tblaney@pkfod.com

Christopher D. Petermann, CPA
Partner, Co-Director of Foundation Services
cpetermann@pkfod.com

www.pkfod.com

About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, nine offices in New York, New Jersey, Connecticut and Maryland, and more than 700 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is ranked 29th on *Accounting Today's* 2018 "Top 100 Firms" list and is recognized as one of the "Top 10 Fastest-Growing Firms." PKF O'Connor Davies is also recognized as a "Leader in Audit and Accounting" and is ranked among the "Top Firms in the Mid-Atlantic," by *Accounting Today.* In 2018, PKF O'Connor Davies was named one of the 50 best accounting employers to work for in North America, by *Vault*.

PKF O'Connor Davies provides specialized services to not-for-profit organizations. Our dedicated industry practice serves over 3,000 not-for-profit organizations, including 250 private foundations (i.e., family, corporate, community and independent foundations) as well as grant making organizations. We are committed to the not-for-profit industry and continue to invest in our professionals by providing training, state-of-the-art technology and audit and tax guidance to meet the evolving needs of the not-for-profit community.

PKF O'Connor Davies is the lead North American representative in PKF International, a global network of legally independent accounting and advisory firms located in over 400 locations, in 150 countries around the world.