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Private Foundations Bulletin

Crunching the Minimum Payout Requirement

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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 a minimum amount annually for charitable purposes. In this bulletin, we will walk you through this rule and the calculations of a foundation's minimum payout requirement.

The "Rule"

A private foundation that is not a private *operating* foundation, is required to distribute annually – through qualifying distributions – 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 compel private foundations to distribute money for charitable purposes.

Qualifying Distributions

In general, any amounts paid – on the cash basis – to accomplish religious, charitable, scientific, literary, or other public purposes as described in Section 170(c)(2)(B) are qualifying distributions. Examples of this are:

- Grants to charities and non-charities for charitable purpose
- Reasonable administrative expenses necessary for the conduct of the charitable activities
- Direct charitable activities
- Program related investments
- Any amount paid to buy an asset used (or held for use) directly to carry out a charitable or other public purpose.

Expenses incurred in managing the endowment are not considered qualifying distributions. However, these expenses reduce the gross investment income which is taxed at 1.39%.

The Calculation

The first step in calculating the amount of such distribution is to calculate the average fair value of noncharitable use assets, i.e., securities, cash, and other assets.

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 monthly 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%.

Adjustments to the Calculation

- ***Cash deemed held for charitable activities*** – Foundations need cash to conduct ongoing business operations; therefore, a foundation is allowed to exclude 1.5% of the fair market value of all assets (minus any acquisition indebtedness) from the average fair value.

- ***Tax on investment income –*** A credit for the excise tax expense as well as any 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 made in prior years, proceeds from the sale or other disposition of property whose cost was treated as a qualifying distribution when the property was acquired, and recoveries or renewals of program-related investments.

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

The final net figure is the foundation's **distributable amount** for the year. Qualifying distributions must be equal or greater than this distributable amount to satisfy the payout rule.

Time Frame

It's important to note that a private foundation has 12 months after the end of a tax year to meet the minimum payout requirement. For example, a new foundation could pay out zero dollars in its initial tax year and satisfy the first year's minimum by applying the first qualifying distributions in the second year retroactively.

The Carry Forward

A non-operating foundation that distributes in excess of the 5% (minimum distribution requirement) may carry forward the excess for up to five years.

The Penalty

If a foundation fails to meet the minimum distribution requirement, it is subject to a penalty which is an excise tax payment of 30% on the undistributed amount.

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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