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What it Takes to Be a Private Operating Foundation

Some describe a private operating foundation as a cross between a public charity and a standard private "grant making" foundation. Like a public charity, it has a specific focus and conducts its own charitable activities. Like a standard private foundation, it is usually controlled by the donor or the substantial contributors. To qualify as a private operating foundation, the foundation must do more than simply conduct its own charitable activities. In addition, most of its income, assets, and any support it receives, must be used directly in the active conduct of its charitable activities.

Direct active involvement required

Usually, a foundation cannot meet operating status by relying on an intermediary entity to carry out the work (e.g., hiring an independent contractor, or establishing a management agreement with a nonprofit organization, or making traditional grants to public charities). Instead the foundation's officers and directors, or other volunteers, or the foundation's own employees, must usually be the persons directly conducting the foundation's charitable work. In addition, in most cases the work of a private operating foundation is focused on just one project, or a few related projects; and, to assure IRS approval, it is preferable if the work is carried out in the public eye. Examples include: the creation and ongoing management of a museum open to the public; a community revitalization project, where the foundation hires researchers, social workers, urban planners and others to work on the revitalization; the preservation, restoration and ongoing stewardship of a wildlife and wetlands area. While a private operating foundation is permitted to make traditional grants, the money expended on such grants may not be included in meeting the *income test* or the other tests (discussed below), except where the foundation can show it is ancillary to other directly conducted exempt activities.

Financial tests must be met

A foundation must prove on a yearly basis, or based on an aggregate of three out of four years, that it is using "most" (roughly speaking – depends on the test, which applies such descriptions as *substantially all* or *substantially more than half*) of its income, assets and support in the direct, active conduct of its charitable cause. Generally speaking, this is determined by showing the foundation meets an *income test*, plus one of three other tests, referred to as the *asset*, *endowment* and *support* tests. (The table on the next page summarizes the tests.)

Benefits/Differences Between Operating and Grant Making Foundations

Qualifying as an operating foundation offers certain tax benefits. For example, in any given year where a foundation qualifies as an operating foundation, it will not be subject to an excise tax for failure to make the annual qualified distributions required of standard private foundations (thus, for example, permitting the accumulation of funds for a year or so before a large, planned expenditure occurs). The operating foundation must only pay "substantially all" of its investment income; contrarily, a standard private foundation must pay a fixed amount based on the assets, which may well mean in some tough investment market years being required to distribute more than was earned. The amount a donor to an operating foundation may claim on his or her tax return in a given year goes up as well (to 50% of adjusted gross income, as opposed to 30%). Also, if the donor makes a gift of appreciated property (e.g., artwork, real estate) to an operating foundation, the value of the gift will be its' appreciated, or fair market, value, whereas, for a standard private foundation, the gift value would be based on the donor's tax basis.

See income test and alternative tests on the following page

The Income Test

A private operating foundation must always meet the income test. To meet the income test, the foundation must either spend 85 percent of its income on direct charitable expenditures (*i.e.,* not grants), or 85 percent of the five percent minimum distribution requirement applicable to foundations, whichever is less. As stated by the rule, the foundation must make "qualifying distributions . . . directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated equal to substantially all of the lesser of (i) its adjusted net income . . . or (ii) its minimum investment return." IRC § 4942(j)(3)(A).

Plus One of the Alternative Tests

In addition to the income test, a private operating foundation must meet any one of the following three tests:

- ***Assets test***. This test will usually be applied by a foundation that has extensive real property, buildings or objects (art, research equipment, etc.) that is devoted directly to carrying out its charitable activities. Contrarily, a foundation whose assets are primarily held for generating income and growth for the charitable work will not usually meet the asset test because, investment assets are *not* considered to be involved directly in the charitable work. The asset test is met where at least 65 percent ("substantially more than half') of the assets are devoted directly to the active conduct of the charitable activities, or to a functionally related business, or a combination of the two. The asset test can also be met where a foundation controls the stock of a corporation and devotes 85 percent ("substantially all") of the assets to the active conduct of its charitable activities. IRC § 4942(j)(3)(B)(i); Reg. § 53.4942(b)-1.
- ***Endowment test***. Most foundations that can meet the threshold income test will be able to meet the endowment test. The endowment test is met where the foundation expends at least two-thirds of its minimum investment return directly for the active conduct of its exempt activities (compared to 85 percent in the income test). IRC § 4942(j)(3)(B)(ii); Reg. § 53.4942(b)-2.
- ***Support test***. This test will apply to a minority of foundations because it requires a foundation to show it receives substantially all of its support from the public, either directly or through other exempt organizations. Specifically, the foundation must normally receive at least 85 percent of its "support" (defined broadly, includes, among other things, gifts, grants, the value of services or facilities granted) from the general public and at least five unrelated exempt organizations (could be foundations or public charities). It cannot ordinarily receive more than 25 percent of its support from any one exempt organization. It cannot ordinarily receive more than 50 percent of its support from gross investment income. IRC § 4942(j)(3)(B)(iii); Reg. § 53.4942(b)-3.

How Many Years Must a Foundation Meet the Test?

A foundation must either meet the applicable tests *each* year for at least three out of four years, or, meet the tests based on the aggregate income, assets and distributions over a four-year period (this latter option is beneficial if large expenditures were made in one year but not in others). Reg. § 53.4942(b)-3(a).

For newly formed foundations, the IRS will either designate the organization with operating foundation status after the first year the foundation meets the tests, or, on a case-by-case basis, the IRS may designate the organization as an operating foundation before the conclusion of its first year, based on supporting documents setting forth the good faith assertions as to why the organization will meet the tests – usually requiring an affidavit or opinion of counsel. Reg. § 53.4942(b)-3(b).