CONDUIT PRIVATE FOUNDATIONS

What is a “Conduit” or “Distributing” Private Foundation? -The Statute

IRC\(^1\) §170(b)(1)(E)(ii) provides that, contrary to the usual rule that classifies private nonoperating foundations as 30% charities, a 50% charity will include:

(ii) any . . . private foundation (as defined in section 509(a)) which, not later than the 15th day of the third month after the close of the foundation's taxable year in which contributions are received, makes qualifying distributions (as defined in section 4942(g), without regard to paragraph (3) thereof ), which are treated, after the application of section 4942(g)(3), as distributions out of corpus (in accordance with section 4942(h)) in an amount equal to 100 percent of such contributions, and with respect to which the taxpayer obtains adequate records or other sufficient evidence from the foundation showing that the foundation made such qualifying distributions . . . [Emphasis added.]

The treatise materials state, without citation, that these requirements are applied annually, and that foundation may qualify for a particular year whether or not it qualified for the year previous.\(^2\)

In order to interpret the statute, we need to know how “qualifying distributions” and “corpus” are defined.

What is a Conduit Private Foundation? -The Regulation

Treas. Reg. §1.170A-9(g) provides:

(g) Private nonoperating foundation distributing amount equal to all contributions received.

(1) In general.

(i) An organization is described in section 170(b)(1)(A)(vii) and (E)(ii) [i.e., in the case of (E)(ii) a 50% conduit charity] if it is a private foundation which, not later than the 15th day of the third month after the close of its taxable year in which any contributions are received, distributes an amount equal in value to 100 percent of all contributions received in such year. Such distributions must be qualifying distributions (as defined in section 4942(g) without regard to paragraph (3) thereof [i.e. w/o regard to the rule on distributions to controlled organizations of other nonoperating private foundations. See statute below.]) which are treated, after the application of section 4942(g)(3), as distributions out of corpus in accordance with section

\(^1\) All references herein to the "IRC" are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

\(^2\) See RIA, Estate Planning Analysis ¶41,942.
(i) In order for an organization to meet the distribution requirements of subdivision (i) of this subparagraph, it must, not later than the 15th day of the third month after the close of its taxable year in which any contributions are received, distribute (within the meaning of subdivision (i) of this subparagraph) an amount equal in value to 100 percent of all contributions received in such year and have no remaining undistributed income for such year.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). X is a private foundation on a calendar year basis. As of January 1, 1971, X had no undistributed income for 1970. X's distributable amount [i.e. the 5% minimum investment return as adjusted] for 1971 was $600,000. In July 1971, A, an individual, contributed $500,000 (fair market value determined at the time of the contribution) of appreciated property to X (which, if sold, would give rise to long-term capital gain). X did not receive any other contribution in either 1970 or 1971. During 1971, X made qualifying distributions of $700,000 [, $600,000 of] which were treated as made out of the undistributed income for 1971 and $100,000 out of corpus. X will meet the requirements of section 170(b)(1)(E)(ii) for 1971 if it makes additional qualifying distributions of $400,000 out of corpus by March 15, 1972.

Example (2). Assume as of January 1, 1971, X had $100,000 of undistributed income for 1970. Under these circumstances, the $700,000 distributed by X in 1971 would be treated as made out of the undistributed income for 1970 and 1971. X would therefore have to make additional qualifying distributions of $500,000 out of corpus between January 1, 1972, and March 15, 1972, in order to meet the requirements of section 170(b)(1)(E)(ii) for 1971.

(2) Special rules. In applying subparagraph (1) of this paragraph—
(i) For purposes of section 170(b)(1)(A)(vii), an organization described in section 170(b)(1)(E)(ii) must distribute all contributions received in any year, whether of cash or property. However, solely for purposes of section 170(e)(1)(B)(ii), an organization described in section 170(b)(1)(E)(ii) is required to distribute all contributions of property only received in any year. Contributions for purposes of this paragraph do not include bequests, legacies, devises, or transfers within the meaning of section 2055 or 2106(a)(2) with respect to which a deduction was not allowed under section 170.

(ii) Any distributions made by a private foundation pursuant to subparagraph (1) of this paragraph with respect to a particular taxable year shall be treated as made first out of contributions of property and then out of contributions of cash received by such foundation in such year.

(iii) A private foundation is not required to trace specific contributions of property, or amounts into which such contributions are converted, to specific distributions.

(iv) For purposes of satisfying the requirements of section 170(b)(1)(D)(ii) [D?], except as provided to the contrary in this subdivision (iv), the fair market value of contributed property, determined on the date of contribution, is required to be used for purposes of determining whether an amount equal in value to 100 percent of the contributions received has been distributed. However, reasonable selling expenses, if any, incurred by the foundation in the sale of the contributed property may be deducted from the fair market value of the contributed property on the date of contribution, and distribution of the balance of the fair market value will satisfy the 100 percent distribution requirement. If a private foundation receives a contribution of property and, within 30 days thereafter, either sells the property or makes an in kind distribution of the property to a public charity, then at the choice of the private foundation the gross amount received on the sale (less reasonable selling expenses incurred) or the fair market value of the contributed property at the date of its distribution to the public charity, and not the fair market value of the contributed property on the date of contribution (less reasonable selling expenses, if any), is considered to be the amount of the fair market value of the contributed property for purposes of the requirements of section 170(b)(1)(D)(ii).

(v) A private foundation may satisfy the requirements of subparagraph (1) of this paragraph for a particular taxable year by electing (pursuant to section 4942(h)(2) and the regulations thereunder) to treat a portion or all of one or more distributions, made not later than the 15th day of the third month after the close of such year, as [having been?] made out of corpus [during the preceding taxable year?]. [Emphasis added.]
What Are Qualifying Distributions?

IRC §4942(g) defines “qualifying distributions.” It reads in pertinent part:

(g) Qualifying distributions defined.

(1) In general. For purposes of this section, the term “qualifying distribution” means—

(A) any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(2)(B), other than any contribution to (i) an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in section 4946) with respect to the foundation, except as provided in paragraph (3), or (ii) a private foundation which is not an operating foundation (as defined in subsection (j)(3)), except as provided in paragraph (3), or

(B) any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in section 170(c)(2)(B).

(2) Certain set-asides. . . .

(A) In general. For all taxable years beginning on or after January 1, 1975, subject to such terms and conditions as may be prescribed by the Secretary, an amount set aside for a specific project which comes within one or more purposes described in section 170(c)(2)(B) may be treated as a qualifying distribution if it meets the requirements of subparagraph (B).

(B) Requirements. An amount set aside for a specific project shall meet the requirements of this subparagraph if at the time of the set-aside the foundation establishes to the satisfaction of the Secretary that the amount will be paid for the specific project within 5 years, and either—

(i) at the time of the set-aside the private foundation establishes to the satisfaction of the Secretary that the project is one which can better be accomplished by such set-aside than by immediate payment of funds, or

(ii)

(I) the project will not be completed before the end of the taxable year of the foundation in which the set-aside is made,

(II) the private foundation in each taxable year beginning after December 31, 1975 (or after the end of the fourth taxable year following the year of its creation, whichever is later), distributes amounts, in cash or its equivalent, equal to not less than the distributable amount determined under subsection (d) (without regard to subsection (i) ) for purposes described in section 170(c)(2)(B) (including but not limited to payments with respect to set-asides which
were treated as qualifying distributions in one or more prior years), and

(III) the private foundation has distributed (including but not limited to payments with respect to set-asides which were treated as qualifying distributions in one or more prior years) during the four taxable years immediately preceding its first taxable year beginning after December 31, 1975, or the fifth taxable year following the year of its creation, whichever is later, an aggregate amount, in cash or its equivalent, of not less than the sum of the following: 80 percent of the first preceding taxable year's distributable amount; 60 percent of the second preceding taxable year's distributable amount; 40 percent of the third preceding taxable year's distributable amount; and 20 percent of the fourth preceding taxable year's distributable amount.

(C) Certain failures to distribute. If, for any taxable year to which clause (ii)(II) of subparagraph (B) applies, the private foundation fails to distribute in cash or its equivalent amounts not less than those required by such clause and—

(i) the failure to distribute such amounts was not willful and was due to reasonable cause, and

(ii) the foundation distributes an amount in cash or its equivalent which is not less than the difference between the amounts required to be distributed under clause (ii)(II) of subparagraph (B) and the amounts actually distributed in cash or its equivalent during that taxable year within the correction period (as defined in section 4963(e)),

such distribution in cash or its equivalent shall be treated for the purposes of this subparagraph as made during such year.

(D) Reduction in distribution amount. If, during the taxable years in the adjustment period for which the organization is a private foundation, the foundation distributes amounts in cash or its equivalent which exceed the amount required to be distributed under clause (ii)(II) of subparagraph (B) (including but not limited to payments with respect to set-asides which were treated as qualifying distributions in prior years), then for purposes of this subsection the distribution required under clause (ii)(II) of subparagraph (B) for the taxable year shall be reduced by an amount equal to such excess.

(E) Adjustment period. For purposes of subparagraph (D) , with respect to any taxable year of a private foundation, the taxable years in the adjustment period are the taxable years (not exceeding 5) beginning after December 31, 1975, and immediately preceding the taxable year.
In the case of a set-aside which satisfies the requirements of clause (i) of subparagraph (B), for good cause shown, the period for paying the amount set aside may be extended by the Secretary.

(3) Certain contributions to section 501(c)(3) organizations. For purposes of this section, the term “qualifying distribution” includes a contribution to a section 501(c)(3) organization described in paragraph (1)(A)(i) or (ii) if—

(A) not later than the close of the first taxable year after its taxable year in which such contribution is received, such organization makes a distribution equal to the amount of such contribution and such distribution is a qualifying distribution (within the meaning of paragraph (1) or (2), without regard to this paragraph) which is treated under subsection (h) as a distribution out of corpus (or would be so treated if such section 501(c)(3) organization were a private foundation which is not an operating foundation), and

(B) the private foundation making the contribution obtains adequate records or other sufficient evidence from such organization showing that the qualifying distribution described in subparagraph (A) has been made by such organization.

(4) Limitation on administrative expenses allocable to making of contributions, gifts, and grants.

(A) In general. The amount of the grant administrative expenses paid during any taxable year which may be taken into account as qualifying distributions shall not exceed the excess (if any) of—

(i) .65 percent of the sum of the net assets of the private foundation for such taxable year and the immediately preceding 2 taxable years, over

(ii) the aggregate amount of grant administrative expenses paid during the 2 preceding taxable years which were taken into account as qualifying distributions.

(B) Grant administrative expenses. For purposes of this paragraph, the term “grant administrative expenses” means any administrative expenses which are allocable to the making of qualified grants.

(C) Qualified grants. For purposes of this paragraph, the term “qualified grant” means any contribution, gift, or grant which is a qualifying distribution.

(D) Net asset. For purposes of this paragraph, the term “net assets” means, with respect to any taxable year, the excess determined under subsection (e)(1) for such taxable year.

(E) Transitional rule. In the case of any preceding taxable year which begins before January 1, 1985, the amount of the grant administrative expenses taken into account under subparagraph (A)(ii) shall not exceed
.65 percent of the net assets of the private foundation for such taxable year.

(F) Termination. This paragraph shall not apply to taxable years beginning after December 31, 1990.

Corpus and Income Distribution Ordering Rules

What is Corpus?

IRC §4942(h)(1) provides:

(h) Treatment of qualifying distributions.

(1) In general. Except as provided in paragraph (2) [see below], any qualifying distribution made during a taxable year shall be treated as made—

(A) first out of the undistributed income of the immediately preceding taxable year (if the private foundation was subject to the tax imposed by this section for such preceding taxable year) to the extent thereof, [of which there should usually be none, absent some oversight]

(B) second out of the undistributed income for the taxable year to the extent thereof, and

(C) then out of corpus.

For purposes of this paragraph, distributions shall be taken into account in the order of time in which made.

The Extra 2½-Month Rule

IRC §4942(h)(2)

As stated above IRC §170(b)(1)(E)(ii) provides that a 50% charity will include:

(ii) any . . . private foundation (as defined in section 509(a)) which, not later than the 15th day of the third month after the close of the foundation's taxable year in which contributions are received, makes qualifying distributions (as defined in section 4942(g)\(^3\), without regard to paragraph (3) thereof [which permits distributions to a controlled organization or a nonoperating foundation under certain circumstances] ), which are treated, after the application of section 4942(g)(3), as distributions out of corpus (in accordance with section 4942(h)) in an amount equal to 100 percent of such contributions, and with respect to which the taxpayer obtains adequate records or other sufficient evidence from the foundation showing that the foundation made such qualifying distributions . . . [Emphasis added.]

The ordering rules of §4942(h)(1) were quoted above. They provide that qualifying distributions are treated as made first out of any undistributed income (UI) for the preceding year, second out of UI for the current year, and last, out of corpus. However, under IRC

\(^3\) 4942(g) contains the basic definition of qualifying distributions for purposes of the rule that private foundations have to make qualifying distributions of the “distributable amount.”
§4942(h)(2), a foundation may elect to treat any portion of distributions made during the 2½ -month period after the end of the year as if made out of corpus under certain conditions:

(2) Correction of deficient distributions for prior taxable years, etc. In the case of any qualifying distribution which (under paragraph (1)) is not treated as made out of the undistributed income of the immediately preceding taxable year [i.e., which must perforce have been made out of UI for the current year or a year prior to the preceding year, or out of corpus], the foundation may elect to treat any portion of such distribution as made out of the undistributed income of a designated prior taxable year or out of corpus. The election shall be made by the foundation at such time and in such manner as the Secretary shall by regulations prescribe. [Emphasis added.]

I believe that the regulations prescribed would include, primarily, Treas. Reg. §53.4942(a)-3(d)(2).

A primary purpose of §4942(h)(2) is to provide a mechanism to avoid the 100% tax of 4942(b) upon failure to distribute all distributable income by the end of the “taxable period,” which cannot occur any earlier than the second year following a failure to distribute all “distributable income.” I believe that the reference to §4942(h)(2) in §170(b)(1)(E)(ii) (the 2½ month rule) is a clumsy way of making §4942(h)(2) do double duty, and that the fit is not a good one.

Again, the all important Treas. Reg. §1.170A-9(g)(2)(v) (quoted above as well) provides:
A private foundation may satisfy the requirements of subparagraph (1) of this paragraph [i.e., the conduit private foundation provisions] for a particular taxable year by electing (pursuant to section 4942(h)(2) and the regulations thereunder) to treat a portion or all of one or more distributions, made not later than the 15th day of the third month after the close of such year, as made out of corpus [during the preceding year?]. [Emphasis and bracketed language added.]

Treas. Reg. §53.4942(a)-3(d)(2) describes how to make the 4942(h)(2) election. Perhaps the reason that the §170(b)(1)(E)(ii) election has to be made under 4942(h)(2) is that but for 4942(h)(2), the 4942(h)(1) ordering rules would characterize distributions made in the first 2½ months of year two as being made out of year two income, and so we need both a §170(b)(1)(E)(ii) election to consider distributions made during the first 2½ months of year two as if they were made in year one, and we need §4942(h)(2) in order to treat those distributions as being made out of corpus rather than income. (Phew!)

What is Undistributed Income and What is the Distributable Amount?

Qualifying distributions have to be out of corpus. However, corpus is only distributable after all income has first been distributed. Therefore, in addition to making distributions equal to 100% of contributions, the foundation must additionally distribute all of its income.4 “Undistributed income” for this purpose is a term of art, defined by reference to three separate definitions. The first thing to notice is that income does not mean normal accounting income. It means 5% of the foundation assets, basically, but this is perhaps an oversimplification. More specifically, “undistributed income” means:

(c) Undistributed income. For purposes of this section, the term “undistributed income” means, with respect to any private foundation for any taxable year as of any time, the amount by which—

(1) the distributable amount for such taxable year, exceeds

(2) the qualifying distributions made before such time out of such distributable amount.5 [Emphasis added.]

The “distributable amount” is

(d) Distributable amount. For purposes of this section, the term “distributable amount” means, with respect to any foundation for any taxable year, an amount equal to—

(1) the sum of the minimum investment return plus the amounts described in subsection (f)(2)(C), reduced by


5 See IRC §4942(g)(3).
(2) the sum of the taxes imposed on such private foundation for the taxable year under subtitle A and section 4940.

The “minimum investment return” is defined in §IRC §4942(e) as follows:

(e) Minimum investment return.

(1) In general. For purposes of subsection (d), the minimum investment return for any private foundation for any taxable year is **5 percent of the excess of**—

(A) the aggregate fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out the foundation's exempt purpose, over

(B) the acquisition indebtedness with respect to such assets (determined under section 514(c)(1) without regard to the taxable year in which the indebtedness was incurred).

IRC §4942 generally treats distributions as being made first out of the prior year's undistributed income, second out of current undistributed income, and then out of corpus.

Here are two examples taken directly from the regulations:

Example (1). X is a private foundation on a calendar year basis. As of January 1, 1971, X had **no undistributed income for 1970**. X's distributable amount [N.B. The distributable amount generally means the 5% minimum investment return plus certain adjustments.] for **1971** was $600,000 [treated as income?]. In July 1971, A, an individual, contributed **$500,000** (fair market value determined at the time of the contribution) of appreciated property to X (which, if sold, would give rise to long-term capital gain). X did not receive any other contribution in either 1970 or 1971. During 1971, X made qualifying distributions of **$700,000** which were treated as made out of the undistributed income for 1971 and **$100,000 out of corpus**. X will meet the requirements of section 170(b)(1)(E)(ii) for 1971 if it makes additional qualifying distributions of **$400,000** out of corpus by March 15, 1972.

Example (2). Assume of January 1, 1971, X had **$100,000** of undistributed income for 1970. Under these circumstances, the **$700,000** distributed by X in 1971 would be treated as made out of the undistributed income for 1970 and 1971. X would therefore have to make additional qualifying distributions of **$500,000** out of corpus between January 1, 1972, and March 15, 1972, in order to meet the requirements of section 170(b)(1)(E)(ii) for 1971.7 [Emphasis added.]

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6IRC §4942(d)(1).

7 Treas. Reg. §1.170A-9(g)(1)(iii), Ex (1) & (2).
The Adequate Records Requirement.

In order to sustain a 50% deduction the taxpayer must maintain adequate records:

**Adequate records required.** A taxpayer claiming a deduction under section 170 for a charitable contribution to a foundation described in subparagraph (1) of this paragraph must obtain adequate records or other sufficient evidence from such foundation showing that the foundation made the required qualifying distributions within the time prescribed. Such records or other evidence must be attached to the taxpayer's return for the taxable year for which the charitable contribution deduction is claimed. If necessary, an amended income tax return or claim for refund may be filed in accordance with §301.6402-2 and §301.6402-3 of this chapter (procedure and administration regulations)."  

Miscellaneous Requirements

**Tracing Not Required.** There is no requirement that property contributed during the year or its proceeds must be the property actually distributed during the year.  

**Certain Distributions Not Considered.** Distributions (1) to an organization controlled directly or indirectly by the foundation, or one or more disqualified persons; or to (2) a private foundation that is not an operating foundation, are not “qualifying distributions.”  

**Valuation of Contributed Property.** The amount that must be distributed is the fair market value of the contributed property, determined on the date donated, reduced by any reasonable selling expenses incurred on sale. However, the amount received on sale by the foundation of the contributed property is otherwise irrelevant.  

**Exception in the Case of Contributed Property Sold Within 30 Days of Receipt.** If the foundation sells the contributed property, or distributes it to a public charity, within 30 days of receiving the property, it may elect to treat the value on the date of contribution as equaling:

1. in the case of a sale of the property—the gross amount received on the sale of the property, less reasonable selling expenses incurred; or
2. in the case of a distribution of the property—an amount equal to the property's fair market value on the date of its distribution to the public charity.

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8 Treas. Reg. §1.170A-9(g)(4).


12 PLR 7825004.