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Private Foundations Bulletin

Private Operating Foundations – The “Hybrid” Vehicle

While most individuals in the philanthropic world are acquainted with private “non-operating” foundations and public charities, a subset or sub-classification of private foundations often goes unnoticed. We are referencing **private operating foundations**. These organizations, while falling under the umbrella of private foundations, are hybrids in that they mostly conduct their own charitable activities similar to public charities rather than through grantmaking. In this article, we will highlight the characteristics of private operating foundations.

Characteristics of Private Operating Foundations

A private operating foundation, like other traditional private foundations, is a tax-exempt organization under Internal Revenue Code (IRC) Section 501(c)(3) that is funded primarily by one donor or a small group of donors and thus fails to meet the public support or facts and circumstances tests required for public charity status. A major differentiating factor between a private non-operating foundation and a private operating foundation is the level to which they engage in grantmaking versus active conduct of charitable, educational or other exempt programs. To be classified as a private operating foundation the organization’s primary objective must be to actively conduct its own programs and activities, while to a lesser extent (or not at all) conduct grantmaking. Some examples of private operating foundations include museums, performing art centers, artist-endowed foundations, zoos, medical research facilities, libraries, and environmental or archeological sites.

An organization must be able to meet certain tests – an income test and one of three alternative tests (assets test, endowment test or support test) – in order to qualify for private operating foundation status. The tests must either be separately satisfied during each of three of four years consisting of the taxable year in question and the three immediately preceding taxable years or by aggregating all income, assets held and distributions over this four-year period.

The Income Test

All private operating foundations must meet this test, which ensures that the organization is making qualifying minimum distributions for the active conduct of their charitable, educational or other exempt programs and activities. To meet this requirement qualifying distributions, which would exclude grants to other organizations and certain individuals depending on the purpose, must be equal to or greater than 85% of the lesser of the organization’s adjusted net income or its minimum investment return. In general, adjusted net income is the amount of a private foundation’s gross income that is more than the expenses of earning the income.

The Alternative Tests

All private operating foundations must also meet one of these three tests:

- **Assets Test** – To meet the assets test substantially more than half (65% or more) of the organization’s assets must be either (a) assets devoted to the active conduct of activities constituting the foundation’s charitable or other exempt purpose, or to a functionally related business or (b) stock of a corporation controlled by the foundation and 85% or more of the assets of the corporation are directly devoted to the active conduct of the foundation’s exempt activities.

- **Endowment Test** – The endowment test requires that a foundation normally make qualifying distributions directly for the active conduct of the activities constituting its exempt purpose in an amount not less than two-thirds of the minimum investment return.
- **Support Test** – The support test is rarely used because it requires the foundation to receive substantially all of its support from the public. This test is met if: (1) 85% or more the foundation's support is normally received from the general public and from five or more exempt organizations (subject to limitations); (2) not more than 25% of its support is normally received from any one such exempt organization; and (3) not more than half its support is normally received from gross investment income.

As one can see, the tests and rules are very stringent in order to qualify for private operating foundation status. The reasons for this have to do with certain tax advantages associated with private operating foundation status both for donors as well as for a foundation should they have these types of activities.

Tax Advantages of Private Operating Foundation Status

Private operating foundations are afforded some advantages that private non-operating foundations do not receive, as outlined.

- While contributions to a private non-operating foundation have a lower level of deductibility to taxpayers, contributions to private operating foundations have the same level of deductibility as contributions to public charities, which could be appealing to some donors.
- A private operating foundation may receive qualifying distributions from other private foundations and contributions from donor-advised funds.
- A private operating foundation is not subject to IRC Section 4942 taxes on failure to distribute income.

Conclusion

Private operating foundations remain only a small subset of private foundations and an even smaller subset of the philanthropic world as a whole. The most cited reason for this is the complicated and often-confusing nature of the tests and rules outlined earlier. These tests not only come into play at the Internal Revenue Service (IRS) determination stage, but also continue to play a factor throughout the life of the organization. However, if the foundation believes it would meet the tests mentioned above and it has professional help to navigate the tests, private operating foundation status might be the most advantageous status for certain donors and to accomplish an organization's mission.

Furthermore, during a foundation's life cycle it may find that it has become more significantly involved in "hands-on" charitable activities than with grantmaking. If these foundations find that the tax considerations of private operating foundations can potentially help with their mission-related activities, they may want to consider changing status by requesting the IRS for a change of classification via Form 8940, *Miscellaneous Determination Requests*.

Contact Us

We welcome the opportunity to answer any questions you may have related to this topic or any other accounting, audit, tax or advisory matters relative to private foundations. Please call 212.286.2600 or email any of the Private Foundation Services team members below:

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