

Private Foundations Bulletin

Unlocking Potential – A Closer Look at Private Operating Foundations

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A private operating foundation is a sub-classification of a private foundation. Unlike a private *non-operating* foundation, a private *operating* foundation utilizes its resources to actively conduct its own mission-related exempt activities. Common examples of private operating foundations include museums, performing art centers, artist-endowed foundations, zoos, medical research facilities, libraries and environmental or archeological sites. But how and why, exactly, would a foundation pursue operating foundation classification?

In this month's bulletin, we dive into the requirements for classification and other key considerations.

Operating Foundation Compliance Requirements

In order to pursue operating foundation classification, a foundation must pass certain testing requirements. These tests include:

- 1) **The Income Test** - All private operating foundations must meet this test. It ensures that the organization is making qualifying minimum distributions for the active conduct of its charitable, educational, or other exempt programs and activities. To meet this requirement, qualifying distributions must be equal to or greater than 85% of the lesser of the foundation's adjusted net income or its minimum investment return. Qualified distributions exclude grants to other organizations and certain individuals depending on the purpose and allocable overhead costs to run such grant programs. In general, adjusted net income is the amount of a private foundation's gross income that is more than the expenses of earning the income.
- 2) **Alternative Tests** – Private operating foundations must meet one of the three below tests:
 - **Assets Test** – To meet the assets test, substantially more than half (65% or more) of the organization's assets must be one of the following:
 - a. Assets devoted to the active conduct of activities constituting the foundation's charitable or other exempt purpose, or to a functionally related business or to any combination thereof.
 - b. Stock of a corporation controlled by the foundation and 85% or more of the assets of the corporation are directly devoted to the active conduct of the foundation's exempt activities.
 - c. Assets, in part, described in "a" and, in part, stock described in "b".
 - **Endowment Test** – The endowment test requires that a foundation normally makes qualifying distributions directly for the active conduct of the activities constituting its exempt purpose in an amount not less than two-thirds of the minimum investment return.
 - **Support Test** – The support test is rarely used because it requires the foundation to receive substantially all its support from the public. This test requires the following conditions are met:
 - Eighty-five percent or more of the foundation's support is normally received from the general public and from five or more exempt organizations (subject to limitations).
 - Not more than 25% of its support is normally received from any one such exempt organization.
 - Not more than half its support is normally received from gross investment income.

In general, a foundation may pass the income test and either of the alternative tests for any three taxable years during a four-year period consisting of the taxable year in question and the three immediately preceding taxable years or on the basis of an aggregation of all four years. However, if the income test is passed based on the aggregation of all four years, then the alternative test must also be based on the aggregation of all four years. As one can easily tell, these tests can be difficult to understand; they are much harder than simply following the 5% distribution rule for a non-operating foundation.

Advantages of Private Operating Foundation Status

Despite the complexity of the spending rules for a private operating foundation, there are various advantages to the operating foundation structure, including:

- **Higher deductibility:** Donations to operating foundations have similar levels of deductibility as contributions to public charities, which may attract more donors.
- **Access to funds:** Depending on the sponsoring organization's policies, generally speaking, donor-advised funds are allowed to contribute to an operating foundation but not to a non-operating private foundation.
- **Tax advantage:** An operating foundation is not subject to IRC Section 4942 taxes on failure to distribute income.
- **Exemption:** Certain operating foundations may qualify as "exempt operating foundations" under IRC Section 4940(d), be exempt from the excise tax under IRC Section 4940 and not be required to exercise expenditure responsibility with respect to certain grants to them.

Despite the Advantages

While the structure of a private operating foundation might be alluring at face value for the aforementioned reasons, according to [Candid](#), less than 10% of private foundations are structured as operating foundations. So, what gives? The truth is that a private operating foundation comes with compliance challenges that must be initially met and maintained throughout the life of the foundation. A private foundation's well-intentioned efforts to advance its exempt purposes can quickly become a costly compliance burden. Private foundations typically will be structured as a non-operating foundation for the ease of compliance and the belief that an operating structure is not necessary to conduct their exempt activities.

Still Intrigued, How Do We Switch?

During a foundation's life cycle, it may become more significantly involved in "hands-on" charitable activities than with grantmaking. If you find that the tax considerations of private operating foundations can potentially help with your foundation's mission-related activities, higher contributions and possibly lower spend requirements, you may want to consider changing status. You can request a change of classification from the IRS via Form 8940, *Miscellaneous Determination Requests*.

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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