

## Private Foundations Bulletin

### Understanding the 5% Payout Rule

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Generally, public charities are supported by broad public funding and typically carry out active charitable programs rather than primarily holding investment assets. Because public charities are already engaged in ongoing programs, Congress did not impose a minimum asset distribution requirement on them. Private foundations, by contrast, are usually funded by an individual, a family or a small group of donors. For this reason, Congress imposed a minimum annual distribution requirement, commonly referred to as the 5% payout rule.

#### The 5% Distribution Requirement

A private foundation is obligated to distribute on an annual basis a minimum of 5% of the total fair market value of its noncharitable-use assets from the prior year. This payout requirement remains one of the most important annual compliance obligations. This rule was created with the purpose of ensuring that a private foundation's funds are being actively used for charitable purposes and not solely being collected and accumulated. A newly formed foundation may be subject to special startup period rules, so the timing of their required distributions can differ from the general rule.

#### What Counts Toward the 5% Payout

As described in Section 170(c)(2)(B), any amount paid on the cash basis in relation to religion, philanthropy, education, science and the environment or any other public purpose are considered to be qualifying distributions. Grants to other private foundations or to certain controlled organizations can qualify, but only if specific requirements are met. Qualifying distributions can also include program-related investments (PRIs) and necessary administrative expenses.

Reasonable administrative expenses may include compensation, office expenses and professional fees, if they are related or directly connected to carrying out the foundation's charitable activities.

#### Calculating the 5% Payout

The initial step consists of determining the average fair market value of the foundation's non-charitable-use assets. These assets typically would consist of securities, cash or other investment assets. Below are a few examples:

##### **Securities**

Securities consist of common and preferred stock, bonds and mutual funds. To determine the average monthly fair market value of these, a foundation is allowed to use any reasonable method when executing the calculation, as long as the approach that has been used is consistent. For example, the value for a particular month might be determined by the closing price on the last day of the month or on the average of the closing price on the first and last trading day of the month.

##### **Cash**

Cash balances are typically computed monthly by averaging the total cash on hand on the first and last day of each month.

## **Real Estate and Other Assets**

With the exception of real estate, for all other assets the fair market value is determined on an annual basis. For real estate, as well as improvements, the fair market value can be reached using an independent appraisal on a five-year basis. A foundation can rely on the independent appraisal report for the tax year the assessment was made and for each of the subsequent four tax years. If an asset is held for less than one tax year, its value is prorated based on the number of days it was held during the year.

## **Dual-Use Property**

When property is used for both charitable and noncharitable purposes, a reasonable allocation should be used. For instance, square footage of a building used as office space for employees who manage endowment, a percentage of total square footage of building can be used. It is also important to keep in mind that a property utilized at 95% or more for charitable purposes may be treated as entirely exempt-use property.

## **Short Tax Periods**

If a foundation is in its first year, last year, or experiencing an accounting period change and that results in the tax period being less than 12 months, then the 5% payout calculation must be adjusted.

## **Other Adjustments to the Calculation**

- **Cash deemed held for charitable purposes** – To conduct daily business operations, a foundation will of course need cash. Because of this, the IRS allows foundations to exclude 1.5% of the fair market value of all assets from the average fair value, not including any acquisition indebtedness.
- **Tax on investment income** – If applicable, prior to adding any recoveries, in order to arrive at the final distribution amount, a credit for the excise tax expense as well as any unrelated business income tax expense is applied.
- **Recoveries** – If any recoveries are applied to the amounts initially treated as qualifying distributions during the tax year, they are then added to the distributable amount. For example, refunds of grants made in prior years, profits from sales or other disposition of property whose cost was recognized as a qualifying distribution when the property was obtained and recoveries or renewals of program-related investments.
- **Exclusions** – Pledges, future contributions and future interests in estates and trusts are generally excluded from the minimum investment return calculation.

The ending net figure is your foundation's distributable amount for the year. In order to satisfy the payout rule, the total Qualifying distributions must be equal or greater than this distributable amount.

## **The Carry Forward**

A private non-operating foundation that makes excess qualifying distributions over the allotted minimum distribution requirement of 5% may carry that excess forward for up to five tax years.

## **The Penalty**

If a foundation fails to distribute its required amount on time, it is subject to an initial excise tax of 30% of the undistributed income. If the shortfall is not corrected within the applicable correction period, an additional 100% tax may apply.

Given these rules, a practical year-end review of asset values, planned grants, administrative expenses and available carryforwards can help foundations stay compliant and avoid unnecessary surprises. That kind of planning can also create more flexibility in managing annual grantmaking and other charitable expenditures.

## **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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