TAX EXEMPT PRIVATE FOUNDATIONS – DISTRIBUTIONS CAN AFFECT EXCISE TAX OBLIGATIONS

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Private foundations that are otherwise exempt from federal income taxation are nonetheless subject to certain excise taxes. For example, private foundations that are not "operating foundations" are subject to an excise tax if they fail to distribute a minimum amount of the organization's assets every year, and are subject to an excise tax on annual net investment income. These rules are designed to encourage private foundations to fulfill their charitable purposes. The following is a brief overview of the current distribution requirements and excise taxes affecting tax exempt private foundations.

Required Distributions

Private foundations that are not operating foundations are required to make "qualifying distributions" every year in an amount equal to at least 5% of the foundation's average value of "noncharitable use" assets. For most private family foundations this means 5% of the average fair market value of all cash, securities and other real or personal property held by the foundation during the taxable year. Generally, cash and securities are valued on a monthly basis and other assets can be valued using any reasonable basis that is consistently applied.

Qualifying distributions include amounts expended directly for charitable purposes and grants made to other qualified charitable organizations. "Charitable purposes" include religious, charitable, scientific, literary, or educational purposes. Qualifying distributions also include reasonable and necessary administrative expenses incurred to accomplish the foundation's charitable purposes.

Any qualifying distributions in excess of the required 5% can be carried forward for five years to satisfy the distribution requirements in future years. If the full amount of the required distribution is not made, the undistributed amount is subject to a 15% excise tax, and will continue to be taxed at 15% for each full year it remains undistributed.

Tax on Net Investment Income

In general, private foundations that are not operating foundations are subject to a 2% excise tax on annual "net investment income." Net investment income is investment income minus investment expenses. Investment income includes dividends, interest, royalties and net capital gains. Investment expenses include all ordinary and necessary expenses incurred to produce or collect investment income. Contributions received, and amounts paid as qualifying distributions, do not increase or decrease net investment income. Capital losses in excess of capital gains in any year do not reduce net investment income and cannot be carried forward to reduce future capital gains.

Although amounts paid as qualifying distributions do not reduce net investment income, if qualifying distributions exceed 1% of the net investment income for the year, plus an amount equal to a certain percentage of the value of the private foundation's noncharitable use assets, the excise tax is reduced to 1%. This percentage is based on the qualifying distributions in certain previous years. First year foundations cannot qualify for the reduced tax.

There are many issues involved in determining the value of a foundation's assets, qualifying distributions, and net investment income for these excise taxes as well as other federal excise tax issues affecting tax exempt private foundations. If you would like additional information on this topic or other topics affecting private foundations, please contact Steve Gustafson, Chair of Gould & Ratner's Tax and Financial Group, at 312/899-1647 or by email at sgustafson@gouldratner.com.

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