

PHILANTHROPIC PARTNERSHIPS USING THE 'OUT OF CORPUS' RULES

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Many private foundations choose not to make grants to other private foundations, or to controlled public charities, because those grants would require compliance with complicated redistribution and timing requirements known as the "out of corpus" rules. The authors suggest that these rules deserve a second look. They are admittedly complex, but they can be put to good use. Rather than viewing them as an insurmountable barrier separating grantmaker from potential grantee, they can be seen as part of a tool kit that enables private foundations to work productively with the grantees of their choice.

For example, a donor might create a private foundation and fund it with substantial assets, with the goal of supporting a particular field of direct charitable activity. The donor wants to control those activities, but does not want to expose the assets of her foundation to liabilities that the direct activities might create. The donor could create one or more additional charitable organizations to carry out those direct activities, control their governance, and still fund them with qualifying distributions from her private foundation by using the out of corpus rules as described below.

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Background

Organizations exempt under Section 501(c)(3) are divided into private foundations and public charities. Private foundations are those organizations exempt under Section 501(c)(3) whose support is derived principally from one or a few major donors. A special regulatory scheme applies to private foundations in addition to the basic rules governing all charities. The private foundation laws impose a 2% tax on investment income, limit self-dealing and business holdings, require annual distributions, prohibit lobbying, and restrict the organization's operations in other ways.¹ Also, large donors to a private foundation have a lower ceiling on the amount of deductible gifts they can claim each year.²

The policy underlying the annual distribution requirement is to ensure that private foundations' charitable assets enter the "charitable stream" instead of simply accumulating over time. Private foundations' annual distributions must be made for charitable purposes and must equal at least 5% of the net fair market value of the private foundation's assets held for investment.³ The tax law refers to these payments as "qualifying distributions." While many grants from private foundations to organizations exempt under Section 501(c)(3) will count as qualifying distributions, other such grants will

Though complex, the out of corpus rules provide an excellent opportunity for private foundations to expand their scope and deepen the reach of their philanthropic activities through effective partnerships.

EXHIBIT 1
General Ordering Rules.

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|-------------------------|-------|-------|-------|-------|-------|-------|-------|
| Distributable Amount | \$100 | \$100 | \$100 | \$100 | \$100 | \$100 | \$100 |
| Qualifying Distribution | 0 | \$100 | \$250 | \$100 | \$100 | \$100 | \$100 |

EXHIBIT 2
Election to Alter the General Ordering Rules.

| | 2006 | 2007 | 2008 | 2009 |
|-------------------------|-------|-------|-------|-------|
| Distributable amount | \$100 | \$110 | \$120 | \$130 |
| Qualifying distribution | \$100 | 0 | 0 | \$250 |

EXHIBIT 3
Grantors' Contributions (see example on page 24).

| From | Type of Entity | Amount | Restrictions/Earmarking/ Other Instructions |
|------|--------------------|--------|---|
| Y | Public Charity | \$150 | |
| Z | Private Foundation | \$70 | |
| Q | Private Foundation | \$140 | |
| F | Private Foundation | \$180 | "Distribute my grant before you distribute Z's grant." "No redistribution is necessary; we've already made enough qualifying distributions to avoid taxes under Section 4942." |

not. Specifically, grants to other private (non-operating) foundations⁴ and grants to organizations that are controlled by the grantor private foundation or its disqualified persons⁵ will *not* count as qualifying distributions. The only exception to this general rule is the statutory scheme known as the "flow-through" or "out of corpus" exception. To take advantage of this exception, the grantee must redistribute the full grant amount *and* must also satisfy its annual distribution obligation for that year from other sources, without counting the grant funds. Strict and specific time limits and ordering rules apply to these distributions.⁶

Definitions

For purposes of this article, the following definitions will apply:

- *Grantor.* As used here, the grantor is a private foundation that wants to count as a qualifying distribution a grant to either (1) another private foundation or (2) a Section 501(c)(3) tax-exempt organization of any kind (private foundation, private operating foundation, or public charity) controlled either by the private foundation or its disqualified persons.
- *Recipient.* This refers to the recipient of a grant from the grantor. To be eligible for an out of

corpus grant, the recipient must be a tax-exempt organization described in Section 501(c)(3).⁷ That specific eligibility requirement is discussed below.

- *Qualifying distribution.* This is an amount paid by a private foundation to accomplish one or more charitable purposes described in Section 170(c)(2)(B). Amounts that a private foundation spends on reasonable and necessary administrative expenses to accomplish these charitable purposes also count toward a private foundation's qualifying distributions.⁸
- *Distributable amount.* The distributable amount is the amount that a private foundation must distribute, as qualifying distributions, in a given year. This amount generally is equal to 5% of the net fair market value of the private foundation's assets held for investment.⁹
- *Undistributed income.* Undistributed income is the distributable amount less any qualifying distributions made.¹⁰
- *Redistribute/Redistribution.* These terms refer to the amount that the grant recipient must grant out or spend on charitable or related administrative activities in order to permit the grantor to take advantage of the out of corpus exception.¹¹
- *Control.* Determining whether a grantor controls the recipient requires looking at

what, if any, control the grantor has over the recipient *organization* and not to any restrictions on the *use* of the grant that the grantor may impose on a particular grant. (The restriction of a grant's use to a particular charitable program also does not constitute control for purposes of this analysis.) Direct control exists if a majority of the recipient's board of directors are the grantor's disqualified persons. Indirect control exists if the grantor's disqualified persons hold so much power over the recipient that they can force the recipient to make a particular expenditure, despite not constituting a majority of the recipient's board of directors. The IRS looks to whether the disqualified persons have the power to control the recipient and not to whether they actually exercise that power. The mere possibility that the grantor's disqualified persons *could* force the recipient to make a particular expenditure is enough to result in control.¹²

- *Tax-exempt organization described in Section 501(c)(3).* Eligible recipients of out of corpus grants must be tax-exempt organizations described in Section 501(c)(3).¹³ A grant to a non-501(c)(3) organization that is controlled by the grantor cannot count towards the grantor's qualifying distributions, regardless of how charitable the purpose of the grant or the activities of the grantee may be.¹⁴ More specifically:

1. Organizations that are described in Section 501(c)(3), and that have received a letter of determination from the IRS as to this status, are eligible recipients.

2. Organizations that are described in Section 501(c)(3) and have not yet received a determination letter from the IRS, or that have not yet applied to the IRS for recognition of tax exemption, may still be eligible recipients of an out of corpus grant. Section 508, the regulations thereunder, and published IRS guidance provide that new organizations will be treated as described in Section 501(c)(3) so long as they apply to the IRS for recognition of tax exemption within 27 months after formation. The grantor can count grants to the recipient as qualifying distributions if (a) the recipient redistributes the grant and otherwise complies with the out of corpus rules, *and* (b) the recipient eventually does obtain a favorable determination letter from the IRS, retroactive to its formation.¹⁵

3. Churches are exempt organizations described in Section 501(c)(3), even though they may never file Form 1023 for recognition of exemption, as long as they otherwise meet the requirements for exemption under Section 501(c)(3) (e.g., are organized and operated for religious purposes, with no private inurement, no substantial non-exempt purpose activities, no substantial lobbying, and no political campaign intervention).¹⁶ Churches, therefore, generally are eligible recipients of out of corpus grants.

Ordering rules for qualifying distributions

Each year, a private foundation must spend its distributable amount as qualifying distributions. If it does not, excise taxes will apply.¹⁷ The public pol-

¹ The basic private foundation rules are found in Sections 4940-4945.

² Section 170(b).

³ This is a very generalized statement; the actual calculation is more complex. Section 4942.

⁴ A private operating foundation is a private foundation that makes distributions directly for the active conduct of charitable activities and is described in Section 4942(j)(3). Grants from private foundations to private operating foundations are treated as qualifying distributions without regard to the out of corpus rule, so long as (1) the grantee is not controlled by the grantor or its disqualified persons and (2) the grantor exercises expenditure responsibility over the grant (a matter not discussed in this article). Therefore, unless otherwise noted, references in this article to "private foundations" refer to non-operating private foundations.

⁵ A disqualified person to a private foundation is a related party with respect to that foundation, as defined in Section 4946.

⁶ Not all grants must be redistributed in this manner. For example, grants from public charities do not have to be redistributed. In addition, a private foundation grantor may decide that it can meet its minimum distribution obligations without counting a particular grant. In that case,

the private foundation grantor would instruct the grantee that the grant need not be redistributed.

⁷ Reg. 53.4942(a)-3(c)(1).

⁸ Section 4942(g).

⁹ Sections 4942(d), 4942(e).

¹⁰ Section 4942(c).

¹¹ Section 4942(g)(3)(A).

¹² Reg. 53.4942(a)-3(a)(3).

¹³ Reg. 53.4942(a)-3(c)(1).

¹⁴ Grants to foreign organizations for charitable purposes may be treated as qualifying distributions in certain circumstances. Such grants, however, are outside the scope of this article.

¹⁵ Grantors should bear in mind that while many applicants receive a favorable exemption determination letter from the IRS, this result is not automatic and cannot be guaranteed. It is possible that the grantor might learn after the fact that the recipient did not obtain tax-exempt charitable status.

¹⁶ Section 508(a) provides that to be described in Section 501(c)(3), an organization must apply to the IRS for recognition of tax exemption. Churches, their integrated auxiliaries, and conventions or associations of churches are excepted out of this requirement under Section 508(c).

¹⁷ Section 4942.

The policy is to ensure that private foundations' charitable assets enter the 'charitable stream.'

icy is clear—donors should not be permitted to take an income tax charitable contribution deduction for donations to their individual private foundations, and then accumulate the funds inside the private foundation indefinitely, without ever putting the money to charitable use. Strict and specific ordering rules apply to the treatment of a private foundation's qualifying distributions to ensure that, above all, private foundations make their own annual distributions to get funds into the charitable stream.

General ordering rules. A private foundation must satisfy its own qualifying distributions for the immediately preceding tax year before it can do anything else. The ordering rules also set forth when a redistribution of a grant will be considered to have been made out of corpus. Unless it makes the election described below, a private foundation must allocate its qualifying distributions in the following order:¹⁸

- First, to its undistributed income for the immediately preceding tax year.
- Second, to its undistributed income for the current tax year.¹⁹
- Finally, out of corpus.

Example. A private foundation, created in 2002, uses the calendar year as its tax year.²⁰ Its distributable amounts and qualifying distributions for 2004 through 2010 are as shown in Exhibit 1 on page 20.

In 2005, the qualifying distribution of \$100 is treated as made out of the \$100 of undistributed income for 2004. In 2006, the qualifying distribution of \$250 is treated as made (1) \$100 out of the undistributed income for 2005, (2) \$100 out of the undistributed income for 2006, and (3) \$50 out of corpus in 2006. In 2007-2010, the qualifying distributions of \$100 for each year are treated as made out of the undistributed income for each of those respective years.

Election to alter the general ordering rules. Once a private foundation has satisfied its qualify-

ing distributions for the immediately preceding tax year, it can elect to treat further distributions as coming *either* out of the undistributed income for a designated prior tax year *or* out of corpus.²¹ The election is made in one of two ways:²²

- The private foundation can file a statement with the IRS during the tax year in which the qualifying distribution is made.
- The private foundation can attach a statement to its tax return. (Merely checking boxes on Form 990-PF is not a valid election; the private foundation also must attach a statement to its tax return.)

Example. For 2006 through 2009, a private foundation has distributable amounts and qualifying distributions shown in Exhibit 2 on page 20.

For the 2009 qualifying distribution of \$250, \$120 is treated as having come from the undistributed income for 2008. If the private foundation has made no election, the remaining \$130 is treated as having come from the undistributed income for 2009.

If, however, the private foundation has made an election, the foundation can choose how to allocate its remaining qualifying distributions for 2009 (after the mandatory allocation to its undistributed income for 2008). It could do so by allocating \$110 out of the undistributed income for 2007, and *either* (1) the remaining \$20 out of corpus in 2009, or (2) the remaining \$20 to offset its 2009 distributable amount.

How it works—A hypothetical scenario

Against this background, consider this illustration of how two imaginary private foundations were able to use the out of corpus rules to maximize the public benefit from their activities.

The Biomedical Research Foundation (Bio) and the Economic Opportunity Foundation (Econ) are grantmaking organizations that are exempt from tax under Section 501(c)(3) and are classified as private foundations. Neither

¹⁸ Section 4942(h)(1).

¹⁹ The private foundation can, however, make an election to allocate the current year's qualifying distributions (in excess of its undistributed income for the immediately preceding tax year) to corpus or to a prior tax year. See the discussion on the election to alter the general ordering rules, below.

²⁰ This example was adapted from Reg. 53.4942(a)-3(d)(3), Example 1.

²¹ Section 4942(h)(2).

²² Reg. 53.4942(a)-3(d)(2).

²³ Sections 4945(d)(4), 4945(h); Reg. 53.4945-5(b); Edie, *Expenditure Responsibility Step by Step* (Council on Foundations, 2002).

²⁴ This assumes that Bio has not instructed Econ that it need not redistribute the grant. If Bio has already met its distributable amount for the year and does not need to count the grant to Econ as a qualifying distribution, Bio could instruct Econ that it need not redistribute the grant. Reg. 53.4942(a)-3(c)(1)(f).

²⁵ Reg. 53.4942(a)-3(c)(1)(i).

²⁶ *Id.*

²⁷ Reg. 53.4942(a)-3(c)(1)(iii).

²⁸ *Id.*

²⁹ *Id.*

³⁰ Reg. 53.4942(a)-3(c)(2)(i).

organization controls the other, either directly or indirectly. Bio has developed a particular expertise in the area of biomedical research and makes multiple grants each year to support this research. Econ has developed a particular expertise in identifying and funding programs that support economic opportunities for low-income and underserved areas. Both Bio and Econ have grantmaking staff who are skilled in each subject area and, because of this, each organization is successful at evaluating grant proposals and understanding the impact that each grant will have on the larger community.

Bio now wishes to support economic development in low-income communities to provide opportunities for individuals who might eventually work in the biomedical research field. Rather than attempt to become expert in economic development, Bio's directors conclude that Econ is best suited to carry out this purpose. Bio's staff talks to Econ's staff about Bio possibly making a grant to Econ to fund Econ's economic development grant programs, with a particular emphasis on economic development that promotes biomedical research. Grants from Bio to Econ will not be qualifying distributions, and will not count toward Bio's minimum distribution requirement, unless Econ redistributes the full amount of the grants out of its corpus. Bio's directors approve a grant to Econ to support economic development in low-income communities, with an emphasis on promotion of biomedical research. For Bio to count the grant as a qualifying distribution, the following must happen:

1. The grant must be made with expenditure responsibility, an oversight and monitoring scheme described in Section 4945(h) and accompanying regulations. The reason is that a grant from one private foundation to another without expenditure responsibility is a taxable expenditure, and a taxable expenditure is not a qualifying distribution.²³
2. Econ must timely redistribute the grant out of its corpus. This means that Econ must satisfy *two* distribution obligations in the following order: (a) it must make its own qualifying distributions (and have no remaining undistributed income) as Section 4942 ordinarily requires and (b) it must redistribute, as qualifying distributions, all of the grant amount it received from Bio before the end of its tax year immediately succeeding the tax year in which it received the grant.²⁴

The redistribution must constitute a qualifying distribution in its own right, without regard to the out of corpus exception. Econ therefore cannot redistribute the grant in such a way that it would need to employ the out of corpus exception with respect to the redistribution.²⁵

Econ must redistribute, out of its corpus, any grant from Bio by the end of Econ's tax year that immediately follows the tax year in which Econ received the grant from Bio.²⁶ In other words, if Econ receives the grant in Year One, it must redistribute the grant from corpus before the end of Year Two. Econ must first make its own qualifying distributions; only then is it permitted to count further distributions out of its corpus, as described in the discussion of the ordering rules, above.

For Bio to claim the grant as a qualifying distribution, it must obtain adequate records or other sufficient evidence from Econ (such as a statement by an appropriate officer, director, or trustee) showing:²⁷

- That Econ redistributed the contribution as a qualifying distribution.
- The names and addresses of the recipients of such redistribution and the amount received by each.
- That the distribution was treated by Econ as a distribution made out of corpus.

If Bio cannot obtain the required records from Econ, it cannot count the grant as a qualifying distribution.²⁸

Econ can use the grant for its own administrative expenses as long as the expenditures would count as qualifying distributions. In this case, to satisfy the recordkeeping requirements listed above, Bio must obtain a statement from Econ setting forth the general purpose for which the expenditure was made and the amount that Econ redistributed (to itself) as a qualifying distribution.²⁹

Bio may count the grant as a qualifying distribution only if Econ redistributes the grant out of corpus in compliance with the ordering rules discussed above. Suppose that Bio, hoping to make sure its grant is redistributed, instructs Econ to redistribute its grant before redistributing all other grants that will satisfy the out of corpus exception. Unfortunately for Bio, the regulations do not allow Econ to agree to this condition. Specifically, Econ is not permitted to treat any particular grantor's grant as being distributed before any other grantor's grant, even if the original grantor instructs Econ to redistribute its grants in a particular order.³⁰ For instance, in the example

Strict and specific ordering rules apply to the treatment of a private foundation's qualifying distributions.

below, one of the grantors attempts to instruct the recipient to redistribute its grant before redistributing another grantor's grant. The Code's ordering rules supersede any attempts by a grantor to "cut ahead" in this manner, so the recipient cannot comply with those instructions.

Econ cannot redistribute a grant out of corpus if it has undistributed income from the preceding tax year. The ordering rules make this very clear. Econ must follow the ordering rules. That includes, if desirable, making the election described in the discussion of the ordering rules, above. Suppose, now, that Econ redistributed some of the grant, but not all, and Bio seeks to count a portion of the redistribution towards its qualifying distributions. The amounts that Econ redistributed will be treated as having been made pro rata out of all of its contributions that Econ must redistribute.³¹ The example below contains an illustration of how this works.

Part XIII of Form 990-PF addresses qualifying distributions and the elections to treat certain distributions as out of corpus. Grantors and recipients should discuss how to complete this part of Form 990-PF with an accountant.

Example. As an alternate hypothetical, assume in the facts above that Econ is a public charity controlled by Bio's disqualified persons. Current tax law does not impose a qualifying distributions obligation on public charities. As described above, however, Econ must still redistribute Bio's grant out of corpus in order for Bio to treat the grant to Econ as a qualifying distribution, because Bio's disqualified persons control Econ. In this case, Econ must calculate what its distributable amount and qualifying distributions would have been if it were a private foundation. Thus, Econ must first distribute amounts equal to what its minimum distribution amount would have been for the year immediately preceding the current year, as if it were a private foundation, without counting Bio's grant. After making this minimum distribution, Econ must then redistribute the grant from Bio such that the redistribution is deemed to be made out of its corpus.

Example. R is a private foundation. In 2009, it has a distributable amount of \$100 and receives \$540 in contributions.³² It makes no qualifying

distributions in 2009. In 2010, its distributable amount is \$125 and it makes qualifying distributions of \$420.

The \$540 in contributions that R received comes from grantors who are a combination of public charities and private foundations. None of the grantors or the grantors' disqualified persons controls R, either directly or indirectly. The grantors' contributions break down as shown in Exhibit 3 on page 20.

In 2010, R's qualifying distribution of \$420 is treated as made:

- \$100 out of the undistributed income for 2009.
- \$125 out of the undistributed income for 2010. (R did not make an election³³ to have any amount distributed in excess of R's 2009 undistributed income treated as distributed out of corpus. Therefore, the ordering rules described above must be followed, and the qualifying distributions allocated first to 2009 then to 2010.)
- The remaining \$195 (\$420 minus \$225) is available to be treated as out of corpus.
- Y's contribution of \$150 is from a public charity and does not have to be redistributed.
- F specifically instructed R that its contribution of \$180 did not need to be redistributed.
- Earmarking is not allowed, so Q's instruction to redistribute its grant before Z's grant is unsuccessful, as is any attempt R makes to earmark its redistribution of Q's contribution.
- The remaining \$195 in qualifying distributions will be treated as having been made out of corpus, and Z and Q will be entitled to a pro-rata share of the qualifying distribution. Z will be able to count \$65 of its \$70 contribution as a qualifying distribution ($[\$195 \times \$70] / \$210 = \65). Q will be able to count \$130 of its \$140 contribution as a qualifying distribution ($[\$195 \times \$140] / \$210 = \130).

Conclusion

The out of corpus rules support partnering in philanthropy. While complex in application, the out of corpus rules provide an excellent opportunity for private foundations to expand their scope and deepen the reach of their philanthropic activities through effective partnerships with other private foundations or controlled charities. Small family foundations, as well as very large family or corporate foundations, can collaborate in this manner. The authors believe that despite its complexity, the out of corpus framework can help private foundations collaborate for public benefit. ■

³¹ *Id.*

³² This example is adapted from Reg. 53.4942(a)-3(c)(3), Example 5.

³³ Under the ordering rules described above, it is possible for a private foundation to supersede the default ordering provisions by making an election to have certain distributions treated as being made out of corpus.