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this section to the amount by which E's 1993 exemption amount exceeds E's 1993 tax benefit under paragraph (b) of this section.

(iii) *Application of limit on tax benefit.* Because E sold 45,000 pounds of CFC–11 tax free in qualifying sales for export in 1993, E's 1993 tax benefit under paragraph (b) of this section is $150,750 ($3.35 × 45,000). Thus, the credit or refund allowed to E under paragraph (f) of this section is limited to $16,750 ($167,500 − $150,750).

Example 3. (i) *Facts.* F, a corporation, manufactures CFC–11, a post-1989 ODC, and does not manufacture any other ODCs. F also imports CFC–11. In 1993, F manufactures 60,000 pounds of CFC–11 (100,000 pounds is the maximum quantity F is allowed to manufacture in 1993 under EPA regulations) and imports 40,000 pounds. F has no additional production allowance from EPA for 1993. In 1993, the tax on CFC–11 is $3.35 per pound. F's 1986 export percentage for post-1989 ODCs is 50%. In 1993, F sells 45,000 pounds of CFC–11 tax free in qualifying sales for export and pays tax under section 4681 on an additional 35,000 pounds of exported CFC–11. The remainder of F's production is not exported.

(ii) *Limit on tax benefit.* F's 1993 exemption amount is $301,500, ($167,500 (50% of $335,000 (the tax that would otherwise be imposed on 100,000 pounds of CFC–11 in 1993) plus $134,000 (the tax that would otherwise be imposed on the 40,000 pounds imported)). The credit or refund allowed to F under paragraph (f) of this section is limited under paragraph (f)(2) of this section to the amount by which F's 1993 exemption amount exceeds F's 1993 tax benefit under paragraph (b) of this section.

(iii) *Application of limit on tax benefit.* Because F sold 45,000 pounds of CFC–11 tax free in qualifying sales for export in 1993, F's 1993 tax benefit under paragraph (b) of this section is $150,750 ($3.35 × 45,000). Thus, the credit or refund allowed to F under paragraph (f) of this section is limited to $150,750 ($301,500 − $150,750). The limitation does not affect F's credit or refund because the tax F paid on exported ODCs is only $117,250 ($3.35 × 35,000).

(h) *Effective date.* This section is effective January 1, 1993.

[T.D. 8622, 60 FR 52853, Oct. 11, 1995]

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

Subpart A—Taxes on Investment Income

Sec.

Subpart B—Taxes on Self-Dealing

Subpart C—Taxes on Failure To Distribute Income

Subpart D—Taxes on Excess Business Holdings

Subpart E—Taxes on Investments Which Jeopardize Charitable Purpose

Subpart F—Taxes on Taxable Expenditures

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Subpart G—Definitions and Special Rules

Subpart H—Application to Certain Nonexempt Trusts

Subpart I—Tax on Investment Income of and Denial of Exemption to Certain Foreign Organizations

Subpart J—Black Lung Benefit Trust Excise Taxes

Subpart K—Second Tier Excise Taxes

Subpart L—Procedure and Administration

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AUTHORITY: 26 U.S.C. 7805; 4960, unless otherwise noted.

Section 53.6011–1 also issued under 26 U.S.C. 6011;

Section 53.6060–1 also issued under 26 U.S.C. 6060(a);

Section 53.6081–1 also issued under 26 U.S.C. 6081(a);

Section 53.6109–1 also issued under 26 U.S.C. 6109(a);

Section 53.6109–2 also issued under 26 U.S.C. 6109(a);

Section 53.6695–1 also issued under 26 U.S.C. 6695(b).

Subpart A—Taxes on Investment Income

§ 53.4940–1 Excise tax on net investment income.

(a) *In general.* For taxable years beginning after September 30, 1977, section 4940 imposes an excise tax of 2 percent of the net investment income (as defined in section 4940(c) and paragraph (c) of this section) of a tax-exempt private foundation (as defined in section 509). For taxable years beginning after December 31, 1969, and before October 1, 1977, the tax imposed by section 4940 is 4 percent of the net investment income. This tax will be reported on the form the foundation is required to file under section 6033 for the taxable year and will be paid annually at the time prescribed for filing such annual return (determined without regard to any extension of time for filing). In addition, an excise tax is imposed in the manner prescribed in paragraph (b) of this section on certain non-exempt private foundations (including certain non-exempt charitable trusts). Except as provided in the succeeding sentence, this tax is to be reported by means of a schedule attached to the organization's income tax return. For taxable years ending on or after December 31, 1975, the tax imposed by section 4940(b) and paragraph (b) of this section on a trust described in section 4947(a)(1) which is a private foundation shall be reported on Form 5227. The tax imposed by section 4940(b) and this section is to be paid annually at the time the organization is required to pay its income taxes imposed under subtitle A. Except as otherwise provided herein, no exclusions or deductions from gross investment income or credits against tax are allowable under this section.

(b) *Taxable foundations.* (1) The excise tax imposed under section 4940 on private foundations which are not exempt from taxation under section 501(a) is equal to:

(i) The amount (if any) by which the sum of

(A) The tax on net investment income imposed under section 4940(a), computed as if such private foundation were exempt from taxation under section 501(a) and described in section 501(c)(3) for the taxable year, plus

(B) The amount of the tax which would have been imposed under section 511 for such taxable year if such private foundation had been exempt from taxation under section 501(a), exceeds.

(ii) The tax imposed under subtitle A on such private foundation for the taxable year.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example 1. Assume that the tax liability under subtitle A for private foundation X, which is not exempt from taxation under section 501(a) for 1970, is $10,000. Had X been exempt under section 501(a) for 1970, the tax imposed under section 4940(a) would have been $4,000 and the tax imposed under section 511 would have been $7,000. The excess of the sum of the taxes which would have been imposed under sections 4940(a) and 511 ($11,000) over the tax that was imposed under subtitle A ($10,000) is $1,000, the amount of the tax imposed on such organization under section 4940(b).

Example 2. Assume the facts stated in Example (1), except that the tax liability under subtitle A is $15,000 rather than $10,000. Because the sum of the taxes which would have been imposed under sections 4940(a) and 511 ($11,000) does not exceed the tax that was imposed under subtitle A ($15,000), there is no tax imposed under section 4940(b) with respect to such foundation.

(c) *Net investment income defined*—(1) *In general.* For purposes of section

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4940(a), *net investment income* of a private foundation is the amount by which:

(i) The sum of the gross investment income (as defined in section 4940(c)(2) and paragraph (d) of this section) and the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (within the meaning of section 4940(c)(4) and paragraph (f) of this section) exceeds

(ii) The deductions allowed by section 4940(c)(3) and paragraph (e) of this section.

Except to the extent inconsistent with the provisions of this section, net investment income shall be determined under the principles of Subtitle A.

(2) *Tax-exempt income.* For purposes of computing net investment income under section 4940, the provisions of section 103 (relating to interest on certain governmental obligations) and section 265 (relating to expenses and interest relating to tax-exempt income) and the regulations thereunder shall apply.

(d) *Gross investment income*—(1) *In general.* For purposes of paragraph (c) of this section, ''gross investment income'' means the gross amounts of income from interest, dividends, rents, and royalties (including overriding royalties) received by a private foundation from all sources, but does not include such income to the extent included in computing the tax imposed by section 511. Under this definition, interest, dividends, rents, and royalties derived from assets devoted to charitable activities are includible in gross investment income. Therefore, for example, interest received on a student loan would be includible in the gross investment income of a private foundation making such loan. For purposes of paragraph (c) of this section, gross investment income also includes the items of investment income described in § 1.512(b)–1(a).

(2) *Certain estate and trust disbursements.* In the case of a distribution from an estate or a trust described in section 4947(a) (1) or (2), such distribution shall not retain its character in the hands of the distributee for purposes of computing the tax under section 4940; except that, in the case of a distribution from a trust described in section 4947(a)(2), the income of such trust attributable to transfers in trust after May 26, 1969, shall retain its character in the hands of a distributee private foundation for purposes of section 4940 (unless such income is taken into account because of the application of section 671).

(3) *Treatment of certain distributions in redemption of stock.* For purposes of applying section 302(b)(1), any distribution made to a private foundation by a disqualified person (as defined in section 4946(a)), in redemption of stock held by such private foundation in a business enterprise shall be treated as not essentially equivalent to a dividend if all of the following conditions are satisfied: (i) Such redemption is of stock which was owned by a private foundation on May 26, 1969 (or which is acquired by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date, which is in effect on such date and at all times thereafter, or would have passed under such a will but before that time actually passes under a trust which would have met the test of this subdivision but for the fact that the trust was revocable (but was not in fact revoked)); (ii) such foundation is required to dispose of such property in order not to be liable for tax under section 4943 (relating to taxes on excess business holdings); and (iii) such foundation receives in return an amount which equals or exceeds the fair market value of such property at the time of such disposition or at the time a contract for such disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law). In the case of a disposition before January 1, 1975, section 4943 shall be applied without taking section 4943(c) (4) into account. A distribution which otherwise qualifies under section 302 as a distribution in part or full payment in exchange for stock shall not be treated as essentially equivalent to a dividend because it does not meet the requirements of this subparagraph.

(e) *Deductions*—(1) *In general.* (i) For purposes of computing net investment

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income, there shall be allowed as a deduction from gross investment income all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income, determined with the modifications set forth in subparagraph (2) of this paragraph. Such expenses include that portion of a private foundation's operating expenses which is paid or incurred for the production or collection of gross investment income. Taxes paid or incurred under this section are not paid or incurred for the production or collection of gross investment income. A private foundation's operating expenses include compensation of officers, other salaries and wages of employees, outside professional fees, interest, and rent and taxes upon property used in the foundation's operations. Where a private foundation's officers or employees engage in activities on behalf of the foundation for both investment purposes and for exempt purposes, compensation and salaries paid to such officers or employees must be allocated between the investment activities and the exempt activities. To the extent a private foundation's expenses are taken into account in computing the tax imposed by section 511, they shall not be deductible for purposes of computing the tax imposed by section 4940.

(ii) Where only a portion of property produces, or is held for the production of, income subject to the section 4940 excise tax, and the remainder of the property is used for exempt purposes, the deductions allowed by section 4940(c)(3) shall be apportioned between the exempt and non-exempt uses.

(iii) No amount is allowable as a deduction under this section to the extent it is paid or incurred for purposes other than those described in subdivision (i) of this subparagraph. Thus, for example, the deductions prescribed by the following sections are not allowable: (1) The charitable deduction prescribed under section 170 and 642(c); (2) the net operating loss deduction prescribed under section 172; and (3) the special deductions prescribed under Part VIII, Subchapter B, Chapter 1.

(2) *Deduction modifications*. The following modifications shall be made in determining deductions otherwise allowable under this paragraph:

(i) The depreciation deduction shall be allowed, but only on the basis of the straight line method provided in section 167(b)(1).

(ii) The depletion deduction shall be allowed, but such deduction shall be determined without regard to section 613, relating to percentage depletion.

(iii) The basis to be used for purposes of the deduction allowed for depreciation or depletion shall be the basis determined under the rules of Part II of Subchapter O of Chapter 1, subject to the provisions of section 4940(c)(3)(B), and without regard to section 4940(c)(4)(B), relating to the basis for determining gain, or section 362(c). Thus, a private foundation must reduce the cost or other substituted or transferred basis by an amount equal to the straight line depreciation or cost depletion, without regard to whether the foundation deducted such depreciation or depletion during the period prior to its first taxable year beginning after December 31, 1969. However, where a private foundation has previously taken depreciation or depletion deductions in excess of the amount which would have been taken had the straight line or cost method been employed, such excess depreciation or depletion also shall be taken into account to reduce basis. If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to a donee private foundation, then the original basis to such foundation of such property shall be determined under the rules of § 1.1015–1(a)(3).

(iv) The deduction for expenses paid or incurred in any taxable year for the production of gross investment income earned as an incident to a charitable function shall be no greater than the income earned from such function which is includible as gross investment income for such year. For example, where rental income is incidentally realized in 1971 from historic buildings held open to the public, deductions for amounts paid or incurred in 1971 for the production of such income shall be

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limited to the amount of rental income includible as gross investment income for 1971.

(f) *Capital gain and losses*—(1) *General rule.* In determining capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for purposes of the tax imposed by section 4940, there shall be taken into account only capital gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program-related investments, as defined in section 4944(c)), and property used for the production of income included in computing the tax imposed by section 511 except to the extent gain or loss from the sale or other disposition of such property is taken into account for purposes of such tax. For taxable years beginning after December 31, 1972, property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interests, mortgages, and securities). Under this subparagraph, gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded. For example, gain or loss on the sale of the buildings used for the exempt activities of a private foundation would not be subject to the section 4940 tax. Where the foundation uses property for its exempt purposes, but also incidentally derives income from such property which is subject to the tax imposed by section 4940(a), any gain or loss resulting from the sale or other disposition of such property is not subject to the tax imposed by section 4940(a). For example, if a tax-exempt private foundation maintains buildings of a historical nature and keeps them open for public inspection, but requires a number of its employees to live in these buildings and charges the employees rent, the rent would be subject to the tax imposed by section 4940(a), but any gain or loss resulting from the sale of such property would not be subject to such tax. However, where the foundation uses property for both exempt purposes and (other than incidentally) for investment purposes (for example, a building in which the foundation's charitable and investment activities are carried on), that portion of any gain or loss from the sale or other disposition of such property which is allocable to the investment use of such property must be taken into account in computing capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such taxable year. For purposes of this paragraph, a distribution of property for purposes described in section 170(c) (1) or (2)(B) which is a qualifying distribution under section 4942 shall not be treated as a sale or other disposition of property.

(2) *Basis.* (i) The basis for purposes of determining gain from the sale or other disposition of property shall be the greater of:

(A) Fair market value on December 31, 1969, plus or minus all adjustments after December 31, 1969, and before the date of disposition under the rules of Part II of Subchapter O of Chapter 1, provided that the property was held by the private foundation on December 31, 1969, and continuously thereafter to the date of disposition, or

(B) Basis as determined under the rules of Part II of Subchapter O of Chapter 1,

subject to the provisions of section 4940(c)(3)(B) (and without regard to section 362(c)).

(ii) For purposes of determining loss from the sale or other disposition of property, basis as determined in subdivision (i)(B) of this subparagraph shall apply.

(3) *Losses.* Where the sale or other disposition of property referred to in section 4940(c)(4)(A) results in a capital loss, such loss may be subtracted from capital gains from the sale or other disposition of other such property during the same taxable year, but only to the extent of such gains. Should losses from the sale or other disposition of such property exceed gains from the sale or other disposition of such property during the same taxable year, such excess may not be deducted from gross investment income under section 4940(c)(3) in any taxable year, nor may

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00067 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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such excess by used to reduce gains in either prior or future taxable years, regardless of whether the foundation is a corporation or a trust.

(4) *Examples*. The provisions of this paragraph may be illustrated by the following examples:

Example 1. A private foundation holds certain depreciable real property on December 31, 1969, having a basis of $102,000. The fair market value of such property on that date was $100,000. For its taxable year 1970 the foundation was allowed depreciation for such property of $5,100 on the straight line method, the allowable amount computed on the $102,000 basis. The property was sold on January 1, 1971, for $100,000. Because fair market value on December 31, 1969, less straight line depreciation of $5,100 ($94,900) is less than basis as determined by Part II of Subchapter O of Chapter 1, $96,900 ($102,000 less $5,100), a gain of $3,100 is recognized (*i.e.*, sales price of $100,000 less the greater of the two possible bases).

Example 2. Assume the same facts in example 1, except that the sale price was $95,000. Because the sale price was $1,900 less than the basis for loss ($96,900 as determined by the application of subparagraph (2)(ii) of this paragraph), there is a capital loss of $1,900 which may be deducted against capital gains for 1971 (if any) in determining net capital gain (capital gain net income for taxable years beginning after December 31, 1976).

Example 3. A private foundation holds certain depreciable real property on December 31, 1969, having a basis of $102,000. The fair market value of such property on that date was $110,000. For its taxable year 1970 the foundation was allowed depreciation for such property of $5,100 on the straight line method, the allowable amount computed on the $102,000 basis. The property was sold on January 1, 1971, for $100,000. Fair market value on December 31, 1969, less straight line depreciation of $5,100 ($104,900) exceeds basis as determined by Part II of Subchapter O of Chapter 1, $96,900 ($102,000 less $5,100), and will be used for purposes of determining gain. Because basis for purposes of determining gain exceeds sale price, there is no gain. There is no loss because basis for purposes of determining loss ($96,900) is less than sale price.

[T.D. 7250, 38 FR 868, Jan. 5, 1973; 38 FR 7549, Mar. 23, 1973, as amended by T.D. 7407, 41 FR 9321, Mar. 4, 1976; T.D. 7606, 44 FR 18971, Mar. 30, 1979; T.D. 7728, 45 FR 72651, Nov. 3, 1980; T.D. 8423, 57 FR 33444, July 29, 1992]

Subpart B—Taxes on Self-Dealing

SOURCE: T.D. 7270, 38 FR 9493, Apr. 17, 1973, unless otherwise noted.

§ 53.4941(a)–1 Imposition of initial taxes.

(a) *Tax on self-dealer*—(1) *In general*. Section 4941(a)(1) of the code imposes an excise tax on each act of self-dealing between a disqualified person (as defined in section 4946(a)) and a private foundation. Except as provided in subparagraph (2) of this paragraph, this tax shall be imposed on a disqualified person even though he had no knowledge at the time of the act that such act constituted self-dealing. Notwithstanding the preceding two sentences, however, a transaction between a disqualified person and a private foundation will not constitute an act of self-dealing if:

(i) The transaction is a purchase or sale of securities by a private foundation through a stockbroker where normal trading procedures on a stock exchange or recognized over-the-counter market are followed;

(ii) Neither the buyer nor the seller of the securities nor the agent of either knows the identity of the other party involved; and

(iii) The sale is made in the ordinary course of business, and does not involve a block of securities larger than the average daily trading volume of that stock over the previous 4 weeks.

However, the preceding sentence shall not apply to a transaction involving a dealer who is a disqualified person acting as a principal or to a transaction which is an act of self-dealing pursuant to section 4941(d)(1)(B) and § 53.4941(d)–2(c)(1). The tax imposed by section 4941(a)(1) is at the rate of 5 percent of the amount involved (as defined in section 4941(e)(2) and § 53.4941(e)–1(b)) with respect to the act of self-dealing for each year or partial year in the taxable period (as defined in section 4941(e)(1)) and shall be paid by any disqualified person (other than a foundation manager acting only in the capacity of a foundation manager) who participates in the act of self-dealing. However, if a foundation manager is also acting as a self-dealer, he may be liable for both the tax imposed by section 4941(a)(1) and the tax imposed by section 4941(a)(2).

(2) *Government officials*. In the case of a government official (as defined in sec. 4946(a)), the tax shall be imposed

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00068 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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upon such government official who participates in an act of self-dealing, only if he knows that such act is an act of self-dealing. See paragraph (b)(3) of this section for a definition of *knowing*.

(3) *Participation*. For purposes of this paragraph, a disqualified person shall be treated as participating in an act of self-dealing in any case in which he engages or takes part in the transaction by himself or with others, or directs any person to do so.

(b) *Tax on foundation manager*—(1) *In general*. Section 4941(a)(2) of the code imposes an excise tax on the participation of any foundation manager in an act of self-dealing between a disqualified person and a private foundation. This tax is imposed only in cases in which the following circumstances are present:

(i) A tax is imposed by section 4941(a)(1),

(ii) Such participating foundation manager knows that the act is an act of self-dealing, and

(iii) The participation by the foundation manager is willful and is not due to reasonable cause.

The tax imposed by section 4941(a)(2) is at the rate of 2½ percent of the amount involved with respect to the act of self-dealing for each year or partial year in the taxable period and shall be paid by any foundation manager described in subdivisions (ii) and (iii) of this subparagraph.

(2) *Participation*. The term ''participation'' shall include silence or inaction on the part of a foundation manager where he is under a duty to speak or act, as well as any affirmative action by such manager. However, a foundation manager will not be considered to have participated in an act of self-dealing where he has opposed such act in a manner consistent with the fulfillment of his responsibilities to the private foundation.

(3) *Knowing*. For purposes of section 4941, a person shall be considered to have participated in a transaction ''knowing'' that it is an act of self-dealing only if:

(i) He has actual knowledge of sufficient facts so that, based solely upon such facts, such transaction would be an act of self-dealing,

(ii) He is aware that such an act under these circumstances may violate the provisions of Federal tax law governing self-dealing, and

(iii) He negligently fails to make reasonable attempts to ascertain whether the transaction is an act of self-dealing, or he is in fact aware that it is such an act.

For purposes of this part and Chapter 42, the term ''knowing'' does not mean ''having reason to know''. However, evidence tending to show that a person has reason to know of a particular fact or particular rule is relevant in determining whether he had actual knowledge of such fact or rule. Thus, for example, evidence tending to show that a person has reason to know of sufficient facts so that, based solely upon such facts, a transaction would be an act of self-dealing is relevant in determining whether he has actual knowledge of such facts.

(4) *Willful*. Participation by a foundation manager shall be deemed willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by a foundation manager is not willful if he does not know that the transaction in which he is participating is an act of self-dealing.

(5) *Due to reasonable cause*. A foundation manager's participation is due to reasonable cause if he has exercised his responsibility on behalf of the foundation with ordinary business care and prudence.

(6) *Advice of counsel*. If a person, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of such counsel expressed in a reasoned written legal opinion that an act is not an act of self-dealing under section 4941, although such act is subsequently held to be an act of self-dealing, the person's participation in such act will ordinarily not be considered ''knowing'' or ''willful'' and will ordinarily be considered ''due to reasonable cause'' within the meaning of section 4941(a)(2). For purposes of this subparagraph, a written legal opinion will be considered ''reasoned'' even if it reaches a conclusion which is subsequently determined

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to be incorrect so long as such opinion addresses itself to the facts and applicable law. However, a written legal opinion will not be considered ''reasoned'' if it does nothing more than recite the facts and express a conclusion. However, the absence of advice of counsel with respect to an act shall not, by itself, give rise to any inference that a person participated in such act knowingly, willfully, or without reasonable cause.

(c) *Burden of proof.* For provisions relating to the burden of proof in cases involving the issue whether a foundation manager or a government official has knowingly participated in an act of self-dealing, see section 7454(b).

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 7299, 38 FR 35304, Dec. 27, 1973]

§ 53.4941(b)–1 Imposition of additional taxes.

(a) *Tax on self-dealer.* Section 4941(b)(1) of the Code imposes an excise tax in any case in which an initial tax is imposed by section 4941(a)(1) on an act of self-dealing by a disqualified person with a private foundation and the act is not corrected within the taxable period (as defined in § 53.4941(e)–1(a)). The tax imposed by section 4941(b)(1) is at the rate of 200 percent of the amount involved and shall be paid by any disqualified person (other than a foundation manager action only in the capacity of a foundation manager) who participated in the act of self-dealing.

(b) *Tax on foundation manager.* Section 4941(b)(2) of the Code imposes an excise tax to be paid by a foundation manager in any case in which a tax is imposed by section 4941(b)(1) and the foundation manager refused to agree to part or all of the correction of the self-dealing act. The tax imposed by section 4941(b)(2) is at the rate of 50 percent of the amount involved and shall be paid by any foundation manager who refused to agree to part or all of the correction of the self-dealing act. For the limitations on liability of a foundation manager, see § 53.4941(c)–1(b).

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 8084, 51 FR 16301, May 2, 1986]

§ 53.4941(c)–1 Special rules.

(a) *Joint and several liability.* (1) In any case where more than one person is liable for the tax imposed by any paragraph of section 4941 (a) or (b), all such persons shall be jointly and severally liable for the taxes imposed under such paragraph with respect to such act of self-dealing.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. A and B, who are managers of private foundation X, lend one of the foundation's paintings to G, a disqualified person, for display in G's office, in a transaction which gives rise to liability for tax under section 4941(a)(2) (relating to tax on foundation managers). An initial tax is imposed on both A and B with respect to the act of lending the foundation's painting to G. A and B are jointly and severally liable for the tax.

(b) *Limits on liability for management.* (1) The maximum aggregate amount of tax collectible under section 4941(a)(2) from all foundation managers with respect to any one act of self-dealing shall be $10,000, and the maximum aggregate amount of tax collectible under section 4941(b)(2) from all foundation managers with respect to any one act of self-dealing shall be $10,000.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. A, a disqualified person with respect to private foundation Y, sells certain real estate having a fair market value of $500,000 to Y for $500,000 in cash. B, C, and D, all the managers of foundation Y, authorized the purchase on Y's behalf knowing that such purchase was an act of self-dealing. The actions of B, C, and D in approving the purchase were willful and not due to reasonable cause. Initial taxes are imposed upon the foundation managers under subsections (a)(2) and (c)(2) of section 4941. The tax to be paid by the foundation managers is $10,000 (the lesser of $10,000 or 2½ percent of the amount involved). The managers are jointly and severally liable for this $10,000, and this sum may be collected by the Internal Revenue Service from any one of them.

§ 53.4941(d)–1 Definition of self-dealing.

(a) *In general.* For purposes of section 4941, the term *self-dealing* means any direct or indirect transaction described in § 53.4941(d)–2. For purposes of this

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section, it is immaterial whether the transaction results in a benefit or a detriment to the private foundation. The term ''self-dealing'' does not, however, include a transaction between a private foundation and a disqualified person where the disqualified person status arises only as a result of such transaction. For example, the bargain sale of property to a private foundation is not a direct act of self-dealing if the seller becomes a disqualified person only by reason of his becoming a substantial contributor as a result of the bargain element of the sale. For the effect of sections 4942, 4943, 4944, and 4945 upon an act of self-dealing which also results in the imposition of tax under one or more of such sections, see the regulations under those sections.

(b) *Indirect self-dealing*—(1) *Certain business transactions.* The term ''indirect self-dealing'' shall not include any transaction described in §53.4941(d)–2 between a disqualified person and an organization controlled by a private foundation (within the meaning of paragraph (6)(5) of this section) if:

(i) The transaction results from a business relationship which was established before such transaction constituted an act of self-dealing (without regard to this paragraph),

(ii) The transaction was at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person, and

(iii) Either:

(*a*) The organization controlled by the foundation could have engaged in the transaction with someone other than a disqualified person only at a severe economic hardship to such organization, or

(*b*) Because of the unique nature of the product or services provided by the organization controlled by the foundation, the disqualified person could not have engaged in the transaction with anyone else, or could have done so only by incurring severe economic hardship. See example (2) of subparagraph (8) of this paragraph.

(2) *Grants to intermediaries.* The term ''indirect self-dealing'' shall not include a transaction engaged in with a government official by an intermediary organization which is a recipient of a grant from a private foundation and which is not controlled by such foundation (within the meaning of paragraph (6) (5) of this section) if the private foundation does not earmark the use of the grant for any named government official and there does not exist an agreement, oral or written, whereby the grantor foundation may cause the selection of the government official by the intermediary organization. A grant by a private foundation is earmarked if such grant is made pursuant to an agreement, either oral or written, that the grant will be used by any named individual. Thus, a grant by a private foundation shall not constitute an indirect act of self-dealing even though such foundation had reason to believe that certain government officials would derive benefits from such grant so long as the intermediary organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation. See example (3) of subparagraph (8) of this paragraph.

(3) *Transactions during the administration of an estate or revocable trust.* The term ''indirect self-dealing'' shall not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if:

(i) The administrator or executor of an estate or trustee of a revocable trust either:

(*a*) Possesses a power of sale with respect to the property,

(*b*) Has the power to reallocate the property to another beneficiary, or

(*c*) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

(ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);

(iii) Such transaction occurs before the estate is considered terminated for Federal income tax purposes pursuant to paragraph (a) of §1.641(b)–3 of this

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chapter (or in the case of a revocable trust, before it is considered subject to sec. 4947);

(iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

(v) With respect to transactions occurring after April 16, 1973, the transaction either:

(*a*) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

(*b*) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or

(*c*) Is required under the terms of any option which is binding on the estate (or trust).

(4) *Transactions with certain organizations.* A transaction between a private foundation and an organization which is not controlled by the foundation (within the meaning of subparagraph (5) of this paragraph), and which is not described in section 4946(a)(1) (E), (F), or (G) because persons described in section 4946(a)(1) (A), (B), (C), or (D) own no more than 35 percent of the total combined voting power or profits or beneficial interest of such organization, shall not be treated as an indirect act of self-dealing between the foundation and such disqualified persons solely because of the ownership interest of such persons in such organization.

(5) *Control.* For purposes of this paragraph, an organization is controlled by a private foundation if the foundation or one or more of its foundation managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute self-dealing. Similarly, for purposes of this paragraph, an organization is controlled by a private foundation in the case of such a transaction between the organization and a disqualified person, if such disqualified person, together with one or more persons who are disqualified persons by reason of such a person's relationship (within the meaning of section 4946(a)(1) (C) through (G)) to such disqualified person, may, only by aggregating their votes or positions of authority with that of the foundation, require the organization to engage in such a transaction. The ''controlled'' organization need not be a private foundation; for example, it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization. For purposes of this paragraph, an organization will be considered to be controlled by a private foundation or by a private foundation and disqualified persons referred to in the second sentence of this subparagraph if such persons are able, in fact, to control the organization (even if their aggregate voting power is less than 50 percent of the total voting power of the organization's governing body) or if one or more of such persons has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing. A private foundation shall not be regarded as having control over an organization merely because it exercises expenditure responsibility (as defined in section 4945 (d)(4) and (h)) with respect to contributions to such organization. See example (6) of subparagraph (8) of this paragraph.

(6) *Certain transactions involving limited amounts.* The term ''indirect self-dealing'' shall not include any transaction between a disqualified person and an organization controlled by a private foundation (within the meaning of subparagraph (5) of this paragraph) or between two disqualified persons where the foundation's assets may be affected by the transaction if:

(i) The transaction arises in the normal and customary course of a retail business engaged in with the general public,

(ii) In the case of a transaction between a disqualified person and an organization controlled by a private foundation, the transaction is at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person, and

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(iii) The total of the amounts involved in such transactions with respect to any one such disqualified person in any one taxable year does not exceed $5,000.

See example (7) of subparagraph (8) of this paragraph.

(7) *Applicability of statutory exceptions to indirect self-dealing.* The term ''indirect self-dealing'' shall not include a transaction involving one or more disqualified persons to which a private foundation is not a party, in any case in which the private foundation, by reason of section 4941(d)(2), could itself engage in such a transaction. Thus, for example, even if a private foundation has control (within the meaning of subparagraph (5) of this paragraph) of a corporation, the corporation may pay to a disqualified person, except a government official, reasonable compensation for personal services.

(8) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. Private foundation P owns the controlling interest of the voting stock of corporation X, and as a result of such interest, elects a majority of the board of directors of X. Two of the foundation managers, A and B, who are also directors of corporation X, form corporation Y for the purpose of building and managing a country club. A and B receive a total of 40 percent of Y's stock, making Y a disqualified person with respect to P under section 4946(a)(1)(E). In order to finance the construction and operation of the country club, Y requested and received a loan in the amount of $4 million from X. The making of the loan by X to Y shall constitute an indirect act of self-dealing between P and Y.

Example 2. Private foundation W owns the controlling interest of the voting stock of corporation X, a manufacturer of certain electronic computers. Corporation Y, a disqualified person with respect to W, owns the patent for, and manufactures, one of the essential component parts used in the computers. X has been making regular purchases of the patented component from Y since 1965, subject to the same terms as all other purchasers of such component parts. X could not buy similar components from another source. Consequently, X would suffer severe economic hardship if it could not continue to purchase these components from Y, since it would then be forced to develop a computer which could be constructed with other components. Under these circumstances, the continued purchase by X from Y of these components shall not be an indirect act of self-dealing between W and Y.

Example 3. Private foundation Y made a grant to M University, an organization described in section 170(b)(1)(A)(ii), for the purpose of conducting a seminar to study methods for improving the administration of the judicial system. M is not controlled by Y within the meaning of subparagraph (5) of this paragraph. In conducting the seminar, M made payments to certain government officials. By the nature of the grant, Y had reason to believe that government officials would be compensated for participation in the seminar. M, however, had completely independent control over the selection of such participants. Thus, such grant by Y shall not constitute an indirect act of self-dealing with respect to the government officials.

Example 4. A, a substantial contributor to P, a private foundation, bequeathed one-half of his estate to his spouse and one-half of his estate to P. Included in A's estate is a one-third interest in AB, a partnership. The other two-thirds interest in AB is owned by B, a disqualified person with respect to P. The one-third interest in AB was subject to an option agreement when it was acquired by the estate. The executor of A's estate sells the one-third interest in AB to B pursuant to such option agreement at the price fixed in such option agreement in a sale which meets the requirements of subparagraph (3) of this paragraph. Under these circumstances, the sale does not constitute an indirect act of self-dealing between B and P.

Example 5. A bequeathed $100,000 to his wife and a piece of unimproved real estate of equivalent value to private foundation Z, of which A was the creator and a foundation manager. Under the laws of State Y, to which the estate is subject, title to the real estate vests in the foundation upon A's death. However, the executor has the power under State law to reallocate the property to another beneficiary. During a reasonable period for administration of the estate, the executor exercises this power and distributes the $100,000 cash to the foundation and the real estate to A's wife. The probate court having jurisdiction over the estate approves the executor's action. Under these circumstances, the executor's action does not constitute an indirect act of self-dealing between the foundation and A's wife.

Example 6. Private foundation P owns 20 percent of the voting stock of corporation W. A, a substantial contributor with respect to P, owns 16 percent of the voting stock of corporation W. B, A's son, owns 15 percent of the voting stock of corporation W. The terms of the voting stock are such that P, A, and B could vote their stock in a block to elect a majority of the board of directors of W. W is treated as controlled by P (within the

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meaning of subparagraph (5) of this paragraph) for purposes of this example A and B also own 50 percent of the stock of corporation Y, making Y a disqualified person with respect to P under section 4946(a)(1)(E). W makes a loan to Y of $1 million. The making of this loan by W to Y shall constitute an indirect act of self-dealing between P and Y.

Example 7. A, a disqualified person with respect to private foundation P, enters into a contract with corporation M, which is also a disqualified person with respect to P. P owns 20 percent of M's stock, and controls M within the meaning of subparagraph (5) of this paragraph. M is in the retail department store business. Purchases by A of goods sold by M in the normal and customary course of business at retail or higher prices are not indirect acts of self-dealing so long as the total of the amounts involved in all of such purchases by A in any one year does not exceed $5,000.

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended at 38 FR 12604, May 14, 1973]

§ 53.4941(d)–2 Specific acts of self-dealing.

Except as provided in § 53.4941(d)–3 or § 53.4941(d)–4:

(a) *Sale or exchange of property*—(1) *In general.* The sale or exchange of property between a private foundation and a disqualified person shall constitute an act of self-dealing. For example, the sale of incidental supplies by a disqualified person to a private foundation shall be an act of self-dealing regardless of the amount paid to the disqualified person for the incidental supplies. Similarly, the sale of stock or other securities by a disqualified person to a private foundation in a ''bargain sale'' shall be an act of self-dealing regardless of the amount paid for such stock or other securities. An installment sale may be subject to the provisions of both section 4941(d)(1)(A) and section 4941(d)(1)(B).

(2) *Mortgaged property.* For purposes of subparagraph (1) of this paragraph, the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the foundation assumes a mortgage or similar lien which was placed on the property prior to the transfer, or takes subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of transfer. For purposes of this subparagraph, the term ''similar lien'' shall include, but is not limited to, deeds of trust and vendors' liens, but shall not include any other lien if such lien is insignificant in relation to the fair market value of the property transferred.

(b) *Leases*—(1) *In general.* Except as provided in subparagraphs (2) and (3) of this paragraph, the leasing of property between a disqualified person and a private foundation shall constitute an act of self-dealing.

(2) *Certain leases without charge.* The leasing of property by a disqualified person to a private foundation shall not be an act of self-dealing if the lease is without charge. For purposes of this subparagraph, a lease shall be considered to be without charge even though the private foundation pays for janitorial services, utilities, or other maintenance costs it incurs for the use of the property, so long as the payment is not made directly or indirectly to a disqualified person.

(3) *Certain leases of office space.* For taxable years beginning after December 31, 1979, the leasing of office space by a disqualified person to a private foundation shall not be an act of self-dealing if:

(i) The leased space is in a building in which there are other tenants who are not disqualified persons,

(ii) The lease is pursuant to a binding lease which was in effect on October 9, 1969, or pursuant to renewals of such a lease,

(iii) The execution of the lease was not a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law) at the time of such execution, and

(iv) The terms of the lease (or any renewal) reflect an arm's length transaction.

A lease or renewal of such lease is described in this subparagraph (3) only if it satisfies the requirements of § 53.4941(d)–4(c) (1) and (2), applied without regard to the December 31, 1979 deadline described therein.

(c) *Loans*—(1) *In general.* Except as provided in subparagraphs (2), (3), and (4) of this paragraph, the lending of money or other extension of credit between a private foundation and a disqualified person shall constitute an act

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of self-dealing. Thus, for example, an act of self-dealing occurs where a third party purchases property and assumes a mortgage, the mortgagee of which is a private foundation, and subsequently the third party transfers the property to a disqualified person who either assumes liability under the mortgage or takes the property subject to the mortgage. Similarly, except in the case of the receipt and holding of a note pursuant to a transaction described in § 53.4941(d)–1(b)(3), an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note.

(2) *Loans without interest.* Subparagraph (1) of this paragraph shall not apply to the lending of money or other extension of credit by a disqualified person to a private foundation if the loan or other extension of credit is without interest or other charge.

(3) *Certain evidences of future gifts.* The making of a promise, pledge, or similar arrangement to a private foundation by a disqualified person, whether evidenced by an oral or written agreement, a promissory note, or other instrument of indebtedness, to the extent motivated by charitable intent and unsupported by consideration, is not an extension of credit (within the meaning of this paragraph) before the date of maturity.

(4) *General banking functions.* Under section 4941(d)(2)(E) the performance by a bank or trust company which is a disqualified person of trust functions and certain general banking services for a private foundation is not an act of self-dealing, where the banking services are reasonable and necessary to carrying out the exempt purposes of the private foundation, if the compensation paid to the bank or trust company, taking into account the fair interest rate for the use of the funds by the bank or trust company, for such services is not excessive. The general banking services allowed by this subparagraph are:

(i) Checking accounts, as long as the bank does not charge interest on any overwithdrawals,

(ii) Savings accounts, as long as the foundation may withdraw its funds on no more than 30-days notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit, and

(iii) Safekeeping activities.

See example (3) § 53.4941(d)–3(c)(2).

(d) *Furnishing goods, services, or facilities*—(1) *In general.* Except as provided in subparagraph (2) or (3) of this paragraph (or § 53.4941(d)–3(b)), the furnishing of goods, services, or facilities between a private foundation and a disqualified person shall constitute an act of self-dealing. This subparagraph shall apply, for example, to the furnishing of goods, services, or facilities such as office space, automobiles, auditoriums, secretarial help, meals, libraries, publications, laboratories, or parking lots. Thus, for example, if a foundation furnishes personal living quarters to a disqualified person (other than a foundation manager or employee) without charge, such furnishing shall be an act of self-dealing.

(2) *Furnishing of goods, services, or facilities to foundation managers and employees.* The furnishing of goods, services, or facilities such as those described in subparagraph (1) of this paragraph to a foundation manager in recognition of his services as a foundation manager, or to another employee (including an individual who would be an employee but for the fact that he receives no compensation for his services) in recognition of his services in such capacity, is not an act of self-dealing if the value of such furnishing (whether or not includible as compensation in his gross income) is reasonable and necessary to the performance of his tasks in carrying out the exempt purposes of the foundation and, taken in conjunction with any other payment of compensation or payment or reimbursement of expenses to him by the foundation, is not excessive. For example, if a foundation furnishes meals and lodging which are reasonable and necessary (but not excessive) to a foundation manager by reason of his being a foundation manager, then, without regard to whether such meals and lodging are excludable from gross income under section 119 as furnished for the convenience of the employer, such furnishing is not an act of self-dealing. For the effect of section

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4945(d)(5) upon an expenditure for unreasonable administrative expenses, see § 53.4945–6(b)(2).

(3) *Furnishing of goods, services, or facilities by a disqualified person without charge.* The furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if they are furnished without charge. Thus, for example, the furnishing of goods such as pencils, stationery, or other incidental supplies, or the furnishing of facilities such as a building, by a disqualified person to a foundation shall be allowed if such supplies or facilities are furnished without charge. Similarly, the furnishing of services (even though such services are not personal in nature) shall be permitted if such furnishing is without charge. For purposes of this subparagraph, a furnishing of goods shall be considered without charge even though the private foundation pays for transportation, insurance, or maintenance costs it incurs in obtaining or using the property, so long as the payment is not made directly or indirectly to the disqualified person.

(e) *Payment of compensation.* The payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person shall constitute an act of self-dealing. See, however, § 53.4941(d)–3(c) for the exception for the payment of compensation by a foundation to a disqualified person for personal services which are reasonable and necessary to carry out the exempt purposes of the foundation.

(f) *Transfer or use of the income or assets of a private foundation*—(1) *In general.* The transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation shall constitute an act of self-dealing. For purposes of the preceding sentence, the purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in an attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person. Similarly, the indemnification (of a lender) or guarantee (of repayment) by a private foundation with respect to a loan to a disqualified person shall be treated as a use for the benefit of a disqualified person of the income or assets of the foundation (within the meaning of this subparagraph). In addition, if a private foundation makes a grant or other payment which satisfies the legal obligation of a disqualified person, such grant or payment shall ordinarily constitute an act of self-dealing to which this subparagraph applies. However, if a private foundation makes a grant or payment which satisfies a pledge, enforceable under local law, to an organization described in section 501(c)(3), which pledge is made on or before April 16, 1973, such grant or payment shall not constitute an act of self-dealing to which this subparagraph applies so long as the disqualified person obtains no substantial benefit, other than the satisfaction of his obligation, from such grant or payment.

(2) *Certain incidental benefits.* The fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing. Thus, the public recognition a person may receive, arising from the charitable activities of a private foundation to which such person is a substantial contributor, does not in itself result in an act of self-dealing since generally the benefit is incidental and tenuous. For example, a grant by a private foundation to a section 509(a) (1), (2), or (3) organization will not be an act of self-dealing merely because such organization is located in the same area as a corporation which is a substantial contributor to the foundation, or merely because one of the section 509(a) (1), (2), or (3) organization's officers, directors, or trustees is also a manager of or a substantial contributor to the foundation. Similarly, a scholarship or a fellowship grant to a person other than a disqualified person, which is paid or incurred by a private foundation in accordance with a program which is consistent with:

(i) The requirements of the foundation's exempt status under section 501(c)(3),

(ii) The requirements for the allowance of deductions under section 170 for

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contributions made to the foundation, and

(iii) The requirements of section 4945(g)(1),

will not be an act of self-dealing under section 4941(d)(1) merely because a disqualified person indirectly receives an incidental benefit from such grant. Thus, a scholarship or a fellowship grant made by a private foundation in accordance with a program to award scholarships or fellowship grants to the children of employees of a substantial contributor shall not constitute an act of self-dealing if the requirements of the preceding sentence are satisfied. For an example of the kind of scholarship program with an employment nexus that meets the above requirements, see § 53.4945–4(b)(5) (example 1).

(3) *Non-compensatory indemnification of foundation managers against liability for defense in civil proceedings.* (i) Except as provided in § 53.4941(d)–3(c), section 4941(d)(1) shall not apply to the indemnification by a private foundation of a foundation manager, with respect to the manager's defense in any civil judicial or civil administrative proceeding arising out of the manager's performance of services (or failure to perform services) on behalf of the foundation, against all expenses (other than taxes, including taxes imposed by chapter 42, penalties, or expenses of correction) including attorneys' fees, judgments and settlement expenditures if—

(A) Such expenses are reasonably incurred by the manager in connection with such proceeding; and

(B) The manager has not acted willfully and without reasonable cause with respect to the act or failure to act which led to such proceeding or to liability for tax under chapter 42.

(ii) Similarly, except as provided in § 53.4941(d)–3(c), section 4941(d)(1) shall not apply to premiums for insurance to make or to reimburse a foundation for an indemnification payment allowed pursuant to this paragraph (f)(3). Neither shall an indemnification or payment of insurance allowed pursuant to this paragraph (f)(3) be treated as part of the compensation paid to such manager for purposes of determining whether the compensation is reasonable under chapter 42.

(4) *Compensatory indemnification of foundation managers against liability for defense in civil proceedings.* (i) The indemnification by a private foundation of a foundation manager for compensatory expenses shall be an act of self-dealing under this paragraph unless when such payment is added to other compensation paid to such manager the total compensation is reasonable under chapter 42. A compensatory expense for purposes of this paragraph (f) is—

(A) Any penalty, tax (including a tax imposed by chapter 42), or expense of correction that is owed by the foundation manager;

(B) Any expense not reasonably incurred by the manager in connection with a civil judicial or civil administrative proceeding arising out of the manager's performance of services on behalf of the foundation; or

(C) Any expense resulting from an act or failure to act with respect to which the manager has acted willfully and without reasonable cause.

(ii) Similarly, the payment by a private foundation of the premiums for an insurance policy providing liability insurance to a foundation manager for expenses described in this paragraph (f)(4) shall be an act of self-dealing under this paragraph (f) unless when such premiums are added to other compensation paid to such manager the total compensation is reasonable under chapter 42.

(5) *Insurance allocation.* A private foundation shall not be engaged in an act of self-dealing if the foundation purchases a single insurance policy to provide its managers both the noncompensatory and the compensatory coverage discussed in this paragraph (f), provided that the total insurance premium is allocated and that each manager's portion of the premium attributable to the compensatory coverage is included in that manager's compensation for purposes of determining reasonable compensation under chapter 42.

(6) *Indemnification.* For purposes of this paragraph (f), the term *indemnification* shall include not only reimbursement by the foundation for expenses that the foundation manager

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has already incurred or anticipates incurring but also direct payment by the foundation of such expenses as the expenses arise.

(7) *Taxable income.* The determination of whether any amount of indemnification or insurance premium discussed in this paragraph (f) is included in the manager's gross income for individual income tax purposes is made on the basis of the provisions of chapter 1 and without regard to the treatment of such amount for purposes of determining whether the manager's compensation is reasonable under chapter 42.

(8) *De minimis items.* Any property or service that is excluded from income under section 132(a)(4) may be disregarded for purposes of determining whether the recipient's compensation is reasonable under chapter 42.

(9) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. M, a private foundation, makes a grant of $50,000 to the governing body of N City for the purpose of alleviating the slum conditions which exist in a particular neighborhood of N. Corporation P, a substantial contributor to M, is located in the same area in which the grant is to be used. Although the general improvement of the area may constitute an incidental and tenuous benefit to P, such benefit by itself will not constitute an act of self-dealing.

Example 2. Private foundation X established a program to award scholarship grants to the children of employees of corporation M, a substantial contributor to X. After disclosure of the method of carrying out such program, X received a determination letter from the Internal Revenue Service stating that X is exempt from taxation under section 501(c)(3), that contributions to X are deductible under section 170, and that X's scholarship program qualifies under section 4945(g)(1). A scholarship grant to a person not a disqualified person with respect to X paid or incurred by X in accordance with such program shall not be an indirect act of self-dealing between X and M.

Example 3. Private foundation Y owns voting stock in corporation Z, the management of which includes certain disqualified persons with respect to Y. Prior to Z's annual stockholder meeting, the management solicits and receives the foundation's proxies. The transfer of such proxies in and of itself shall not be an act of self-dealing.

Example 4. A, a disqualified person with respect to private foundation S, contributes certain real estate to S for the purpose of building a neighborhood recreation center in a particular underprivileged area. As a condition of the gift, S agrees to name the recreation center after A. Since the benefit to A is only incidental and tenuous, the naming of the recreation center, by itself, will not be an act of self-dealing.

(g) *Payment to a government official.* Except as provided in section 4941(d)(2)(G) or § 53.4941(d)–3(e), the agreement by a private foundation to make any payment of money or other property to a government official, as defined in section 4946(c), shall constitute an act of self-dealing. For purposes of this paragraph, an individual who is otherwise described in section 4946(c) shall be treated as a government official while on leave of absence from the government without pay.

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 7938, 49 FR 3848, Jan. 31, 1984; T.D. 8639, 60 FR 65568, Dec. 20, 1995]

§ 53.4941(d)–3 Exceptions to self-dealing.

(a) *General rule.* In general, a transaction described in section 4941(d)(2) (B), (C), (D), (E), (F), (G), or (H) is not an act of self-dealing. Section 4941(d)(2) (B), (C), and (H) provide limited exceptions to certain specific transactions, as described in paragraphs (b)(2), (b)(3), (c)(2), and (d)(3) of § 53.4941(d)–2. Section 4941(d)(2) (D), (E), (F), and (G) and paragraphs (b) through (e) of this section described certain transactions which are not acts of self-dealing.

(b) *Furnishing of goods, services, or facilities to a disqualified person*—(1) *In general.* Under section 4941(d)(2)(D), the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such goods, services, or facilities are made available to the general public on at least as favorable a basis as they are made available to the disqualified person. This subparagraph shall not apply, however, in the case of goods, services, or facilities furnished later than May 16, 1973, unless such goods, services, or facilities are functionally related, within the meaning of section 4942(j)(5), to the exercise or performance by a private foundation of its charitable, educational, or other purpose or function constituting the

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basis for its exemption under section 501(c)(3).

(2) *General public.* For purposes of this paragraph, the term ''general public'' shall include those persons who, because of the particular nature of the activities of the private foundation, would be reasonably expected to utilize such goods, services, or facilities. This paragraph shall not apply, however, unless there is a substantial number of persons other than disqualified persons who are actually utilizing such goods, services, or facilities. Thus, a private foundation which furnishes recreational or park facilities to the general public may furnish such facilities to a disqualified person provided they are furnished to him on a basis which is not more favorable than that on which they are furnished to the general public. Similarly, the sale of a book or magazine by a private foundation to disqualified persons shall not be an act of self-dealing if the publication of such book or magazine is functionally related to a charitable or educational activity of the foundation and the book or magazine is made available to the disqualified persons and the general public at the same price. In addition, if the terms of the sale require, for example, payment within 60 days from the date of delivery of the book or magazine, such terms are consistent with normal commercial practices, and payment is made within the 60-day period, the transaction shall not be treated as a loan or other extension of credit under § 53.4941(d)–2(c)(1).

(c) *Payment of compensation for certain personal services*—(1) *In general.* Under section 4941(d)(2)(E), except in the case of a Government official (as defined in section 4946(c)), the payment of compensation (and the payment or reimbursement of expenses, including reasonable advances for expenses anticipated in the immediate future) by a private foundation to a disqualified person for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of the private foundation shall not be an act of self-dealing if such compensation (or payment or reimbursement) is not excessive. For purposes of this subparagraph the term ''personal services'' includes the services of a broker serving as agent for the private foundation, but not the services of a dealer who buys from the private foundation as principal and resells to third parties. For the determination whether compensation is excessive, see § 1.162–7 of this chapter (Income Tax Regulations). This paragraph applies without regard to whether the person who receives the compensation (or payment or reimbursement) is an individual. The portion of any payment which represents payment for property shall not be treated as payment of compensation (or payment or reimbursement of expenses) for the performance of personal services for purposes of this paragraph. For rules with respect to the performance of general banking services, see § 53.4941(d)–2(c)(4). Further, the making of a cash advance to a foundation manager or employee for expenses on behalf of the foundation is not an act of self-dealing, so long as the amount of the advance is reasonable in relation to the duties and expense requirements of the foundation manager. Except where reasonably allowable pursuant to subdivision (iii) of this subparagraph, such advances shall not ordinarily exceed $500. For example, if a foundation makes an advance to a foundation manager to cover anticipated out-of-pocket current expenses for a reasonable period (such as a month) and the manager accounts to the foundation under a periodic reimbursement program for actual expenses incurred, the foundation will not be regarded as having engaged in an act of self-dealing:

(i) When it makes the advance,

(ii) When it replenishes the funds upon receipt of supporting vouchers from the foundation manager, or

(iii) If it temporarily adds to the advance to cover extraordinary expenses anticipated to be incurred in fulfillment of a special assignment (such as long distance travel).

(2) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. M, a partnership, is a firm of 10 lawyers engaged in the practice of law. A and B, partners in M, serve as trustees to private foundation W and, therefore, are disqualified persons. In addition, A and B own more than 35 percent of the profits interest in M, thereby making M a disqualified person. M performs various legal services for W from time

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to time as such services are requested. The payment of compensation by W to M shall not constitute an act of self-dealing if the services performed are reasonable and necessary for the carrying out of W's exempt purposes and the amount paid by W for such services is not excessive.

Example 2. C, a manager of private foundation X, owns an investment counseling business. Acting in his capacity as an investment counselor, C manages X's investment portfolio for which he receives an amount which is determined to be not excessive. The payment of such compensation to C shall not constitute an act of self-dealing.

Example 3. M, a commercial bank, serves as a trustee for private foundation Y. In addition to M's duties as trustee, M maintains Y's checking and savings accounts and rents a safety deposit box to Y. The use of the funds by M and the payment of compensation by Y to M for such general banking services shall be treated as the payment of compensation for the performance of personal services which are reasonable and necessary to carry out the exempt purposes of Y if such compensation is not excessive.

Example 4. D, a substantial contributor to private foundation Z, owns a factory which manufactures microscopes. D contracts with Z to manufacture 100 microscopes for Z. Any payment to D under the contract shall constitute an act of self-dealing, since such payment does not constitute the payment of compensation for the performance of personal services.

(d) *Certain transactions between a foundation and a corporation*—(1) *In general.* Under section 4941(d)(2)(F), any transaction between a private foundation and a corporation which is a disqualified person will not be an act of self-dealing if such transaction is engaged in pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, so long as all the securities of the same class as that held (prior to such transaction) by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value. For purposes of this paragraph, all of the securities are not "subject to the same terms unless, pursuant to such transaction," The corporation makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities. The fact that a private foundation receives property, such as debentures, while all other persons holding securities of the same class receive cash for their interests, will be evidence that such offer was not made on a uniform basis. This paragraph may apply even if no other person holds any securities of the class held by the foundation. In such event, however, the consideration received by holders of other classes of securities, or the interests retained by holders of such other classes, when considered in relation to the consideration received by the foundation, must indicate that the foundation received at least as favorable treatment in relation to its interests as the holders of any other class of securities. In addition, the foundation must receive no less than the fair market value of its interests.

(2) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. Private foundation X owns 50 percent of the class A preferred stock of corporation M, which is a disqualified person with respect to X. The terms of such securities provide that the stock may be called for redemption at any time by M at 105 percent of the face amount of the stock. M exercises this right and calls all the class A preferred stock by paying 105 percent of the face amount in cash. At the time of the redemption of the class A preferred stock, it is determined that the fair market value of the preferred stock is equal to its face amount. In such case, the redemption by M of the preferred stock of X is not an act of self-dealing.

Example 2. Private foundation Y, which is on a calendar year basis, acquires 60 percent of the class A preferred stock of corporation N by will on January 10, 1970. N, which is also on a calendar year basis, is a disqualified person with respect to Y. In 1971, N offers to redeem all of the class A preferred stock for a consideration equal to 100 percent of the face amount of such stock by the issuance of debentures. The offer expires January 2, 1972. Both Y and all other holders of the class A preferred stock accept the offer and enter into the transaction on January 2, 1972, at which time it is determined that the fair market value of the debentures is no less than the fair market value of the preferred stock. The transaction on January 2, 1972, shall not be treated as an act of self-dealing for 1972. However, because under § 53.4941 (e)–1 (e)(1)(i) an act of self dealing occurs on the first day of each taxable year or portion of a taxable year that an extension of credit from a foundation to a disqualified person goes uncorrected, if such debentures are held by Y after December 31, 1972, except as provided in § 53.4941(d)–4(c)(4),

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such extension of credit shall not be excepted from the definition of an act of self dealing by reason of the January 2, 1972, transaction. See § 53.4941(d)–4(c)(4) for rules indicating that under certain circumstances such debentures could be held by Y until December 31, 1979.

(e) *Certain payments to government officials.* Under section 4941(d)(2)(G), in the case of a government official, in addition to the exceptions provided in section 4941(d)(2) (B), (C), and (D), section 4941(d)(1) shall not apply to:

(1) A prize or award which is not includible in gross income under section 74(b), if the government official receiving such prize or award is selected from the general public;

(2) A scholarship or a fellowship grant which is excludable from gross income under section 117(a) and which is to be utilized for study at an educational institution described in section 151(e)(4);

(3) Any annuity or other payment (forming part of a stock-bonus, pension, or profit sharing plan) by a trust which constitutes a qualified trust under section 401;

(4) Any annuity or other payment under a plan which meets the requirements of section 404(a)(2);

(5) Any contribution or gift (other than a contribution or gift of money) to, or services or facilities made available to, any government official, if the aggregate value of such contributions, gifts, services, and facilities does not exceed $25 during any calendar year;

(6) Any payment made under 5 U.S.C. Chapter 41 (relating to government employees' training programs);

(7) Any payment or reimbursement of traveling expenses (including amounts expended for meals and lodging, regardless of whether the government official is away from home within the meaning of section 162(a)(2), and including reasonable advances for such expenses anticipated in the immediate future) for travel solely from one point in the United States to another in connection with one or more purposes described in section 170(c) (1) or (2)(B), but only if such payment or reimbursement does not exceed the actual cost of the transportation involved plus an amount for all other traveling expenses not in excess of 125 percent of the maximum amount payable under 5 U.S.C. 5702(a) for like travel by employees of the United States;

(8) Any agreement to employ or make a grant to a government official for any period after the termination of his government service if such agreement is entered into within 90 days prior to such termination;

(9) If a government official attends or participates in a conference sponsored by a private foundation, the allocable portion of the cost of such conference and other nonmonetary benefits (for example, benefits of a professional, intellectual, or psychological nature, or benefits resulting from the publication or the distribution to participants of a record of the conference), as well as the payment or reimbursement of expenses (including reasonable advances for expenses anticipated in connection with such a conference in the near future), received by such government official as a result of such attendance or participation shall not be subject to section 4941(d)(1), so long as the conference is in furtherance of the exempt purposes of the foundation; or

(10) In the case of any government official who was on leave of absence without pay on December 31, 1969, pursuant to a commitment entered into on or before such date for the purpose of engaging in certain activities for which such individual was to be paid by one or more private foundations, any payment of compensation (or payment or reimbursement of expenses, including reasonable advances for expenses anticipated in the immediate future) by such private foundations to such individual for any continuous period after December 31, 1969, and prior to January 1, 1971, during which such individual remains on leave of absence to engage in such activities. A commitment is considered entered into on or before December 31, 1969, if on or before such date, the amount and nature of the payments to be made and the name of the individual receiving such payments were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee orally or in writing.

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 7938, 49 FR 3848, Jan. 31, 1984]

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§ 53.4941(d)–4 Transitional rules.

(a) *Certain transactions involving securities acquired by a foundation before May 27, 1969*—(1) *In general.* Under section 101(l)(2)(A) of the Tax Reform Act of 1969 (83 Stat. 533), any transaction between a private foundation and a corporation which is a disqualified person shall not be an act of self-dealing if such transaction is pursuant to the terms of securities of such corporation, if such terms were in existence at the time such securities were acquired by the foundation, and if such securities were acquired by the foundation before May 27, 1969.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. Private foundation X purchased preferred stock of corporation M, a disqualified person with respect to X, on March 15, 1969. The terms of such securities on such date provided that the stock could be called by M at any time if M paid the outstanding shareholders cash equal to 105 percent of the face amount of the stock. If M exercises this right and calls the stock owned by X on February 15, 1970, such call shall not constitute an act of self-dealing even if such price is not equivalent to fair market value on such date and even if not all of the securities of that class are called.

(b) *Disposition of certain business holdings*—(1) *In general.* Under section 101(l)(2)(B) of the Tax Reform Act of 1969 (83 Stat. 533), the sale, exchange, or other disposition of property which is owned by a private foundation on May 26, 1969, to a disqualified person shall not be an act of self-dealing if the foundation is required to dispose of such property in order not to be liable for tax under section 4943 (determined without regard to section 4943(c)(2)(C) and as if every disposition by the foundation were made to disqualified persons) and if such disposition satisfies the requirements of subparagraph (2) of this paragraph. For purposes of applying this paragraph in the case of a disposition completed before January 1, 1975, or after October 4, 1976, and before January 1, 1977, the amount of excess business holdings is determined under section 4943(c) without taking subsection (c)(4) into account.

(2) *Terms of the disposition.* Subparagraph (1) of this paragraph shall not apply unless:

(i) The private foundation receives an amount which equals or exceeds the fair market value of the business holdings at the time of disposition or at the time a contract for such disposition was previously executed; and

(ii) At the time with respect to which subdivision (i) of this subparagraph is applied, the transaction would not have constituted a prohibited transaction within the meaning of section 503(b) or the corresponding provisions of prior law if such provisions had been applied at such time.

(3) *Property received under a trust or will.* For purposes of this paragraph, property shall be considered as owned by a private foundation on May 26, 1969, if such property is acquired by such foundation under the terms of a will executed on or before such date, under the terms of a trust which was irrevocable on such date, or under the terms of a revocable trust executed on or before such date if the property would have passed under a will which would have met the requirements of this subparagraph but for the fact that a grantor dies without having revoked the trust. An amendment or republication of a will which was executed on or before May 26, 1969, does not prevent any interest in a business enterprise which was to pass under the terms of such will (which terms were in effect on May 26, 1969, and at all times thereafter) from being treated as owned by a private foundation on or before May 26, 1969, solely because:

(i) There is a reduction in the interest in the business enterprise which the foundation was to receive under the terms of the will (for example, if the foundation is to receive the residuary estate and one class of stock is disposed of by the decedent during his lifetime or by a subsequent codicil),

(ii) Such amendment or republication is necessary in order to comply with section 508(e) and the regulations thereunder,

(iii) There is a change in the executor of the will, or

(iv) There is any other change which does not otherwise change the rights of

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the foundation with respect to such interest in the business enterprise.

However, if under such amendment or republication there is an increase of the interest in the business enterprise which the foundation was to receive under the terms of the will in effect on May 26, 1969, such increase shall not be treated as owned by the private foundation on or before May 26, 1969, but under such circumstances the interest which would have been acquired before such increase shall be treated as owned by the private foundation on or before May 26, 1969.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. On May 26, 1969, private foundation X owns 10 percent of corporation Y's voting stock, which is traded on the New York Stock Exchange. Disqualified persons with respect to X own an additional 40 percent of such voting stock. X is on a calendar year basis. Prior to January 1, 1975, X privately sold its entire 10 percent for cash to B, a disqualified person, at the price quoted on the stock exchange at the close of the day less commissions. Since the 10 percent owned by X would constitute excess business holdings without the application of section 4943(c) (2)(C) or (4), the disposition will not constitute an act of self-dealing.

Example 2. Assume the facts as stated in example (1), except that the only stock of corporation Y which X owns is 1.5 percent of Y's voting stock. Since the 1.5 percent owned by X would constitute excess business holdings without the application of section 4943(c) (2)(C) or (4), the disposition of the stock to B for cash will not constitute an act of self-dealing.

Example 3. Assume the facts as stated in example (1), except that B, instead of paying cash as consideration for the stock, issued a 10-year secured promissory note as consideration for the stock. The issuance of such promissory note will not be treated as an act of self-dealing until taxable years beginning after December 31, 1979, unless such issuance would have been a prohibited transaction under section 503(b), or unless the transaction does not remain throughout its life at least as favorable as an arm's-length contract negotiated currently. See paragraph (c) of this section.

(c) *Existing leases and loans*—(1) *In general.* Under section 101(l)(2)(C) of the Tax Reform Act of 1969 (83 Stat. 533), the leasing of property or the lending of money (or other extension of credit) between a disqualified person and a private foundation pursuant to a binding contract which was in effect on October 9, 1969 (or pursuant to a renewal or modification of such a contract, as described in subparagraph (2) of this paragraph), shall not be an act of self-dealing until taxable years beginning after December 31, 1979, if:

(i) At the time the contract was executed, such contract was not a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law), and

(ii) The leasing or lending of money (or other extension of credit) remains throughout the term of the lease or extension of credit at least as favorable as a current arm's-length transaction with an unrelated person.

(2) *Renewal or modification of existing contracts.* A renewal or a modification of an existing contract is referred to in subparagraph (1) of this paragraph only if any modifications of the terms of such contract are not substantial and the relative advantages of the modified contract compared with contracts entered into at arm's-length with an unrelated person at the time of the renewal or modification are at least as favorable to the private foundation as the relative advantages of the original contract compared with contracts entered into at arm's-length with an unrelated person at the time of execution of the original contract. Such renewal or modification need not be provided for in the original contract; it may take place before or after the expiration of the original contract and at any time before the first day of the first taxable year of the private foundation beginning after December 31, 1979. Where, in a normal commercial setting, an unrelated party in the position of a private foundation could be expected to insist upon a renegotiation or termination of a binding contract, the private foundation must so act. Thus, for example, if a disqualified person leases office space from a private foundation on a month-to-month basis, and a party in the position of the private foundation could be expected to renegotiate the rent required in such contract because of a rise in the fair market value of such office space, the private foundation must so act in order to avoid participation in an act of self-

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dealing. Where the private foundation has no right to insist upon renegotiation, an act of self-dealing shall occur if the terms of the contract become less favorable to the foundation than an arm's-length contract negotiated currently, unless:

(i) The variation from current fair market value is de minimis, or

(ii) The contract is renegotiated by the foundation and the disqualified person so that the foundation will receive no less than fair market value. For purposes of subdivision (i) of this subparagraph de minimis ordinarily shall be no more than one-half of 1 percent in the rate of return in the case of a loan, or 10 percent of the rent in the case of a lease.

(3) *Example*. The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following example.

Example. Under a binding contract entered into on January 1, 1964, X, a private foundation, leases a building for 10 years from Z, a disqualified person. At the time the contract was executed, the lease was not a "prohibited transaction" within the meaning of section 503(b), since the rent charged X was only 50 percent of the rent which would have been charged in an arm's-length transaction with an unrelated person. On January 1, 1974, X renewed the lease for 5 additional years. The terms of the renewal agreement provided for a 20 percent increase in the amount of rent charged X. However, at the time of such renewal, the rent which would have been charged in an arm's-length transaction had also increased by 20 percent from that of 1964. The renewal agreement shall not be treated as an act of self-dealing.

(4) *Certain exchanges of stock or securities for bonds, debentures or other indebtedness*. (i) In the case of a transaction described in paragraph (a) or (b) of this section or paragraph (d) of § 53.4941(d)–3, where a bond, debenture, or other indebtedness of a disqualified person is acquired by a private foundation in exchange for stock or securities which it held on October 9, 1969, and at all times thereafter, such indebtedness shall be treated as an extension of credit pursuant to a binding contract in effect on October 9, 1969, to which this paragraph applies. Thus, so long as the extension of credit remains at least as favorable as an arm's-length transaction with an unrelated person and neither the acquisition of the securities which were exchanged for the indebtedness nor the exchange of such securities for the indebtedness was a prohibited transaction within the meaning of section 503(b) (or the corresponding provisions of prior law) at the time of such acquisition, such extension of credit shall not be an act of self-dealing until taxable years beginning after December 31, 1979.

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

Example 1. Assume the facts as stated in example (2) of § 53.4941 (d)–3 (d)(2), except that the preferred stock was held by Y on October 9, 1969, and at all times thereafter until the redemption occurred on January 2, 1972. In addition, assume that the acquisition of the preferred stock was not a prohibited transaction within the meaning of section 503(b) at the time of such acquisition and the exchange of the preferred stock for the debentures would not have been a prohibited transaction within the meaning of section 503(b). For 1973 through 1979, the extension of credit arising from the holding of the debentures is not an act of self-dealing so long as the extension of credit remains at least as favorable as an arm's-length transaction with an unrelated person. See, however, example (3) of § 53.4941 (e)–1 (e)(1)(ii).

Example 2. Assume the same facts as stated in example (1) of § 53.4941 (d)–4 (b)(4), except that private foundation X sold its entire 10 percent of corporation Y's voting stock in exchange for Y's secured notes which mature on December 31, 1985. For taxable years beginning before January 1, 1980, the extension of credit arising from the holding of such notes by X is not an act of self-dealing so long as the extension of credit remains at least as favorable as an arm's-length transaction with an unrelated person and neither the acquisition of the securities which were exchanged for the indebtedness nor the exchange of such securities for the indebtedness was a prohibited transaction within the meaning of section 503(b) (or the corresponding provisions of prior law). Under § 53.4941(e)–1, a new extension of credit occurs on the first day of each taxable year in which an indebtedness is outstanding; therefore, if the secured notes are held by X after December 31, 1979, a new extension of credit not excepted from the definition of an act of self-dealing will occur on the first day of the first taxable year beginning after December 31, 1979, and on the first day of each succeeding taxable year in which X holds such secured notes.

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(d) *Sharing of goods, services, or facilities before January 1, 1980.* (1) Under section 101(1)(2)(D) of the Tax Reform Act of 1969 (83 Stat. 533), the use (other than leasing) of goods, services, or facilities which are shared by a private foundation and a disqualified person shall not be an act of self-dealing until taxable years beginning after December 31, 1979, if:

(i) The use is pursuant to an arrangement in effect before October 9, 1969, and at all times thereafter;

(ii) The arrangement was not a prohibited transaction (within the meaning of sec. 503(b) or the corresponding provisions of prior law) at the time it was made; and

(iii) The arrangement would not be a prohibited transaction if section 503(b) continued to apply.

For purposes of this paragraph, such arrangement need not be a binding contract.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. In 1964 X, a private foundation, and B, a disqualified person, arranged for the sharing of computer time in B's son's company for a 10-year period commencing January 1, 1965. B's son has the unilateral right to terminate the arrangement at any time. X uses the computer facilities in connection with an analysis of its grant-making activities, while B's use is related to his business affairs. Both X and B make reasonable fixed payments to the computer company based on the number of hours of computer use and comparable to fees charged in arm's-length transactions with unrelated parties. The company imposes a maximum limit per month on the sum of the number of hours for which X and B use the computer facilities. Under these circumstances, the sharing of computer time is not an act of self-dealing.

(e) *Use of certain property acquired before October 9, 1969.* (1) Under section 101(1)(2)(E) of the Tax Reform Act of 1969 (83 Stat. 533), the use of property in which a private foundation and a disqualified person have a joint or common interest will not be an act of self-dealing if the interests of both in such property were acquired before October 9, 1969.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. Prior to October 9, 1969, C, a disqualified person, gave beachfront property to private foundation X for use as a recreational facility for underprivileged, inner-city children during the summer months. However, C retained the right to use such property for his life. The use of such property by C or X is not an act of self-dealing.

(f) *Disposition of leased property*—(1) *In general.* Under section 101(l)(2)(F) of the Tax Reform Act of 1969, as amended by the Tax Reform Act of 1976 (90 Stat. 1713), the sale, exchange or other disposition (other than by lease) to a disqualified person of property being leased to the disqualified person by a private foundation is not an act of self-dealing if:

(i) The private foundation is leasing substantially all of the property to the disqualified person under a lease to which paragraph (c) of this section applies;

(ii) The disposition occurs after October 4, 1976, and before January 1, 1978; and

(iii) The disposition satisfies the requirements of paragraph (f)(2) of this section.

(2) *Terms of disposition.* Paragraph (f)(1) of this section applies only if:

(i) The private foundation receives an amount that equals or exceeds the fair market value of the property either at the time of the disposition or at the time (after June 30, 1976) the contract for such disposition was executed;

(ii) In computing the fair market value of the property, no diminution of that value results from the fact that the property is subject to any lease to disqualified persons; and

(iii) At the time with respect to which paragraph (f)(2)(i) of this section is applied, the transaction would not have constituted a prohibited transaction within the meaning of section 503(b) or the corresponding provisions of prior law if those provisions had been applied at the time of the transaction.

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 7678, 45 FR 12416, Feb. 26, 1980]

§53.4941(e)–1 Definitions.

(a) *Taxable period*—(1) *In general.* For purposes of any act of self-dealing, the term ''taxable period'' means the period beginning with the date on which

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the act of self-dealing occurs and ending on the earliest of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed by section 4941(a)(1),

(ii) The date on which correction of the act of self-dealing is completed, or

(iii) The date on which the tax imposed by section 4941(a)(1) is assessed.

(2) *Date of occurrence.* An act of self-dealing occurs on the date on which all the terms and conditions of the transaction and the liabilities of the parties have been fixed. Thus, for example, if a private foundation gives a disqualified person a binding option on June 15, 1971, to purchase property owned by the foundation at any time before June 15, 1972, the act of self-dealing has occurred on June 15, 1971. Similarly, in the case of a conditional sales contract, the act of self-dealing shall be considered as occurring on the date the property is transferred subject only to the condition that the buyer make payment for receipt of such property.

(3) *Special rule.* Where a notice of deficiency referred to in subparagraph (1)(i) of this paragraph is not mailed because a waiver of the restrictions on assessment and collection of a deficiency has been accepted, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the taxable period.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. On July 16, 1970, F, a manager of private foundation X acting on behalf of the foundation, knowing his act to be one of self-dealing, willfully and without reasonable cause engaged in an act of self-dealing by selling certain real estate to A, a disqualified person. On March 25, 1973, the Internal Revenue Service mailed a notice of deficiency to A with respect to the tax imposed on the sale under section 4941(a)(1). The taxable period with respect to the act of self-dealing for both A and F is July 16, 1970, through March 25, 1973.

Example 2. Assume the facts as stated in example (1), except that the act of self-dealing is corrected by A on March 17, 1971. The taxable period with respect to the act of self-dealing for both A and F is July 16, 1970, through March 17, 1971.

Example 3. Assume the facts as stated in example (1), except that on August 20, 1972, A files a waiver of the restrictions on assessment and collection of the tax imposed on the sale under section 4941(a)(1) which is accepted. The taxable period with respect to the act of self-dealing for both A and F is July 16, 1970, through August 20, 1972.

(b) *Amount involved*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, for purposes of any act of self-dealing, the term ''amount involved'' means the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.

(2) *Exceptions.* (i) In the case of the payment of compensation for personal services to persons other than Government officials, the amount involved shall be only the excess compensation paid by the private foundation.

(ii) Where the use of money or other property is involved, the amount involved shall be the greater of the amount paid for such use or the fair market value of such use for the period for which the money or other property is used. Thus, for example, in the case of a lease of a building by a private foundation to a disqualified person, the amount involved is the greater of the amount of rent received by the private foundation from the disqualified person or the fair rental value of the building for the period such building is used by the disqualified person.

(iii) In cases in which a transaction would not have been an act of self-dealing had the private foundation received fair market value, the amount involved is the excess of the fair market value of the property transferred by the private foundation over the amount which the private foundation receives, but only if the parties have made a good faith effort to determine fair market value. For purposes of this subdivision a good faith effort to determine fair market value shall ordinarily have been made where:

(*a*) The person making the valuation is not a disqualified person with respect to the foundation and is both competent to make the valuation and not in a position, whether by stock ownership or otherwise, to derive an economic benefit from the value utilized, and

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(*b*) The method utilized in making the valuation is a generally accepted method for valuing comparable property, stock, or securities for purposes of arm's-length business transactions where valuation is a significant factor.

See section 4941(d)(2)(F) and §§ 53.4941(d)–1(b)(3), 53.4941(d)–3 (d)(1) and 53.4941(d)–4(b). Thus, for example, if a corporation which is a disqualified person with respect to a private foundation recapitalizes in a transaction which would be described in section 4941(d)(2)(F) but for the fact that the private foundation receives new stock worth only $95,000 in exchange for the stock which it previously held in the corporation and which has a fair market value of $100,000 at the time of the recapitalization, the amount involved would be $5,000 ($100,000—$95,000) if there had been a good faith attempt to value the stock. Similarly, if an estate enters into a transaction with a disqualified person with respect to a foundation and such transaction would be described in § 53.4941(d)–1(b)(3) but for the fact that the estate receives less than fair market value for the property exchanged, the amount involved is the excess of the fair market value of the property the estate transfers to the disqualified person over the money and the fair market value of the property received by the estate.

(3) *Time for determining fair market value*. The fair market value of the property or the use thereof, as the case may be, shall be determined as of the date on which the act of self-dealing occurred in the case of the initial taxes imposed by section 4941(a) and shall be the highest fair market value during the taxable period in the case of the additional taxes imposed by section 4941(b).

(4) *Examples*. The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, a disqualified person with respect to private foundation M, uses an airplane owned by M on June 15 and June 16, 1970, for a 2-day trip to New York City on personal business and pays M $500 for the use of such airplane. The fair rental value for the use of the airplane for those 2 days is $3,000. For purposes of section 4941(a), the amount involved with respect to the act of self-dealing is $3,000.

Example 2. On April 10, 1970, B, a manager of private foundation P, borrows $100,000 from P at 6 percent interest per annum. Both principal and interest are to be paid 1 year from the date of the loan. The fair market value of the use of the money on April 10, 1970, is 10 percent per annum. Six months later, B and P terminate the loan, and B repays the $100,000 principal plus $3,000 ($100,000 × 6 percent for one-half year) interest. For purposes of section 4941(a), the amount involved with respect to the act of self-dealing is $5,000 ($100,000 × 10 percent for one-half year) for each year or partial year in the taxable period.

Example 3. C, a substantial contributor to private foundation S, leases office space in a building owned by S for $3,600 for 1 year beginning on January 1, 1971. The fair rental value of the building for a 1-year lease on January 1, 1971, is $5,600. On December 31, 1971, the lease is terminated. For purposes of section 4941(a), the amount involved with respect to the act of self-dealing is $5,600 for each year or partial year in the taxable period.

Example 4. D, a disqualified person with respect to private foundation T, purchases 100 shares of stock from T for $5,000 on June 15, 1982. The fair market value of the 100 shares of stock on that date is $4,800. D sells the 100 shares of stock on December 20, 1983, for $6,000. On December 27, 1983, a notice of deficiency with respect to the taxes imposed under subsections (a) and (b) of section 4941 is mailed to D and the taxable period ends. D fails to correct during the taxable period. Between June 15, 1982, and the end of the taxable period, the stock was quoted on the New York Stock Exchange at a high of $67 per share. The amount involved with respect to the tax imposed under subsection (a) is $5,000, and the amount involved with respect to the tax imposed under subsection (b) for failure to correct is $6,700 (100 shares at $67 per share), the highest fair market value during the taxable period.

Example 5. Corporation M, a disqualified person with respect to private foundation V, redeems all of its Class B common stock, some of which is held by V. The redemption of V's stock would be described in section 4941(d)(2)(F) but for the fact that V receives only $95,000 in exchange for stock which has a fair market value of $100,000 at the time of the transaction. The $95,000 value of V's stock, which is not publicly traded, was determined by investment bankers in accordance with accepted methods of valuation that would be utilized if the M stock held by V were to be offered for sale to the public. Therefore, the amount involved with respect to the transaction will ordinarily be limited to $5,000 ($100,000—$95,000).

(c) *Correction*—(1) *In general*. Correction shall be accomplished by undoing

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the transaction which constituted the act of self-dealing to the extent possible, but in no case shall the resulting financial position of the private foundation be worse than that which it would be if the disqualified person were dealing under the highest fiduciary standards. For example, where a disqualified person sells property to a private foundation for cash, correction may be accomplished by recasting the transaction in the form of a gift by returning the cash to the foundation. Subparagraphs (2) through (6) of this paragraph illustrate the minimum standards of correction in the case of certain specific acts of self-dealing. Principles similar to the principles contained in such subparagraphs shall be applied with respect to other acts of self-dealing. Any correction pursuant to this paragraph and section 4941 shall not be an act of self-dealing.

(2) *Sales by foundation.* (i) In the case of a sale of property by a private foundation to a disqualified person for cash, undoing the transaction includes, but is not limited to, requiring rescission of the sale where possible. However, in order to avoid placing the foundation in a position worse than that in which it would be if rescission were not required, the amount returned to the disqualified person pursuant to the rescission shall not exceed the lesser of the cash received by the private foundation or the fair market value of the property received by the disqualified person. For purposes of the preceding sentence, fair market value shall be the lesser of the fair market value at the time of the act of self-dealing or the fair market value at the time of rescission. In addition to rescission, the disqualified person is required to pay over to the private foundation any net profits he realized after the original sale with respect to the property he received from the sale. Thus, for example, the disqualified person must pay over to the foundation any income derived by him from the property he received from the original sale to the extent such income during the correction period exceeds the income derived by the foundation during the correction period from the cash which the disqualified person originally paid to the foundation.

(ii) If, prior to the end of the correction period, the disqualified person resells the property in an arm's-length transaction to a bona fide purchaser who is not the foundation or another disqualified person, no rescission is required. In such case, the disqualified person must pay over to the foundation the excess (if any) of the greater of the fair market value of such property on the date on which correction of the act of self-dealing occurs or the amount realized by the disqualified person from such arm's length resale over the amount which would have been returned to the disqualified person pursuant to subdivision (i) of this subparagraph if rescission had been required. In addition, the disqualified person is required to pay over to the foundation any net profits he realized, as described in subdivision (i) of this subparagraph.

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

Example 1. On July 1, 1970, private foundation M sold a painting to A, a disqualified person, for $5,000, in a transaction not within any of the exceptions to self-dealing. The fair market value of the painting on such date was $6,000. On March 25, 1971, the painting is still owned by A and has a fair market value of $7,200. A did not derive any income as a result of purchasing the painting. In order to correct the act of self-dealing under this subparagraph on March 25, 1971, the sale must be rescinded by the return of the painting to M. However, pursuant to such rescission, M must not pay A more than $5,000, the original consideration received by M.

Example 2. Assume the facts as stated in Example (1), except that A sold the painting on December 15, 1970, in an arm's-length transaction to C, a bona fide purchaser who is not a disqualified person, for $6,100. In addition, assume that the fair market value of the painting on March 25, 1971, is $7,600. In order to correct the act of self-dealing under this subparagraph on March 25, 1971, A must pay M $2,600 ($7,600, the fair market value at the time of correction, less $5,000, the amount which would have been returned to A if rescission had been required). Since the painting was sold to C in an arm's-length transaction prior to correction, no rescission is required.

(3) *Sales to foundation.* (i) In the case of a sale of property to a private foundation by a disqualified person for cash, undoing the transaction includes,

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but is not limited to, requiring rescission of the sale where possible. However, in order to avoid placing the foundation in a position worse than that in which it would be if rescission were not required, the amount received from the disqualified person pursuant to the rescission shall be the greatest of the cash paid to the disqualified person, the fair market value of the property at the time of the original sale, or the fair market value of the property at the time of rescission. In addition to rescission, the disqualified person is required to pay over to the private foundation any net profits he realized after the original sale with respect to the consideration he received from the sale. Thus, for example, the disqualified person must pay over to the foundation any income derived by him from the cash he received from the original sale to the extent such income during the correction period exceeds the income derived by the foundation during the correction period from the property which the disqualified person originally transferred to the foundation.

(ii) If, prior to the end of the correction period, the foundation resells the property in an arm's-length transaction to a bona fide purchaser who is not a disqualified person, no rescission is required. In such case, the disqualified person must pay over to the foundation the excess (if any) of the amount which would have been received from the disqualified person pursuant to subdivision (i) of this subparagraph, if rescission had been required over the amount realized by the foundation upon resale of the property. In addition, the disqualified person is required to pay over to the foundation any net profits he realized, as described in subdivision (i) of this subparagraph.

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

Example 1. On February 10, 1972, D, a disqualified person with respect to private foundation P, sells 100 shares of X stock to P for $2,500 in a transaction which does not fall within any of the exceptions to selfdealing. The fair market value of the 100 shares of X stock on February 10, 1972, is $3,200. On June 1, 1973, the 100 shares of X stock have a fair market value of $2,900. From February 10, 1972, through June 1, 1973, P has received dividends of $90 from the stock, and D has received interest of $300 from the $2,500 which D received as consideration for the stock. In order to correct the act of self-dealing under this subparagraph on June 1, 1973, the sale must be rescinded by the return of the stock to D. However, pursuant to such rescission, D must pay P $3,200, the fair market value of the stock on the date of sale. In addition, D must pay P $210, the amount of income derived by D during the correction period from the $2,500 received from P ($300) minus the income derived by P during the correction period from the stock sold to P ($90).

Example 2. Assume the facts as stated in Example (1), except that on September 1, 1972, P sells the 100 shares of X stock to E, a bona fide purchaser who is not a disqualified person, in an arm's-length transaction for $2,750. Assume further that P has not received any dividends from the stock prior to the sale to E, but that P receives interest of $260 from the $2,750 received as consideration for the stock for the period from September 1, 1972, to June 1, 1973. In order to correct the act of self-dealing under this subparagraph on June 1, 1973, D must pay P $450 ($3,200, the amount which would have been received from D if rescission had been required, less $2,750, the amount realized by P from the sale to E). In addition, D must pay P $40, the amount of income derived by D during the correction period from the $2,500 received from P ($300) minus the income derived by P during the correction period from the stock sold to P ($260 from the $2,750 received as consideration for the stock). Since the stock was sold to E in an arm's-length transaction prior to correction, no rescission is required.

(4) *Use of property by a disqualified person.* (i) In the case of the use by a disqualified person of property owned by a private foundation, undoing the transaction includes, but is not limited to, terminating the use of such property. In addition to termination, the disqualified person must pay the foundation:

(*a*) The excess (if any) of the fair market value of the use of the property over the amount paid by the disqualified person for such use until such termination, and

(*b*) The excess (if any) of the amount which would have been paid by the disqualified person for the use of the property on or after the date of such termination, for the period such disqualified person would have used the property (without regard to any further extensions or renewals of such period) if such termination had not occurred, over the fair market value of such use for such period.

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In applying (*a*) of this subdivision the fair market value of the use of property shall be the higher of the rate (that is, fair rental value per period in the case of use of property other than money or fair interest rate in the case of use of money) at the time of the act of self-dealing (within the meaning of paragraph (e)(1) of this section) or such rate at the time of correction of such act of self-dealing. In applying (*b*) of this subdivision the fair market value of the use of property shall be the rate at the time of correction.

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

Example 1. On January 1, 1972, private foundation S rented the third story of its office building to A, a disqualified person, for 1 year at an annual rent of $10,000, in a transaction not within any of the exceptions to self-dealing. Both S and A are on the calendar year basis. The fair rental value of such office space for a 1-year period on January 1, 1972, is $12,000. On June 30, 1972, the fair rental value of such office space for a 1-year period is $13,000. In order to correct the act of self-dealing under this subparagraph on June 30, 1972, A must terminate his use of the property. In addition, A must pay S $1,500, the excess of $6,500 (the fair rental value for 6 months as of June 30, 1972) over $5,000 (the amount paid to S from Jan. 1, 1972, to June 30, 1972).

Example 2. On January 1, 1972, private foundation R rented the fourth story of its office building to B, a disqualified person, for 1 year at an annual rent of $10,000, in a transaction not included in any of the exceptions to self-dealing. Both R and B are on the calendar year basis. On January 1, 1973, B continues to rent the office space as a periodic tenant paying his rent monthly at an annual rate of $10,000. The fair rental value of such office space for a 1-year period on January 1, 1972, is $12,000, and as of January 1, 1973, is $1,250 per month. As of December 31, 1973, the fair rental value of such office space is $14,000 for a 1-year period and $1,200 on a monthly basis. In order to correct his acts of self-dealing (within the meaning of paragraph (e)(1) of this section) under this subparagraph on December 31, 1973, B must terminate his use of the property. In addition, B must pay R $9,000, $4,000 for his use of the property for 1972 (the excess of $14,000, the fair rental value for 1 year as of Dec. 31, 1973, over $10,000, the amount B paid R for his use of the property for 1972) and $5,000 for his use of the property for 1973 (the excess of $15,000, the fair rental value for 12 months as of Jan. 1, 1973, over $10,000, the amount B paid R for his use of the property for 1973).

Example 3. B, a substantial contributor to private foundation T, leases office space in a building owned by T for $5,000 for 1 year beginning on November 10, 1972, in a transaction not included in any of the exceptions to self-dealing. The fair rental value of the building for a 1-year period on November 10, 1972, is $4,000. On May 10, 1973, the fair rental value of the building for the remaining period of the lease is $2,200. In order to correct the acts of self-dealing under this subparagraph on May 10, 1973, B and T must terminate the lease. In addition, B must pay T $300 (the excess of $2,500, the amount which would have been paid by B for the remaining period of the lease if it had not been terminated, over $2,200, the fair rental value at the time of correction for the remaining period of the lease).

(5) *Use of property by a private foundation.* (i) In the case of the use by a private foundation of property owned by a disqualified person, undoing the transaction includes, but is not limited to, terminating the use of such property. In addition to termination, the disqualified person must pay the foundation:

(*a*) The excess (if any) of the amount paid to the disqualified person for such use until such termination over the fair market value of the use of the property, and

(*b*) The excess (if any) of the fair market value of the use of the property, for the period the foundation would have used the property (without regard to any further extensions or renewals of such period) if such termination had not occurred, over the amount which would have been paid to the disqualified person on or after the date of such termination for such use for such period.

In applying (*a*) of this subdivision the fair market value of the use of property shall be the lesser of the rate (that is, fair rental value per period in the case of use of property other than money or fair interest rate in the case of use of money) at the time of the act of self-dealing (within the meaning of paragraph (e)(1) of this section) or such rate at the time of correction of such act of self-dealing. In applying (*b*) of this subdivision the fair market value of the use of property shall be the rate at the time of correction.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00090 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On July 1, 1972, private foundation X leases office space in a building owned by C, a disqualified person, for 1 year at an annual rent of $6,000. Both X and C are on the calendar year basis. The fair rental value of such office space for a 1-year period as of July 1, 1972, is $4,200. As of January 1, 1973, the fair rental value of such office space for a 1-year period is $5,400, and as of June 30, 1973, the fair rental value of such office space for a 1-year period is $4,800. In order to correct his acts of self-dealing (within the meaning of paragraph (e)(1) of this section) under this subparagraph on June 30, 1973, C must terminate X's use of the property. In addition, C must pay X $1,500, $900 (the excess of $3,000, the amount paid to C from July 1, 1972, through December 31, 1972, over $2,100, the fair rental value for 6 months as of July 1, 1972) plus $600 (the excess of $3,000, the amount paid to C from January 1, 1973, through June 30, 1973, over $2,400, the fair rental value for 6 months as of June 30, 1973).

Example 2. On April 1, 1973, D, a disqualified person with respect to private foundation Y, loans $100,000 to Y at 6 percent interest per annum. Both principal and interest are to be paid on April 1, 1978. The fair market value of the use of the money on April 1, 1973, is 9 percent per annum. On April 1, 1974, D and Y terminate the loan. On such date, the fair market value of the use of $100,000 is 10 percent per annum. In order to correct the act of self-dealing on April 1, 1974, in addition to the termination of the loan from D to Y, D must pay Y $16,000, the excess of $40,000 ($100,000 × 10 percent, the fair market value of the use determined at the time of correction, from April 1, 1974, to April 1, 1978) over $24,000 (the amount of interest Y would have paid to D from April 1, 1974, to April 1, 1978, if the loan from D to Y had not been terminated).

(6) *Payment of compensation to a disqualified person.* In the case of the payment of compensation by a private foundation to a disqualified person for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of such foundation, undoing the transaction requires that the disqualified person pay to the foundation any amount which is excessive. However, termination of the employment or independent contractor relationship is not required.

(7) *Special rule for correction of valuation errors.* (i) In the case of a transaction described in paragraph (b)(2)(iii) of this section, a ''correction'' of the act of self-dealing shall ordinarily be deemed to occur if the foundation is paid an amount of money equal to the amount involved (as defined in paragraph (b)(2)(iii) of this section) plus such additional amounts as are necessary to compensate it for the loss of the use of the money or other property during the period commencing on the date of the act of self-dealing and ending on the date the transaction is corrected pursuant to this subparagraph.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in example (5) of paragraph (b)(4) of this section. Such transaction shall be considered as corrected by a payment of $5,000 by M to V, together with an additional payment to V of an amount equal to the interest which V could have obtained on $5,000 for the period commencing on the date of the redemption and ending on the date the act is corrected.

(d) *Cross reference.* For rules relating to taxable events that are corrected within the correction period, defined in section 4963 (e), see section 4961 (a), and the regulations thereunder.

(e) *Act of self-dealing*—(1) *Number of acts; use of money or property*—(i) *In general.* If a transaction between a private foundation and a disqualified person is determined to be self-dealing (as defined in section 4941(d)), for purposes of section 4941 there is generally one act of self-dealing. For the date on which such act is treated as occurring, see paragraph (a)(2) of this section. If, however, such transaction relates to the leasing of property, the lending of money or other extension of credit, other use of money or property, or payment of compensation, the transaction will generally be treated (for purposes of section 4941 but not section 507 or section 6684) as giving rise to an act of self-dealing on the day the transaction occurs plus an act of self-dealing on the first day of each taxable year or portion of a taxable year which is within the taxable period and which begins after the taxable year in which the transaction occurs.

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

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Example 1. On August 31, 1970, X, a private foundation, sells a building to A, a disqualified person with respect to X. A is on the calendar year basis. Under these circumstances, the transaction between A and X is one act of self-dealing which is treated for purposes of section 4941 as occurring on August 31, 1970.

Example 2. Assume the facts as stated in example (1), except that, instead of selling the building to A, X leases the building to A for a term of 4 years beginning July 31, 1970, at an annual rental of $12,000. The fair rental value of the building is also $12,000 per annum as of July 31, 1970, and throughout the next 4 years. This transaction is corrected on September 30, 1973, in accordance with paragraph (c)(4) of this section. Under these circumstances, the transaction between A and X constitutes four separate acts of self-dealing, which are treated for purposes of section 4941 as occurring on July 31, 1970, January 1, 1971, January 1, 1972, and January 1, 1973. Consequently, there are four taxable periods. The first taxable period is from July 31, 1970, to September 30, 1973; the second is from January 1, 1971, to September 30, 1973; the third is from January 1, 1972, to September 30, 1973; and the fourth is from January 1, 1973, to September 30, 1973. For purposes of the initial taxes in section 4941(a), the amount involved is $5,000 for the first taxable period, $12,000 for the second, $12,000 for the third, and $9,000 for the fourth. The initial taxes to be paid by A are thus $1,000 ($5,000 × 5% × 4 taxable years or partial taxable years in the taxable period) for the first act; $1,800 ($12,000 × 5% × 3) for the second act; $1,200 ($12,000 × 5% × 2) for the third act; and $450 ($9,000 × 5% × 1) for the fourth act.

Example 3. Assume the facts as stated in example (1) of § 53.4941(d)–4(c)(4)(ii). If the debentures are held by Y after December 31, 1979, the extension of credit will not be excepted from the definition of an act of self-dealing, because an act of self-dealing will be treated (for purposes of section 4941) as occurring on January 1, 1980.

(2) *Number of acts; joint participation by disqualified persons*—(i) *In general.* If joint participation in a transaction by two or more disqualified persons constitutes self-dealing (such as a joint sale of property to a private foundation or joint use of its money or property), such transaction shall generally be treated as a separate act of self-dealing with respect to each disqualified person for purposes of section 4941. For purposes of section 507 and, in the case of a foundation manager, section 6684, however, such transaction shall be treated as only one act of self-dealing. For purposes of this subparagraph, an individual and one or more members of his family (within the meaning of section 4946(d)) shall be treated as one person, regardless of whether a member of the family is a disqualified person not only by reason of section 4946(a)(1)(D) but also by reason of another subparagraph of section 4946(a)(1). However, the liability imposed on a disqualified person and one or more members of his family for joint participation in an act of self-dealing shall be joint and several in accordance with section 4941(c)(1) and § 53.4941(c)–1(a).

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Private foundation X permits A, a substantial contributor to X, and her spouse, H, to use an automobile owned by X and normally used in its foundation activities to travel from State Z to State Y for a vacation on December 1, 1971. The automobile is then returned to X until December 21, 1971, when X again permits them to use the automobile to return to their home in State Z. Under these circumstances, there is one act of self-dealing on December 1, 1971, and a second act of self-dealing on December 21, 1971.

Example 2. Assume the facts as stated in example (1), except that B joined A and H on their vacation and traveled with them both to and from State Y. B is a disqualified person with respect to X, but he is not related by blood or marriage to A or H. Assume also that X is not paid for the use of its automobile, but that the fair rental value during the taxable period is $300 (or $100 per person) for a one-way trip between State Y and State Z. Under these circumstances, there are four acts of self-dealing, two with respect to A and H and two with respect to B. The amount involved with respect to A and H is $200 for each act, and the amount involved with respect to B is $100 for each act.

(f) *Fair market value.* For purposes of §§ 53.4941(a)–1 through 53.4941 (f)–1, fair market value shall be determined pursuant to the provisions of § 53.4942(a)–2 (c)(4).

[T.D. 7270, 38 FR 9493, Apr. 17, 1973, as amended by T.D. 8084, 51 FR 16301, May 2, 1986]

§ 53.4941(f)–1 Effective dates.

(a) *In general.* Except as provided in paragraph (b) of this section, §§ 53.4941(a)–1 through 53.4941(e)–1 shall apply to all acts of self-dealing engaged in after December 31, 1969.

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(b) *Transitional rules*—(1) *Commitments made prior to January 1, 1970, between private foundations and government officials*. Section 4941 shall not apply to a payment for one or more purposes described in section 170(c) (1) or (2)(B) made on or after January 1, 1970, by a private foundation to a government official, if such payment is made pursuant to a commitment entered into prior to such date, but only if such commitment was made in accordance with the foundation's usual practices and is reasonable in amount in light of the purposes of the payment. For purposes of this subparagraph, a commitment will be considered entered into prior to January 1, 1970, if prior to such date, the amount and nature of the payments to be made and the name of the payee were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee in writing.

(2) *Special transitional rule*. In the case of an act of self-dealing engaged in prior to July 5, 1971, section 4941(a) (1) shall not apply if:

(i) The participation (as defined in § 53.4941(a)–1(a)(3)) by the disqualified person in such act is not willful and is due to reasonable cause (as defined in § 53.4941(a)–1(b) (4) and (5)),

(ii) The transaction would not be a prohibited transaction if section 503(b) applied, and

(iii) The act is corrected (within the meaning of § 53.4941(e)–1(c)) within a period ending [insert 90 days after date on which final regulations under section 4941 are filed by the Federal Register], extended (prior to the expiration of the original period) by any period which the Commissioner determines is reasonable and necessary (within the meaning of § 53.4941(e)–1(d)) to bring about correction of the act of self-dealing.

Subpart C—Taxes on Failure To Distribute Income

SOURCE: T.D. 7249, 38 FR 768, Jan. 4, 1973, unless otherwise noted.

§ 53.4942(a)–1 Taxes for failure to distribute income.

(a) *Imposition of tax*—(1) *Initial tax*. Except as provided in paragraph (b) of this section, section 4942(a) imposes an excise tax of 15 percent on the undistributed income (as defined in paragraph (a) of § 53.4942(a)–2) of a private foundation for any taxable year which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year (if such first day falls within the taxable period as defined in paragraph (c)(1) of this section). For purposes of section 4942 and this section, the term *distributed* means distributed as qualifying distributions under section 4942(g). See paragraph (d)(2) of § 53.4942(a)–3 with respect to correction of deficient distributions for prior taxable years.

(2) *Additional tax*. In any case in which an initial excise tax is imposed by section 4942(a) on the undistributed income of a private foundation for any taxable year, section 4942(b) imposes an additional excise tax on any portion of such income remaining undistributed at the close of the correction period (as defined in paragraph (c)(1) of this section). The tax imposed by section 4942(b) is equal to 100 percent of the amount remaining undistributed at the close of the taxable period.

(3) *Payment of tax*. Payment of the excise taxes imposed by section 4942 (a) or (b) is in addition to, and not in lieu of, making the distribution of such undistributed income as required by section 4942. See section 507(a)(2) and the regulations thereunder.

(4) *Examples*. The provisions of this paragraph may be illustrated by the following examples:

Example 1 M, a private foundation which uses the calendar year as its taxable year, has at the end of 1981, $50,000 of undistributed income (as defined in paragraph (a) of § 53.4942 (a)–2) for 1981. As of January 1, 1983, $40,000 is still undistributed. On August 15, 1983, a notice of deficiency with respect to the excise taxes imposed by section 4942 (a) and (b) is mailed to *M* under section 6212 (a) and the taxable period ends. Thus, under these facts, an initial excise tax of $6,000 (15 percent of $40,000) is imposed upon *M*. An additional excise tax of $40,000 (100 percent of $40,000) is imposed by section 4942(b). Under section 4961(a), however, if the undistributed

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income is reduced to zero during the correction period, this latter tax will not be assessed, and if assessed, it will be abated, and if collected, it will be credited or refunded as an overpayment.

Example 2. Assume the facts as stated in example (1), except that the notice of deficiency is mailed to *M* on September 7, 1984, and as of January 1, 1984, only $10,000 of the $50,000 of undistributed income with respect to 1981 is undistributed. Therefore, initial excise taxes of $6,000 (15 percent of $40,000, M's undistributed income from 1981, as of January 1, 1983) and $1,500 (15 percent of $10,000, *M's* undistributed income from 1981 as of January 1, 1984) are imposed by section 4942(a). If the $10,000 remains undistributed as of September 7, 1984, the end of the taxable period, an additional excise tax of $10,000 (100 percent of $10,000, *M's* undistributed income from 1981, as of September 7, 1984) is imposed by section 4942(b).

(b) *Exceptions*—(1) *In general.* The initial excise tax imposed by section 4942(a) shall not apply to the undistributed income of a private foundation:

(i) For any taxable year for which it is an operating foundation (as defined in section 4942(j)(3) and the regulations thereunder), or

(ii) To the extent that the foundation failed to distribute any amount solely because of incorrect valuation of assets under paragraph (c)(4) of § 53.4942(a)–2, if:

(*a*) The failure to value the assets properly was not willful and was due to reasonable cause,

(*b*) Such amount is distributed as qualifying distributions (within the meaning of paragraph (a) of § 53.4942 (a)–3) by the foundation during the allowable distribution period (as defined in paragraph (c)(2) of this section),

(*c*) The foundation notifies the Commissioner that such amount has been distributed (within the meaning of subdivision (ii)(*b*) of this subparagraph) to correct such failure, and

(*d*) Such distribution is treated under paragraph (d)(2) of § 53.4942(a)–3 as made out of the undistributed income for the taxable year for which a tax would (except for this subdivision) have been imposed by section 4942(a).

(2) *Improper valuation.* For purposes of subparagraph (1)(ii) of this paragraph, failure to value an asset properly shall be regarded as ''not willful'' and ''due to reasonable cause'' whenever, under all the facts and circumstances, the foundation can show that it has made all reasonable efforts in good faith to value such an asset in accordance with the provisions of paragraph (c)(4) of § 53.4942(a)–2. If a foundation, after full disclosure of the factual situation, obtains a bona fide appraisal of the fair market value of an asset by a person qualified to make such an appraisal (whether or not such a person is a disqualified person with respect to the foundation), and such foundation relies upon such appraisal, then failure to value the asset properly shall ordinarily be regarded as ''not willful'' and ''due to reasonable cause''. Notwithstanding the preceding sentence, the failure to obtain such a bona fide appraisal shall not, by itself, give rise to any inference that a foundation's failure to value an asset properly was willful or not due to reasonable cause.

(3) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. In 1976 M, a private foundation which was established in 1975 and which uses the calendar year as the taxable year, incorrectly values its assets under paragraph (c)(4) of § 53.4942(a)–2 in a manner which is not willful and is due to reasonable cause. As a result of the incorrect valuation of assets, $20,000 which should be distributed with respect to 1976 is not distributed, and as of January 1, 1978, such amount is still undistributed. On March 29, 1978, a notice of deficiency with respect to the excise taxes imposed by section 4942 (a) and (b) is mailed to M under section 6212(a). On May 5, 1978 (within the allowable distribution period), M makes a qualifying distribution of $20,000 which is treated under paragraph (d)(2) of § 53.4942(a)–3 as made out of M's undistributed income for 1976. M notifies the Commissioner of its action. Under the stated facts, an initial excise tax of $3,000 (15 percent of $20,000) would (except for the exception contained in subparagraph (1)(ii) of this paragraph) have been imposed by section 4942(a), but since all of the requirements of such subparagraph are satisfied no tax is imposed by section 4942(a).

(c) *Certain periods.* For purposes of this section—

(1) *Taxable period.* (i) The term ''taxable period'' means, with respect to the undistributed income of a private foundation for any taxable year, the period beginning with the first day of the taxable year and ending on the earlier of:

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(A) The date of mailing of a notice of deficiency under section 6212(a) with respect to the initial excise tax imposed under section 4942(a), or

(B) The date on which the initial excise tax imposed under section 4942(a) is assessed.

For example, assume M, a private foundation which uses the calendar year as the taxable year, has $15,000 of undistributed income for 1981. A notice of deficiency is mailed to M under section 6212(a) on June 1, 1983. With respect to the undistributed income of M for 1981, the taxable period began on January 1, 1981, and ended on June 1, 1983.

(ii) Where a notice of deficiency referred to in subdivision (i) of this subparagraph is not mailed because there is a waiver of the restrictions on assessment and collection of a deficiency, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the taxable period.

(2) *Allowable distribution period.* (i) The term ''allowable distribution period'' means the period beginning with the first day of the first taxable year following the taxable year in which the incorrect valuation of foundation assets (described in paragraph (b)(1)(ii) of this section) occurred and ending 90 days after the date of mailing of a notice of deficiency under section 6212(a) with respect to the initial excise tax imposed by section 4942(a). This period shall be extended by any period in which a deficiency cannot be assessed under section 6213(a), and any other period which the Commissioner determines is reasonable and necessary to permit a distribution of undistributed income under section 4942.

(ii) Where a notice of deficiency referred to in subdivision (i) of this subparagraph is not mailed because there is a waiver of the restrictions on assessment and collection of a deficiency, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the allowable distribution period.

(3) *Cross reference.* For rules relating to taxable events that are corrected within the correction period, defined in section 4963(e), see section 4961 (a) and the regulations thereunder.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. In 1975 M, a private foundation which uses the calendar year as the taxable year, made an error in valuing its assets which was not willful and was due to reasonable cause. The error caused M not to distribute $25,000 that should have been distributed with respect to 1975. On March 1, 1978, a notice of deficiency with respect to the excise taxes imposed by section 4942 (a) and (b) was mailed to M under section 6212(a). With respect to the undistributed income for 1975, the *taxable period* is the period from January 1, 1975, through March 1, 1978, and the *allowable distribution period* is the period from January 1, 1976, through May 30, 1978 (90 days after the mailing of the notice of deficiency).

Example 2. Assume the facts as stated in example (1), except that the Commissioner determines that it is reasonable and necessary to extend the period for distribution through June 15, 1978. Thus, the *allowable distribution period* is from January 1, 1976, through June 15, 1978.

(d) *Effective date.* Except as otherwise specifically provided, section 4942 and the regulations thereunder shall only apply with respect to taxable years beginning after December 31, 1969.

[T.D. 7256, 38 FR 3317, Feb. 7, 1973, as amended by T.D. 8084, 51 FR 16302, May 2, 1986]

§ 53.4942(a)–2 Computation of undistributed income.

(a) *Undistributed income.* For purposes of section 4942, 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 (as defined in paragraph (b) of this section) for such taxable year, exceeds

(2) The qualifying distributions (as defined in § 53.4942(a)–3) made before such time out of such distributable amount.

(b) Distributable amount—(1) In general. For purposes of paragraph (a) of this section, the term ''distributable amount'' means:

(i) For taxable years beginning before January 1, 1982, an amount equal to the greater of the minimum investment return (as defined in paragraph (c) of this section) or the adjusted net income (as defined in paragraph (d) of this section); and

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(ii) For taxable years beginning after December 31, 1981, an amount equal to the minimum investment return (as defined in paragraph (c) of this section), reduced by the sum of the taxes imposed on such private foundation for such taxable year under subtitle A of the Code and section 4940, and increased by the amounts received from trusts described in subparagraph (2) of this paragraph.

(2) *Certain trust amounts*—(i) *In general*. The distributable amount shall be increased by the income portion (as defined in subdivision (ii) of this subparagraph) of distributions from trusts described in section 4947(a)(2) with respect to amounts placed in trust after May 26, 1969. If such distributions are made with respect to amounts placed in trust both on or before and after May 26, 1969, such distributions shall be allocated between such amounts to determine the extent to which such distributions shall be included in the foundation's distributable amount. For rules relating to the segregation of amounts placed in trust on or before May 26, 1969, from amounts placed in trust after such date and to the allocation of income derived from such amounts, see paragraph (c) (5) of § 53.4947–1.

(ii) *Income portion of distributions to private foundations*. For purposes of subdivision (i) of this subparagraph, the income portion of a distribution from a section 4947(a)(2) trust to a private foundation in a particular taxable year of such foundation shall be the greater of:

(*a*) The amount of such distribution which is treated as income (within the meaning of section 643(b)) of the trust, or

(*b*) The guaranteed annuity, or fixed percentage of the fair market value of the trust property (determined annually), which the private foundation is entitled to receive for such year, regardless of whether such amount is actually received in such year or in any prior or subsequent year.

(iii) *Limitation*. Notwithstanding subdivisions (i) and (ii) of this subparagraph, a private foundation shall not be required to distribute a greater amount for any taxable year than would have been required (without regard to this subparagraph) for such year had the corpus of the section 4947(a) (2) trust to which the distribution described in subdivision (ii) of this subparagraph is attributable been taken into account by such foundation as an asset described in paragraph (c) (1) (i) of this section.

(c) *Minimum investment return*—(1) *In general*. For purposes of paragraph (b) of this section, the ''minimum investment return'' for any private foundation for any taxable year is the amount determined by multiplying:

(i) The excess of the aggregate fair market value of all assets of the foundation, other than those described in subparagraph (2) or (3) of this paragraph, over the amount of the acquisition indebtedness with respect to such assets (determined under section 514(c)(1), but without regard to the taxable year in which the indebtedness was incurred), by

(ii) The applicable percentage (as defined in subparagraph (5) of this paragraph) for such year.

For purposes of subdivision (i) of this subparagraph, the aggregate fair market value of all assets of the foundation shall include the average of the fair market values on a monthly basis of securities for which market quotations are readily available (within the meaning of subparagraph (4)(i)(*a*) of this paragraph), the average of the foundation's cash balances on a monthly basis (less the cash balances excluded from the computation of the minimum investment return by operation of subparagraph (3)(iv) of this paragraph), and the fair market value of all other assets (except those assets described in subparagraph (2) or (3) of this paragraph) for the period of time during the taxable year for which such assets are held by the foundation. Any determination of the fair market value of an asset required pursuant to the provisions of this subparagraph shall be made in accordance with the rules of subparagraph (4) of this paragraph.

(2) *Certain assets excluded*. For purposes of this paragraph, the assets taken into account in determining minimum investment return shall not include the following:

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(i) Any future interest (such as a vested or contingent remainder, whether legal or equitable) of a foundation in the income or corpus of any real or personal property, other than a future interest created by the private foundation after December 31, 1969, until all intervening interests in, and rights to the actual possession or enjoyment of, such property have expired, or, although not actually reduced to the foundation's possession, until such future interest has been constructively received by the foundation, as where it has been credited to the foundation's account, set apart for the foundation, or otherwise made available so that the foundation may acquire it at any time or could have acquired it if notice of intention to acquire had been given;

(ii) The assets of an estate until such time as such assets are distributed to the foundation or, due to a prolonged period of administration, such estate is considered terminated for Federal income tax purposes by operation of paragraph (a) of §1.641(b)–3 of this chapter (Income Tax Regulations);

(iii) Any present interest of a foundation in any trust created and funded by another person (see, however, paragraph (b) (2) of this section with respect to amounts received from certain trusts described in section 4947(a) (2));

(iv) Any pledge to the foundation of money or property (whether or not the pledge may be legally enforced); and

(v) Any assets used (or held for use) directly in carrying out the foundation's exempt purpose.

(3) *Assets used (or held for use) in carrying out the exempt purpose*—(i) *In general*. For purposes of subparagraph (2)(v) of this paragraph, an asset is "used (or held for use) directly in carrying out the foundation's exempt purpose" only if the asset is actually used by the foundation in the carrying out of the charitable, educational, or other similar purpose which gives rise to the exempt status of the foundation, or if the foundation owns the asset and establishes to the satisfaction of the Commissioner that its immediate use for such exempt purpose is not practical (based on the facts and circumstances of the particular case) and that definite plans exist to commence such use within a reasonable period of time. Consequently, assets which are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or, generally, leased real estate) are not being used (or held for use) directly in carrying out the foundation's exempt purpose, even though the income from such assets is used to carry out such exempt purpose. Whether an asset is held for the production of income or for investment rather than used (or held for use) directly by the foundation to carry out its exempt purpose is a question of fact. For example, an office building used for the purpose of providing offices for employees engaged in the management of endowment funds of the foundation is not being used (or held for use) directly by the foundation to carry out its charitable, educational, or other similar exempt purpose. However, where property is used both for charitable, educational, or other similar exempt purposes and for other purposes, if such exempt use represents 95 percent or more of the total use, such property shall be considered to be used exclusively for a charitable, educational, or other similar exempt purpose. If such exempt use of such property represents less than 95 percent of the total use, reasonable allocation between such exempt and nonexempt use must be made for purposes of this paragraph. Property acquired by the foundation to be used in carrying out its charitable, educational, or other similar exempt purpose may be considered as used (or held for use) directly to carry out such exempt purpose even though the property, in whole or in part, is leased for a limited period of time during which arrangements are made for its conversion to the use for which it was acquired, provided such income-producing use of the property does not exceed a reasonable period of time. Generally, 1 year shall be deemed to be a reasonable period of time for purposes of the immediately preceding sentence. For treatment of the income derived from such income-producing use, see paragraph (d)(2)(viii) of this section. Where the income-producing use continues beyond a reasonable period of time, the property shall not be deemed to be used by the foundation to carry

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out its charitable, educational, or other similar exempt purpose, but, instead, as of the time the income-producing use becomes unreasonable, such property shall be treated as disposed of within the meaning of paragraph (d)(2)(iii)(*b*) of this section to the extent that the acquisition of the property was taken into account as a qualifying distribution (within the meaning of paragraph (a)(2) of § 53.4942(a–3) for any taxable year. If, subsequently, the property is used by the foundation directly in carrying out its charitable, educational, or other similar exempt purpose, a qualifying distribution in the amount of its then fair market value, determined in accordance with the rules contained in subparagraph (4) of this paragraph, shall be deemed to have been made as of the time such exempt use begins.

(ii) *Illustrations.* Examples of assets which are ''used (or held for use) directly in carrying out the foundation's exempt purpose'' include, but are not limited to, the following:

(*a*) Administrative assets, such as office equipment and supplies which are used by employees or consultants of the foundation, to the extent such assets are devoted to and used directly in the administration of the foundation's charitable, educational or other similar exempt activities;

(*b*) Real estate or the portion of a building used by the foundation directly in its charitable, educational, or other similar exempt activities;

(*c*) Physical facilities used in such activities, such as paintings or other works of art owned by the foundation which are on public display, fixtures and equipment in classrooms, research facilities and related equipment which under the facts and circumstances serve a useful purpose in the conduct of such activities;

(*d*) Any interest in a functionally related business (as defined in subdivision (iii) of this subparagraph) or in a program-related investment (as defined in section 4944(c));

(*e*) The reasonable cash balances (as described in subdivision (iv) of this subparagraph) necessary to cover current administrative expenses and other normal and current disbursements directly connected with the foundation's charitable, educational, or other similar exempt activities; and

(*f*) Any property leased by a foundation in carrying out its charitable, educational, or other similar exempt purpose at no cost (or at a nominal rent) to the lessee or for a program-related purpose (within the meaning of section 4944(c)), such as the leasing of renovated apartments to low-income tenants at a low rental as part of the lessor foundation's program for rehabilitating a blighted portion of a community. For treatment of the income derived from such use, see paragraph (d) (2) (viii) of this section.

(iii) *Functionally related business—(a) In general.* The term ''functionally related business'' means:

(*1*) A trade or business which is not an unrelated trade or business (as defined in section 513), or

(*2*) An activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the charitable, educational, or other similar exempt purpose of the organization.

(*b*) *Examples.* The provisions of this subdivision may be illustrated by the following examples:

Example 1. X, a private foundation, maintains a community of historic value which is open to the general public. For the convenience of the public, X, through a wholly owned, separately incorporated, taxable entity, maintains a restaurant and hotel in such community. Such facilities are within the larger aggregate of activities which makes available for public enjoyment the various buildings of historic interest and which is related to X's exempt purpose. Thus, the operation of the restaurant and hotel under such circumstances constitutes a functionally related business.

Example 2. Y, a private foundation, as part of its medical research program under section 501(c) (3), publishes a medical journal in carrying out its exempt purpose. Space in the journal is sold for commercial advertising. Notwithstanding the fact that the advertising activity may be subject to the tax imposed by section 511, such activity is within a larger complex of endeavors which makes available to the scientific community and the general public developments with respect to medical research and is therefore a functionally related business.

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(iv) *Cash held for charitable, etc. activities.* For purposes of subdivision (ii)(*e*) of this subparagraph, the reasonable cash balances which a private foundation needs to have on hand to cover expenses and disbursements described in such subdivision will generally be deemed to be an amount, computed on an annual basis, equal to one and one-half percent of the fair market value of all assets described in subparagraph (1)(i) of this paragraph, without regard to subdivision (ii)(*e*) of this subparagraph. However, if the Commissioner is satisfied that under the facts and circumstances an amount in addition to such one and one-half percent is necessary for payment of such expenses and disbursements, then such additional amount may also be excluded from the amount of assets described in subparagraph (1)(i) of this paragraph. All remaining cash balances, including amounts necessary to pay any tax imposed by section 511 or any section of chapter 42 of the Code except section 4940, are to be included in the assets described in subparagraph (1)(i) of this paragraph.

(4) *Valuation of assets*—(i) *Certain securities.* (*a*) For purposes of subparagraph (1)(i) of this paragraph, a private foundation may use any reasonable method to determine the fair market value on a monthly basis of securities for which market quotations are readily available, as long as such method is consistently used. For purposes of this subparagraph, market quotations are readily available if a security is:

(*1*) Listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign national or regional exchange;

(*2*) Regularly traded in the national or regional over-the-counter market, for which published quotations are available; or

(*3*) Locally traded, for which quotations can readily be obtained from established brokerage firms.

(*b*) For purposes of this subdivision, commonly accepted methods of valuation must be used in making an appraisal. Valuations made in accordance with the principles stated in the regulations under section 2031 constitute acceptable methods of valuation. This paragraph (c)(4)(i)(*b*) applies only for taxable years beginning before January 1, 1976. See section 4942(e)(2)(B) and paragraph (c)(4)(i)(*c*) of this section for special valuation rules that apply for subsequent taxable years.

(*c*) For purposes of this subdivision (i) and with respect to taxable years beginning after December 31, 1975, if the private foundation can show that the value of securities determined on the basis of market quotations as provided by subdivision (i)(*a*) does not reflect the fair market value thereof because:

(*1*) The securities constitute a block of securities so large in relation to the volume of actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market.

(*2*) The securities are securities in a closely held corporation and sales are few or of a sporadic nature, and, or

(*3*) The sale of the securities would result in a forced or distress sale because the securities could not be offered to the public for sale without first being registered under the Securities Act of 1933 or because of other factors,

then the price at which the securities could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. On the other hand, if the securities to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to the true value of the securities. No decrease in the fair market value of any given class of securities determined on the basis of market quotations as provided by subdivision (i)(*a*) shall be allowed except as authorized by this subdivision, and no such decrease shall in the aggregate exceed 10 percent of the fair market value of such class of securities so determined on the basis of market quotations and without regard to this subdivision.

(*d*) In the case of securities described in subdivision (i)(*a*) of this subparagraph, which are held in trust for, or on behalf of, a foundation by a bank or

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other financial institution which values such securities periodically by use of a computer, a foundation may determine the correct value of such securities by use of such computer pricing system, provided the Commissioner has accepted such computer pricing system as a valid method for valuing securities for Federal estate tax purposes.

(*e*) This subdivision may be illustrated by the following examples:

Example 1. U, a private foundation, owns 1,000 shares of the stock of M Corporation. M stock is regularly traded on the New York Stock Exchange. U consistently follows a practice of valuing its 1,000 shares of M stock on the last trading day of each month based upon the quoted closing price for M stock. U's method of valuing its M Corporation stock is permissible under the rules contained in subdivision (i)(*a*) of this subparagraph.

Example 2. Assume the facts as stated in example (1), except that U consistently follows a practice of valuing its 1,000 shares of M stock by taking the mean of the closing prices for M stock on the first and last trading days of each month and the trading day nearest the 15th day of each month. U's method of valuing its M stock is permissible under the rules contained in subdivision (i)(*a*) of this subparagraph.

Example 3. Assume the facts as stated in example (1), except that U consistently follows a practice of valuing its M stock by taking the mean of the highest and lowest quoted prices for the stock on the last trading day of each month. U's method of valuing its M stock is permissible under the rules contained in subdivision (1)(*a*) of this subparagraph.

Example 4. V, a private foundation, owns 1,000 shares of the stock of N Corporation. N stock is regularly traded in the national over-the-counter market and published quotations of the bid and asked prices for the stock are available. V consistently follows a practice of valuing its 1,000 shares of N stock on the first trading day of each month by taking the mean of the bid and asked prices on that day. V's method of valuing its N Corporation stock is permissible under the rules contained in subdivision (i)(*a*) of this subparagraph.

Example 5. W, a private foundation, owns 1,000 shares of the stock of O Corporation. O stock is locally traded and quotations can readily be obtained from established brokerage firms. W consistently follows a practice of valuing its O stock on the 15th day of each month by obtaining a bona fide quotation of bid and asked prices for the stock from an established brokerage firm and taking the mean of such prices on that day. If a quotation is unavailable on the regular valuation date, W values its O stock based upon a bona fide quotation on the first day thereafter on which such a quotation is available. W's method of valuing its O Corporation stock is permissible under the rules contained in subdivision (i)(*a*) of this subparagraph.

(ii) *Cash.* In order to determine the amount of a foundation's cash balances, the foundation shall value its cash on a monthly basis by averaging the amount of cash on hand as of the first day of each month and as of the last day of each month.

(iii) *Common trust funds.* If a private foundation owns a participating interest in a common trust fund (as defined in section 584) established and administered under a plan providing for the periodic valuation of participating interests during the fund's taxable year and the reporting of such valuations to participants, the value of the foundation's interest in the common trust fund based upon the average of the valuations reported to the foundation during its taxable year will ordinarily constitute an acceptable method of valuation.

(iv) *Other assets.* (*a*) Except as otherwise provided in subdivision (iv)(*b*) of this subparagraph, the fair market value of assets other than those described in subdivisions (i) through (iii) of this subparagraph shall be determined annually. Thus, the fair market value of securities other than those described in subdivision (i) of this subparagraph shall be determined in accordance with this subdivision (*a*). If, however, a private foundation owns voting stock of an issuer of unlisted securities and has, or together with disqualified persons or another private foundation has, effective control of the issuer (within the meaning of § 53.4943–3(b)(3)(ii), then to the extent that the issuer's assets consist of shares of listed securities issues, such assets shall be valued monthly on the basis of market quotations or in accordance with section 4942(e)(2)(B), if applicable. Thus, for example, if a private foundation and a disqualified person together own all of the unlisted voting stock of a holding company which in turn holds a portfolio of securities of issues which are listed on the New York Stock Exchange, in determining the net worth of the holding company, the underlying portfolio securities are to be valued monthly by reference to market quotations for their issues unless a decrease in such value is authorized in accordance with section 4942(e)(2)(b). Such determination may be made by employees of the private foundation or by any other person, without regard to whether such person is a disqualified person with respect to the foundation. A valuation made pursuant to the provisions of this subdivision, if accepted by the Commissioner, shall be valid only for the taxable year for which it is made. A new valuation made in accordance with these provisions is required for the succeeding taxable year.

(*b*) If the requirements of this subdivision are met, the fair market value of any interest in real property, including any improvements thereon, may be determined on a 5-year basis. Such value must be determined by means of a certified, independent appraisal made in writing by a qualified person who is neither a disqualified person with respect to, nor an employee of, the private foundation. The appraisal is certified only if it contains a statement at the end thereof to the effect that, in the opinion of the appraiser, the values placed on the assets appraised were determined in accordance with valuation principles regularly employed in making appraisals of such property using all reasonable valuation methods. The foundation shall retain a copy of the independent appraisal for its records. If a valuation made pursuant to the provisions of this subdivision in fact falls within the range of reasonable values for the appraised property, such valuation may be used by the foundation for the taxable year for which the valuation is made and for each of the succeeding 4 taxable years. Any valuation made pursuant to the provisions of this subdivision may be replaced during the 5-year period by a subsequent 5-year valuation made in accordance with the rules set forth in this subdivision, or with an annual valuation made in accordance with subdivision (iv)(*a*) of this subparagraph, and the most recent such valuation of such assets shall be used in computing the foundation's minimum investment return. In the case of a foundation organized before May 27, 1969, a valuation made in accordance with this subdivision applicable to the foundation's first taxable year beginning after December 31, 1972, and the 4 succeeding taxable years must be made no later than the last day of such first taxable year. In the case of a foundation organized after May 26, 1969, a valuation made in accordance with this subdivision applicable to the foundation's first taxable year beginning after February 5, 1973 and the succeeding 4 taxable years must be made no later than the last day of such first taxable year. Any subsequent valuation made in accordance with this subdivision must be made no later than the last day of the first taxable year for which such new valuation is applicable. A valuation, if properly made in accordance with the rules set forth in this subdivision, will not be disturbed by the Commissioner during the 5-year period for which it applies even if the actual fair market value of such property changes during such period.

(*c*) For purposes of this subdivision, commonly accepted methods of valuation must be used in making an appraisal. Valuations made in accordance with the principles stated in the regulations under section 2031 constitute acceptable methods of valuation. The term *appraisal*, as used in this subdivision, means a determination of fair market value and is not to be construed in a technical sense peculiar to particular property or interests therein, such as, for example, mineral interests in real property.

(v) *Definition of ''securities''*. For purposes of this subparagraph, the term ''securities'' includes, but is not limited to, common and preferred stocks, bonds, and mutual fund shares.

(vi) *Valuation date*. (*a*) In the case of an asset which is required to be valued on an annual basis as provided in subdivision (iv)(*a*) of this subparagraph, such asset may be valued as of any day in the private foundation's taxable year to which such valuation applies, provided the foundation follows a consistent practice of valuing such asset as of such date in all taxable years.

(*b*) A valuation described in subdivision (iv)(*b*) of this subparagraph may be made as of any day in the first taxable

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year of the private foundation to which such valuation is to be applied.

(vii) *Assets held for less than a taxable year*. For purposes of this paragraph, any asset described in subparagraph (1)(i) of this paragraph which is held by a foundation for only part of a taxable year shall be taken into account for purposes of determining the foundation's minimum investment return for such taxable year by multiplying the fair market value of such asset (as determined pursuant to this subparagraph) by a fraction, the numerator of which is the number of days in such taxable year that the foundation held such asset and the denominator of which is the number of days in such taxable year.

(5) *Applicable percentage*—(i) *In general*. For purposes of paragraph (c)(1)(ii) of this section, except as provided in paragraph (c)(5)(ii) or (iii) of this section, the applicable percentage is:

(*a*) Six percent for a taxable year beginning in 1970 or 1971;

(*b*) Five and a half percent for a taxable year beginning in 1972;

(*c*) Five and one-quarter percent for a taxable year beginning in 1973;

(*d*) Six percent for a taxable year beginning in 1974 or 1975; and

(*e*) Five percent for taxable years beginning after Dec. 31, 1975.

(ii) *Transitional rule*. In the case of organizations organized before May 27, 1969 (including organizations deemed to be so organized by virtue of the provisions of paragraph (e)(2) of this section), section 4942 shall, for all purposes other than the determination of the minimum investment return under section 4942(j)(3)(B)(ii), for taxable years:

(*a*) Beginning before January 1, 1972, apply without regard to section 4942(e).

(*b*) Beginning in 1972, apply with an applicable percentage of 4⅛ percent,

(*c*) Beginning in 1973, apply with an applicable percentage of 4⅜ percent and

(*d*) Beginning in 1974, apply with an applicable percentage of 5½ percent.

(iii) *Short taxable periods*. In any case in which a taxable year referred to in this subparagraph is a period less than 12 months, the applicable percentage to be applied to the amount determined under the provisions of subparagraph (1) of this paragraph shall be equal to the applicable percentage for the calendar year in which the short taxable period began multiplied by a fraction, the numerator of which is the number of days in such short taxable period and the denominator of which is 365.

(d) *Adjusted net income*—(1) *Definition*. For purposes of paragraph (b) of this section, the term ''adjusted net income'' means the excess (if any) of:

(i) The gross income for the taxable year (including gross income from any unrelated trade or business) determined with the income modifications provided by subparagraph (2) of this paragraph, over

(ii) The sum of the deductions (including deductions directly connected with the carrying on of any unrelated trade or business), determined with the deduction modifications provided by subparagraph (4) of this paragraph, which would be allowed to a corporation subject to the tax imposed by section 11 for the taxable year.

In computing the income includible under this paragraph as gross income and the deductions allowable under this paragraph from such income, the principles of subtitle A of the Code shall apply except to the extent such principles conflict with section 4942 and the regulations thereunder (without regard to this sentence). Except as otherwise provided in this paragraph, no exclusions or deductions from gross income or credits against tax are allowable under this paragraph. For purposes of subdivision (i) of this subparagraph, the term ''gross income'' does not include gifts, grants, or contributions received by the private foundation but does include income from a functionally related business (as defined in paragraph (c)(3)(iii) of this section).

(2) *Income modifications*. The income modifications referred to in subparagraph (1)(i) of this paragraph are as follows:

(i) Section 103 (relating to interest on certain governmental obligations) shall not apply. Hence, interest which would have been excluded from gross income by section 103 shall be included in gross income.

(ii) Capital gains and losses from the sale or other disposition of property

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shall be taken into account only in an amount equal to any net short-term capital gain (as defined in section 1222(5)) for the taxable year. Long-term capital gain or loss is not included in the computation of adjusted net income. Similarly, net section 1231 gains shall be excluded from the computation of adjusted net income. However, net section 1231 losses shall be included in the computation of adjusted net income, if such losses are otherwise described in subparagraph (1)(ii) of this paragraph. Any net short-term capital loss for a given taxable year shall not be taken into account in computing adjusted net income for such year or in computing net short-term capital gain for purposes of determining adjusted net income for prior or future taxable years regardless of whether the foundation is a corporation or a trust.

(iii) The following amounts shall be included in gross income for the taxable year:

(*a*) Amounts received or accrued as repayments of amounts which were taken into account as a qualifying distribution within the meaning of paragraph (a)(2)(i) of § 53.4942(a)–3 for any taxable year;

(*b*) Notwithstanding subdivision (ii) of this subparagraph, gross amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of such property was taken into account as a qualifying distribution (within the meaning of paragraph (a)(2)(ii) of § 53.4942(a)–3) for any taxable year; and

(*c*) Any amount set aside under paragraph (b) of § 53.4942(a)–3 to the extent it is determined that such amount is not necessary for the purposes for which it was set aside.

(iv) Any distribution received by a private foundation from a disqualified person in redemption of stock held by such private foundation in a business enterprise shall be treated as not essentially equivalent to a dividend under section 302(b)(1) if all of the following conditions are satisfied:

(*a*) Such redemption is of stock which was owned by a private foundation on May 26, 1969 (or which is acquired by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date which are in effect on such date and at all times thereafter);

(*b*) Such foundation is required to dispose of such property in order not to be liable for tax under section 4943 (relating to taxes on excess business holdings) applied, in the case of a disposition before January 1, 1975, without taking section 4943(c)(4) into account; and

(*c*) Such foundation receives in return an amount which equals or exceeds the fair market value of such property at the time of such disposition or at the time a contract for such disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law).

(v) If, as of the date of distribution of property for purposes described in section 170(c) (1) or (2)(B), the fair market value of such property exceeds its adjusted basis, such excess shall not be deemed an amount includible in gross income.

(vi) The income received by a private foundation from an estate during the period of administration of such estate shall not be included in such foundation's gross income, unless, due to a prolonged period of administration, such estate is considered terminated for Federal income tax purposes by operation of paragraph (a) of § 1.641(b)–3 of this chapter (Income Tax Regulations).

(vii) Distributions received by a private foundation from a trust created and funded by another person shall not be included in the foundation's gross income. However, with respect to distributions from certain trusts described in section 4947(a)(2), see paragraph (b)(2) of this section.

(viii) Gross income shall include all amounts derived from, or in connection with, property held by the foundation, even though the fair market value of such property may not be included in such foundation's assets for purposes of determining minimum investment return by operation of paragraph (c)(3) of this section.

(ix) Gross income shall include amounts treated in a preceding taxable year as a "qualifying distribution" by operation of paragraph (c) of

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§ 53.4942(a)–3 where such amounts are not redistributed by the close of the donee organization's succeeding taxable year in accordance with the rules prescribed in such paragraph (c). In such cases, such amounts shall be included in the donor foundation's gross income for such foundation's first taxable year beginning after the close of the donee organization's first taxable year following the donee organization's taxable year of receipt.

(x) For taxable years ending after October 4, 1976, section 4942(f)(2)(D) states that section 483 (relating to imputed interest on deferred payments) does not apply to payments made pursuant to a binding contract entered into in a taxable year beginning before January 1, 1970. Amounts that are not treated as imputed interest because of section 4942(f)(2)(D) and this subdivision will represent gain or loss from the sale of property. If the gain or loss is long term capital gain or loss, section 4942(f)(2)(B) excludes the gain or loss from the computation of the foundation's gross income. If, in a taxable year beginning after December 31, 1969, there is a substantial change in the terms of a contract entered into in a taxable year beginning before January 1, 1970, then any payment made pursuant to the changed contract is not considered a payment made pursuant to a contract entered into in a taxable year beginning before January 1, 1970. Whether or not a change in the terms of a contract (for example, a change relating to time of payment, sales price, or obligations under the contract) is a substantial change is determined by applying the rules under section 483 and § 1.483–1(b)(4). As used in this subdivision, a binding contract includes an irrevocable written option.

(3) *Adjusted basis*—(i) *In general.* For purposes of subparagraph (2)(ii) of this paragraph, the adjusted basis for purposes of determining gain from the sale or other disposition of property shall be determined in accordance with the rules set forth in subdivision (ii) of this subparagraph and the adjusted basis for purposes of determining loss from such disposition shall be determined in accordance with the rules set forth in subdivision (iii) of this subparagraph. Further, the provisions of this subparagraph do not apply for any purpose other than for purposes of subparagraph (2)(ii) of this paragraph. For example, the determination of gain pursuant to the provisions of section 341 is determined without regard to this subparagraph.

(ii) *Gain from sale or other disposition.* The adjusted basis for purposes of determining gain from the sale or other disposition of property shall be the greater of:

(*a*) The fair market value of such property on December 31, 1969, plus or minus all adjustments after December 31, 1969, and before the date of sale or other disposition under the rules of Part II, Subchapter O, Chapter 1 of the Code, provided that the property was held by the private foundation on December 31, 1969, and continuously thereafter to such date of sale or other disposition; or

(*b*) The adjusted basis as determined under the rules of Part II, Subchapter O, Chapter 1 of the Code, subject to the provisions of section 4940(c)(3)(B) and the regulations thereunder (and without regard to section 362(c)). With respect to assets acquired prior to December 31, 1969, which were subject to depreciation or depletion, for purposes of determining the adjustments to be made to basis between the date of acquisition and December 31, 1969, and amount equal to straight-line depreciation or cost depletion shall be taken into account. In addition, in determining such adjustments to basis, if any other adjustments would have been made during such period (such as a change in useful life based upon additional data or a change in facts), such adjustments shall also be taken into account.

(iii) *Loss from sale or other disposition.* For purposes of determining loss from the sale or other disposition of property, adjusted basis as determined in subdivision (ii)(*b*) of this subparagraph shall apply.

(iv) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A private foundation, which uses the cash receipts and disbursements method of accounting, purchased certain depreciable real property on December 1, 1969. On December 31, 1969, the fair market value

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of such property was $100,000 and its adjusted basis (determined under the provisions of this subparagraph) was $102,000. The property was sold on January 2, 1970, for $105,000. Because fair market value on December 31, 1969, $100,000, is less than the adjusted basis as determined by Part II, Subchapter O, Chapter 1 of the Code, $102,000, a short-term gain of $3,000 is recognized (*i.e.*, sale price of $105,000 less the greater of the two possible bases) for purposes of subparagraph (2)(ii) of this paragraph.

Example 2. Assume the facts as stated in example (1), except that the sale price was $95,000. Because the sale price was $7,000 less than the adjusted basis for loss ($102,000 as determined by the application of subdivision (iii) of this subparagraph), there is a capital loss of $7,000 which may be deducted against short-term capital gains for 1970 (if any) in determining net short-term capital gain.

Example 3. A private foundation, which uses the cash receipts and disbursements method of accounting, purchased unimproved land on December 1, 1969. On December 31, 1969, the fair market value of such property was $110,000 and its adjusted basis (determined under the provisions of this subparagraph) was $102,000. The property was sold on January 2, 1970, for $105,000. Since the fair market value on December 31, 1969, $110,000, exceeds the adjusted basis as determined by Part II, Subchapter O, Chapter 1 of the Code, $102,000, such fair market value will be used for purposes of determining gain. However, because the adjusted basis for purposes of determining gain exceeds the sale price, there is no gain. Furthermore, because the adjusted basis for purposes of determining loss, $102,000, is less than sale price, there is no loss.

(4) *Deduction modifications*—(i) *In general.* For purposes of computing adjusted net income under subparagraph (1) of this paragraph, no deduction shall be allowed other than all the ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of such income, except as provided in subdivision (ii) of this subparagraph. Such expenses include that portion of a private foundation's operating expenses which is paid or incurred for the production or collection of gross income. Operating expenses include compensation of officers, other salaries and wages of employees, interest, rent, and taxes. Where only a portion of the property produces (or is held for the production of) income subject to the provisions of section 4942, and the remainder of the property is used for charitable, educational, or other similar exempt purposes, the deductions allowed by this subparagraph shall be apportioned between the exempt and nonexempt uses. Similarly, where the deductions with respect to property used for a charitable, educational, or other similar exempt purpose exceed the income derived from such property, such excess shall not be allowed as a deduction, but may be treated as a qualifying distribution described in paragraph (a)(2)(ii) of § 53.4942(a)–3. Furthermore, this subdivision does not allow deductions which are not paid or incurred for the purposes herein prescribed. Thus, for example, the deductions prescribed by the following sections are not allowable: (*a*) The charitable contributions deduction prescribed under sections 170 and 642(c); (*b*) the net operating loss deduction prescribed under section 172; and (*c*) the special deductions prescribed under Part VIII, Subchapter B, Chapter 1 of the Code.

(ii) *Special rules.* For purposes of computing adjusted net income under subparagraph (1) of this paragraph: (*a*) The allowances for depreciation and depletion as determined under section 4940(c)(3)(B) and the regulations thereunder shall be taken into account, and (*b*) section 265 (relating to expenses and interest relating to tax-exempt interest) shall not apply.

(e) *Certain transitional rules*—(1) *In general.* In the case of organizations organized before May 27, 1969, section 4942 shall:

(i) Not apply to an organization to the extent its income is required to be accumulated pursuant to the mandatory terms (as in effect on May 26, 1969, and at all times thereafter) of an instrument executed before May 27, 1969, with respect to the transfer of income producing property to such organization, except that section 4942 shall apply to such organization if the organization would have been denied exemption had section 504(a) not been repealed, or would have had its deductions under section 642(c) limited had section 681(c) not been repealed. In applying the preceding sentence, in addition to the limitations contained in

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section 504(a) or 681(c) before its repeal, section 504(a)(1) or 681(c)(1) shall be treated as not applying to an organization to the extent its income is required to be accumulated pursuant to the mandatory terms (as in effect on January 1, 1951, and at all times thereafter) of an instrument executed before January 1, 1951, with respect to the transfer of income producing property to such organization before such date, if such transfer was irrevocable on such date; and

(ii) Not apply to an organization which is prohibited by its governing instrument or other instrument from distributing capital or corpus to the extent the requirements of section 4942 are inconsistent with such prohibitions.

(2) *Certain existing organizations.* For purposes of this section, an organization will be deemed to be organized prior to May 26, 1969, if it is either a testamentary trust created under the will of an individual who died prior to such date or an inter visos trust which was in existence and irrevocable prior to such date, even though it is not funded until after May 26, 1969. Similarly, a split-interest trust, as described in section 4947(a)(2) (without regard to section 4947(a)(2)(C)), which became irrevocable prior to May 27, 1969, and which is treated as a private foundation under section 4947(a)(1) subsequent to such date, likewise shall be treated as an organization organized prior to such date. See section 507(b)(2) and the regulations thereunder with respect to the applicability of transitional rules where there has been a merger of two or more private foundations or a reorganization of a private foundation.

(3) *Limitation.* With respect to taxable years beginning after December 31, 1971, subparagraph (1) (i) and (ii) of this paragraph shall apply only for taxable years during which there is pending any judicial proceeding by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument (as in effect on May 26, 1969) in order to comply with the provisions of section 4942, and in the case of subparagraph (1)(i) of this paragraph for all taxable years following the taxable year in which such judicial proceeding is terminated during which the governing instrument or any other instrument does not permit compliance with such provisions. Thus, the exception described in subparagraph (1)(ii) of this paragraph applies after 1971 only for taxable years during which such judicial proceeding is pending. Accordingly, beginning with the first taxable year following the taxable year in which such judicial proceeding is terminated, such foundation will be required to meet the requirements of section 4942 and the regulations thereunder (and be subject to the taxes provided upon failure to do so) except to the extent such foundation is required to accumulate income as described in subparagraph (1)(i) of this paragraph, even if the governing instrument continues to prohibit invasion of capital or corpus. In any case where a foundation's governing instrument or any other instrument requires accumulation of income as described in subparagraph (1)(i) of this paragraph beginning with the first taxable year following the taxable year in which such judicial proceeding is terminated, the distributable amount (as defined in paragraph (b) of this section) for such foundation shall be reduced by the amount of the income required to be accumulated. Therefore, if the foundation's adjusted net income for any taxable year equals or exceeds its minimum investment return for such year, the accumulation provisions will be given full effect. However, if the minimum investment return exceeds the adjusted net income for any taxable year, the foundation will be required to distribute such excess for such year. For purposes of this paragraph, a judicial proceeding will be treated as pending only if the foundation is diligently pursuing its judicial remedies and there is no unreasonable delay in such proceeding for which the private foundation is responsible.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. X, a private foundation organized in 1930, is required by the mandatory

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terms of its governing instrument to accumulated 25 percent of its adjusted net income and to add such accumulations to corpus. The instrument also prohibits distribution of corpus for any purpose. On July 13, 1971, X instituted an action in the appropriate State court to reform the instrument by deleting the accumulation and corpus provisions described above. If the court's final order reforms the accumulation provisions to allow distributions of income sufficient to avoid the imposition of a tax under section 4942, then section 4942 applies to X, regardless of the court's action with respect to the corpus provisions. However, if the court rules that the accumulation provision may not be reformed, section 4942 applies to X only to the extent provided for in subparagraph (3) of this paragraph, regardless of the court's action with respect to the corpus provision.

Example 2. Private foundation Y was created by the will of A who died in 1940. Y's governing instrument requires that 40 percent of Y's adjusted net income be added to corpus each year. In an action commenced prior to December 31, 1971, a court of competent jurisdiction rules that this accumulation provisions must be complied with. In Y's succeeding taxable year its adjusted net income is $120,000, and its minimum investment return is $140,000. Thus, Y is required to accumulated $48,000 (40 percent of $120,000) and shall be allowed to do so. Therefore, Y's distributable amount for such taxable year shall be the greater of its adjusted net income ($120,000) or its minimum investment return ($140,000), reduced by the amount of the income required to be accumulated ($48,000) and the taxes imposed by Subtitle A of the Code and section 4940 and increased by any trust distributions described in paragraph (b)(2) of this section. Accordingly, Y's distributable amount for such taxable year is $92,000 ($140,000 reduced by $48,000), before other adjustments. If Y's minimum investment return had been $120,000 instead of $140,000, its distributable amount for such taxable year would have been $72,000 ($120,000 reduced by $48,000), before other adjustments. Similarly, if Y's minimum investment return had been $100,000 instead of $140,000, its distributable amount for such taxable year would also have been $72,000, before other adjustments.

[T.D. 7256, 38 FR 3317, Feb. 5, 1973; 38 FR 4577, Feb. 16, 1973, as amended by T.D. 7486, 42 FR 24265, May 13, 1977; T.D. 7594, 44 FR 7138, Feb. 6, 1979; T.D. 7610, 44 FR 21644, Apr. 11, 1979; T.D. 7715, 45 FR 56803, Aug. 26, 1980; T.D. 7849, 47 FR 50857, Nov. 10, 1982; T.D. 7878, 48 FR 11943, Mar. 22, 1983]

§ 53.4942(a)–3 Qualifying distributions defined.

(a) *In general*—(1) *Distributions generally.* For purposes of section 4942 and the regulations thereunder, the amount of a qualifying distribution of property (as defined in subparagraph (2) of this paragraph) is the fair market value of such property as of the date such qualifying distribution is made. The amount of an organization's qualifying distributions will be determined solely on the cash receipts and disbursements method of accounting described in section 446(c)(1).

(2) *Definition.* The term ''qualifying distribution'' means:

(i) Any amount (including program related investments, as defined in section 4944(c), and reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(1) or (2)(B), other than any contribution to:

(*a*) A private foundation which is not an operating foundation (as defined in section 4942(j)(3)), except as provided in paragraph (c) of this section;

(*b*) An organization controlled (directly or indirectly) by the contributing private foundation or one or more disqualified persons with respect to such foundation, except as provided in paragraph (c) of this section; or

(*c*) An organization described in section 4942(g)(4)(A)(i) or (ii), if paid by a private foundation that is not an operating foundation;

(ii) 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) (1) or (2)(B). See paragraph (c)(3) of § 53.4942(a)–2 for the definition of *used (or held for use)*; or

(iii) Any amount set aside within the meaning of paragraph (b) of this section.

(3) *Control.* For purposes of subparagraph (2)(i)(*b*) of this paragraph, an organization is ''controlled'' by a foundation or one or more disqualified persons with respect to the foundation if any of such persons may, by aggregating their votes or positions of authority, require the donee organization to make an expenditure, or prevent the donee organization from making an expenditure, regardless of the method by

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which the control is exercised or exercisable. ''Control'' of a donee organization is determined without regard to any conditions imposed upon the donee as part of the distribution or any other restrictions accompanying the distribution as to the manner in which the distribution is to be used, unless such conditions or restrictions are described in paragraph (a)(8) of § 1.507–2 of this chapter (Income Tax Regulations). In general, it is the donee, not the distribution, which must be ''controlled'' by the distributing private foundation for the provisions of subparagraph (2)(i)(*b*) of this paragraph to apply. Thus, the furnishing of support to an organization and the consequent imposition of budgetary procedures upon that organization with respect to such support shall not in itself be treated as subjecting that organization to the distributing foundation's control within the meaning of this subparagraph. Such ''budgetary procedures'' include expenditure responsibility requirements under section 4945(d)(4). The ''controlled'' organization need not be a private foundation; it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization.

(4) *Borrowed funds*—(i) *In general*. For purposes of this paragraph, if a private foundation borrows money in a particular taxable year to make expenditures for a specific charitable educational, or other similar purpose, a qualifying distribution out of such borrowed funds will, except as otherwise provided in subdivision (ii) of this subparagraph, be deemed to have been made only at the time that such borrowed funds are actually distributed for such exempt purpose.

(ii) *Funds borrowed before 1970*. (*a*) If a private foundation has borrowed money in a taxable year beginning before January 1, 1970, or subsequently borrows money pursuant to a written commitment which was binding as of the last day of such taxable year, to make expenditures for a specific charitable, educational, or other similar exempt purpose, if such borrowed funds are in fact expended for such purpose in any taxable year, and if such loan is thereafter repaid, in whole or in part, in a taxable year beginning after December 31, 1969, then, at the election of the foundation as provided in subdivision (ii)(*b*) of this subparagraph, a qualifying distribution will be deemed to have been made at such time or times that such loan principal is so repaid rather than at the earlier time that the borrowed funds were actually distributed for such exempt purpose.

(*b*) The election described in subdivision (ii)(*a*) of this subparagraph is to be made by attaching a statement to the form the private foundation is required to file under section 6033 for the first taxable year beginning after December 31, 1969, in which a repayment of loan principal is made. Such statement shall be made a part of such form and shall be attached to such form in each succeeding taxable year in which any repayment of loan principal is made. The statement shall set forth the name and address of the lender, the amount borrowed, the specific use made of such borrowed funds, and the private foundation's election to treat repayments of loan principal as qualifying distributions.

(iii) *Interest*. Any payment of interest with respect to a loan described in subdivision (i) or (ii) of this subparagraph shall be treated as a deduction under paragraph (d)(1)(ii) of § 53.4942(a)–2 in the taxable year in which it is made.

(5) *Changes in use of an asset*. If an asset not used (or held for use) directly in carrying out one or more purposes described in section 170(c) (1) or (2)(B) is subsequently converted to such a use, the foundation may treat such conversion as a qualifying distribution. The amount of such qualifying distribution shall be the fair market value of the converted asset as of the date of its conversion. For purposes of the preceding sentence, fair market value shall be determined by making a valuation of the converted asset as of the date of its conversion in accordance with the rules set forth in paragraph (c)(4) of § 53.4942(a)-2.

(6) *Certain foreign organizations*—(i) *In general*. A distribution for purposes described in section 170(c)(2)(B) to a foreign organization, which has not received a ruling or determination letter that it is an organization described in section 509(a)(1), (a)(2), or (a)(3) or in

section 4942 (j)(3), will be treated as a distribution made to an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4942(j)(3) if the distributing foundation has made a good faith determination that the donee organization is an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4942(j)(3). A determination ordinarily will be considered a good faith determination if the determination is based on current written advice received from a qualified tax practitioner concluding that the donee is an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4942(j)(3), and if the foundation reasonably relied in good faith on the written advice in accordance with the requirements of §1.6664–4(c)(1) of this chapter. The written advice must set forth sufficient facts concerning the operations and support of the donee organization for the Internal Revenue Service to determine that the donee organization would be likely to qualify as an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4942(j)(3) as of the date of the written advice. For purposes of this section, except as provided in the next sentence, written advice will be considered current if, as of the date of distribution, the relevant law on which the advice is based has not changed since the date of the written advice and the factual information on which the advice is based is from the donee's current or prior taxable year (or annual accounting period if the donee does not have a taxable year for United States federal tax purposes). Written advice that a donee met the public support test under section 170(b)(1)(A)(vi) or section 509(a)(2) for a test period of five years will be treated as current for purposes of distributions to the donee during the two taxable years (or, as applicable, annual accounting periods) of the donee immediately following the end of the five-year test period.

(ii) *Definitions.* For purposes of this paragraph (a)(6)—

(*a*) The term ''foreign organization'' means any organization that is not described in section 170(c)(2)(A).

(*b*) The term ''qualified tax practitioner'' means an attorney, a certified public accountant, or an enrolled agent, within the meaning of 31 CFR 10.2 and 10.3, who is subject to the requirements in 31 CFR part 10.

(7) *Payment of tax.* The payment of any tax imposed under chapter 42 of the Code shall not be treated as a qualifying distribution.

(8) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. M, a private foundation which uses the calendar year as the taxable year, makes the following payments in 1970: (i) a payment of $44,000 to five employees for conducting a foundation program of educational grants for research and study; (ii) $20,000 for various items of overhead, 10 percent of which is attributable to the activities of the employees mentioned in payment (i) of this example and the other 90 percent of which is attributable to administrative expenses which were not paid to accomplish any section 170(c) (1) or (2)(B) purpose; and (iii) a $100,000 general purpose grant paid to an educational institution described in section 170(b)(1)(A)(ii) which is not controlled by M or any disqualified persons with respect to M. Payments (i) and (ii) of this example are qualifying distributions to the extent of $46,000 ($44,000 of salaries and 10 percent of the overhead, both of which are reasonable administrative expenses paid to accomplish section 170(c) (1) or (2)(B) purposes). Payment (iii) of this example is also a qualifying distribution, since it is a contribution for section 170(c)(2)(B) purposes to an organization which is not described in subparagraph (2)(i) (*a*) or (*b*) of this paragraph. The other 90 percent of payment (ii) of this example may constitute items of deduction under paragraph (d)(1)(ii) of §53.4942(a)–2 if such items otherwise qualify under such paragraph.

Example 2. On February 21, 1972, N, a private foundation which uses the calendar year as the taxable year, pays $500,000 for real property on which it plans to build hospital facilities to be used for medical care and education. The real property produces no income and the hospital facilities will not be constructed until 1974 according to the set-aside plan submitted to and approved by the Commissioner pursuant to paragraph (b) of this section. The purchase of the land is a qualifying distribution under subparagraph (2)(ii) of this paragraph. If, however, the property used were to produce rental income

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for more than a reasonable period of time before construction of the hospital is begun, then as of the time such rental use becomes unreasonable (i) such purchase would no longer constitute a qualifying distribution under subparagraph (2)(ii) of this paragraph, and (ii) the amount of the qualifying distribution would be included in N's gross income. See paragraphs (c)(3)(i) and (d)(2)(iii)(*b*) of § 53.4942(a)–2.

Example 3. In 1971, X, a private foundation engaged in holding paintings and exhibiting them to the public, purchases an additional building to be used to exhibit the paintings. Such expenditure is a qualifying distribution under subparagraph (2)(ii) of this paragraph. In 1975, X sells the building. Under paragraph (d)(2)(iii)(*b*) of § 53.4942(a)–2, all of the proceeds of the sale (less direct costs of the sale) are included in X's adjusted net income for 1975.

Example 4. In January 1969, M, a private foundation which uses the calendar year as the taxable year, borrows $10 million to give to N, a private college, for the construction of a science center. M borrowed the money from X, a commercial bank. M is to repay X at the rate of $1.1 million per year ($1 million principal and $0.1 million interest) for 10 years, beginning in January, 1973. M distributed $5 million of the borrowed funds to N in February 1969 and the other $5 million in March 1970. M files a statement with the form it is required to file under section 6033 for 1973 which contains the information required by subparagraph (4)(ii)(*b*) of this paragraph. Pursuant to M's election, each repayment of loan principal constitutes a qualifying distribution in the year of repayment. Accordingly, the distribution of $5 million to N in March 1970 will not be treated as a qualifying distribution. Each payment of interest ($0.1 million annually) with respect to M's loan from X is treated as a deduction under paragraph (d)(1)(ii) of § 53.4942(a)–2 in the taxable year in which it is made.

Example 5. Private foundation Y engages in providing care for the aged. Y makes a distribution of cash to H, a hospital described in section 170(b)(1)(A)(iii) which is not controlled by Y or any disqualified person with respect to Y. The distribution is made subject to the conditions that H will invest the money as a separate fund which will bear a name commemorating the creator of Y and will use the income from such fund only for H's exempt hospital purposes which relate to care for the aged. Under these circumstances, the distribution from Y to H is a qualifying distribution pursuant to subparagraph (2)(i) of this paragraph.

(b) *Certain set-asides*—(1) *In general.* An amount set aside for a specific project that is for one or more of the purposes described in section 170(c) (1) or (2)(B) may be treated as a qualifying distribution in the year in which set aside (but not in the year in which actually paid), if the requirements of section 4942(g)(2) and this paragraph (b) are satisfied. The requirements of this paragraph (b) are satisfied if the private foundation establishes to the satisfaction of the Commissioner that the amount set aside will be paid for the specific project within 60 months after it is set aside, and

(i) The set-aside satisfies the suitability test described in subparagraph (2) of this paragraph, or

(ii) With respect to a set-aside made in a taxable year beginning after December 31, 1974, the private foundation satisfies the cash distribution test described in subparagraph (3) of this paragraph.

If the suitability test or cash distribution test is otherwise satisfied, the 60 month period for paying the amount set aside may, for good cause shown, be extended by the Commissioner.

(2) *Suitability test.* The suitability test is satisfied if the private foundation establishes to the satisfaction of the Commissioner that the specific project for which the amount is set aside is one that can be better accomplished by the set-aside than by the immediate payment of funds. Specific projects that can be better accomplished by the use of a set-aside include, but are not limited to, projects in which relatively long-term grants or expenditures must be made in order to assure the continuity of particular charitable projects or program-related investments (as defined in section 4944(c)) or where grants are made as part of a matching-grant program. Such projects include, for example, a plan to erect a building to house the direct charitable, educational, or other similar exempt activity of the private foundation (such as a museum building in which paintings are to be hung), even though the exact location and architectural plans have not been finalized; a plan to purchase an additional group of paintings offered for sale only as a unit that requires an expenditure of more than one year's income; or a plan to fund a specific research program that is of such

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magnitude as to require an accumulation of funds before beginning the research, even though not all of the details of the program have been finalized.

(3) *Cash distribution test; in general.* The cash distribution test is satisfied if:

(i) The specific project for which the amount is set aside will not be completed before the end of the taxable year in which the set-aside is made,

(ii) The private foundation actually distributes, in cash or its equivalent and for one or more of the purposes described in section 170(c) (1) or (2)(B), the ''start-up period minimum amount'' described in subparagraph (4) of this paragraph during the private foundation's start-up period, and

(iii) The private foundation actually distributes, in cash or its equivalent and for one or more of the purposes described in section 170(c) (1) or (2)(B), the ''full-payment period minimum amount'' described in subparagraph (5) of this paragraph in each taxable year of the private foundation's full-payment period.

For purposes of the cash distribution test, an amount set aside will be treated as distributed in the year in which actually paid and not in the year in which set aside.

(4) *Minimum distribution required during start-up period*—(i) *Start-up period.* For private foundations created before January 1, 1972, the start-up period is the four taxable years immediately preceding the taxable year beginning in calendar year 1976. For private foundations created after December 31, 1971 (or for organizations that first become private foundations after that date), the start-up period is the four taxable years following the taxable year in which the private foundation was created (or otherwise became a private foundation). For purposes of this subparagraph (4), a private foundation will be considered ''created'' in the taxable year in which the private foundation's distributable amount (as determined under section 4942(d)) first exceeds $500.

(ii) *Start-up period minimum amount.* The amount that a private foundation must actually distribute in cash or its equivalent during the private foundation's start-up period is not less than the sum of:

(*a*) Twenty percent of the private foundation's distributable amount (as determined under section 4942(d)) for the first taxable year of the start-up period,

(*b*) Forty percent of the private foundation's distributable amount for the second taxable year of the start-up period,

(*c*) Sixty percent of the private foundation's distributable amount for the third taxable year of the start-up period, and

(*d*) Eighty percent of the private foundation's distributable amount for the fourth taxable year of the start-up period.

(iii) *Timing of distributions.* The requirement that a private foundation distribute the start-up period minimum amount during the start-up period is a requirement that such amount be distributed before the end of the start-up period, and is not a requirement that any portion of such amount be distributed in any one taxable year of the start-up period.

(iv) *Distribution actually made during start-up period.* In general, only a distribution actually made during the start-up period is taken into account in determining whether a private foundation has distributed the start-up period minimum amount. However, in the case of a private foundation created after December 31, 1971 (or an organization that first became a private foundation after that date), a distribution actually made during the taxable year in which the foundation was created (the year immediately preceding the first taxable year of the private foundation's start-up period) may be treated as a distribution actually made during the start-up period. In addition, a distribution actually made by a private foundation within 5½ months after the end of the start-up period will be treated as a distribution actually made during the start-up period if:

(*a*) The private foundation was unable to determine the distributable amount for the fourth taxable year of the start-up period until after the end of such period, and

(*b*) The private foundation actually made distributions prior to the end of

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the start-up period based upon a reasonable estimate of the private foundation's distributable amount for the fourth taxable year of the start-up period.

(v) *Examples.* The provisions of this subparagraph (4) may be illustrated by the following examples:

Example 1. F, a private foundation created on January 1, 1975, uses the calendar year as its taxable year. The start-up period for F is January 1, 1976 through December 31, 1979. F has distributable amounts under section 4942(d) for taxable years 1976 through 1979 in the following amounts: 1976, $100,000; 1977, $120,000; 1978, $150,000; 1979, $200,000. F's start-up period minimum amount is the sum of the following amounts: 20% of $100,000 ($20,000); 40% of $120,000 ($48,000); 60% of $150,000 ($90,000); and 80% of $200,000 ($160,000); which equals $318,000. Thus F is required to actually distribute at least $318,000 in cash or its equivalent during the start-up period.

Example 2. F, a private foundation created in 1969, uses the calendar year as its taxable year. F's start-up period is the calendar years 1972 through 1975. F makes two cash distributions in 1972. The first distribution is made on account of a set-aside made in 1969. Under section 4942(g), that distribution is treated as a qualifying distribution made in 1969. The second distribution is treated under section 4942(h) has made out of F's undistributed income for 1971. In addition, F makes a cash distribution in 1976 that is treated under section 4942(h) as made out of F's undistributed income for 1975. In determining whether F has distributed its start-up period minimum amount within the start-up period, the 1972 distributions are both taken into account because they were actually made during F's start-up period. The 1976 distribution is not taken into account, however, because that distribution was not actually made during F's start-up period.

(5) *Minimum distribution required during full-payment period*—(i) *Full-payment period.* A private foundation's full-payment period includes each taxable year that begins after the end of the private foundation's start-up period.

(ii) *Full-payment period minimum amount.* The amount that a private foundation must actually distribute in cash or its equivalent in a taxable year of the private foundation's full-payment period is not less than 100 percent of the private foundation's distributable amount determined under section 4942(d) (without regard to section 4942(i)) with respect to the taxable year.

(iii) *Carryover of distributions in excess of full-payment period minimum amount.* If, in a taxable year beginning after December 31, 1975, a private foundation distributes an amount in excess of the full-payment period minimum amount for the taxable year, the excess shall be used to reduce the full-payment period minimum amount in the taxable years in the adjustment period. The amount of the excess distribution used to reduce the full-payment period minimum amount in each successive taxable year of the adjustment period shall be equal to the amount of such excess less the sum of the full-payment period minimum amounts for all prior taxable years in the adjustment period to which the excess was previously applied. The taxable years in the adjustment period are the five taxable years immediately following the taxable year in which the excess distribution is made. Any distribution in excess of the full-payment period minimum amount made during a taxable year of the adjustment period shall not be taken into account under this subparagraph (iii) until any earlier excess has been completely applied against full-payment period minimum amounts during its adjustment period.

(iv) *Distributions actually made during a taxable year.* Except as described in subdivision (ii) of subparagraph (6), only a distribution actually made during a taxable year of the full-payment period is taken into account in determining whether a private foundation has distributed the full-payment period minimum amount for such year.

(v) *Examples.* The provisions of this subparagraph (5) may be illustrated by the following examples:

Example 1. F, a private foundation created on January 1, 1973, uses the calendar year as its taxable year. F has a start-up period of January 1, 1974, through December 31, 1977, and a full-payment period that includes every taxable year beginning after December 31, 1977. F's distributable amount (as determined under section 4942(d)) for 1978 is $500,000. Thus, F's full-payment period minimum amount for 1978 is $500,000. During 1978 F distributes $100,000 in cash to Charity X and $400,000 in cash to Charity Y on account of a set-aside made in 1973. F has distributed its full-payment period minimum amount for 1978 because it has made actual cash distributions during that year which total

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$500,000. However, F has made qualifying distributions (as determined under section 4942(g)) with respect to 1978 of only $100,000. In order to avoid liability for the tax on undistributed income under section 4942(a), F must distribute or set aside an additional $400,000 before January 1, 1980.

Example 2. Assume the facts as stated in Example (1) except that in 1978 F makes cash distributions totaling $600,000. Since the total cash distributions made in 1978 ($600,000) exceed the full-payment period minimum amount for 1978 ($500,000), there exists a $100,000 excess which must be used by F to reduce its full-payment period minimum amounts for the years 1979–1983 (the taxable years in the adjustment period with respect to the 1978 excess). Therefore, if F's distributable amount (as determined under section 4942(d)) for 1979 is $500,000, F's full-payment period minimum amount for 1979 is $400,000 ($500,000–$100,000).

(6) *Failure to distribute minimum amounts*—(i) *In general.* If a private foundation fails to actually distribute the start-up period minimum amount during the start-up period or, except as described in subdivision (ii) of this subparagraph (6), if a private foundation fails to actually distribute the full-payment period minimum amount during a taxable year of the full-payment period, then any set-aside made by the private foundation during the start-up period (if the failure relates to the start-up period) or during the taxable year (if the failure relates to the full-payment period) that was not approved by the Commissioner under the suitability test described in subparagraph (2) of this paragraph will not be treated as a qualifying distribution. Further, any set-aside made after the year of such a failure to so distribute a minimum amount will be treated as a qualifying distribution only if the Commissioner approves the set-aside under the suitability test. In any case in which a set-aside ceases to be treated as a qualifying distribution as a result of a failure to distribute the full-payment period minimum amount, a private foundation may be assessed a deficiency under section 4942(a) within the period described in section 6501(n)(3).

(ii) *Correction of certain failures to distribute.* If a private foundation's failure to distribute the full-payment period minimum amount during a taxable year of the full-payment period was not willful and was due to reasonable cause, the private foundation may correct the failure to so distribute. Correction will be achieved if the private foundation distributes within the correction period cash or its equivalent in an amount not less than the difference between the full-payment period minimum amount for the taxable year and the amount actually distributed during the taxable year. The correction period is the correction period as defined in section 4962(e), determined with respect to the earliest occurring taxable event (as defined in section 4962(e)(2)(A)) that would result if the failure to distribute a full-payment period minimum amount were not corrected. The additional distribution will be treated for purposes of subparagraph (5) of this paragraph as made during the taxable year with respect to which the failure occurred. If a private foundation fails to distribute the full-payment period minimum amount during a taxable year of the full-payment period because such amount can be determined only after the end of the taxable year, no "willful failure to distribute" the full-payment period minimum amount will occur if the private foundation makes an additional distribution within 5½ months after the end of the taxable year.

(7) *Approval and information requirements*—(i) *Suitability test.* If an amount is set aside under the suitability test of section 4942(g)(2)(B)(i) and subparagraph (2) of this paragraph, the private foundation must apply for the Commissioner's approval of the set-aside before the end of the taxable year in which the amount is set aside. The Commissioner will either approve or disapprove the set-aside in writing. An otherwise proper set-aside will not be treated as a qualifying distribution under this paragraph (b) with respect to a taxable year if the Commissioner's approval is not sought before the end of the taxable year in which the amount is actually set aside. To obtain approval by the Commissioner for a set-aside under the suitability test, the private foundation must write to Commissioner of Internal Revenue, Attention: OP:E:EO:T, 1111 Constitution Avenue, NW., Washington, DC 20224, and include:

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(*a*) A statement describing the nature and purposes of the specific project and the amount of the set-aside for which approval is requested;

(*b*) A statement describing the amounts and approximate dates of any planned additions to the set-aside after its initial establishment;

(*c*) A statement of the reasons why the project can be better accomplished by a set-aside than by the immediate payment of funds;

(*d*) A detailed description of the project, including estimated costs, sources of any future funds expected to be used for completion of the project, and the location or locations (general or specific) of any physical facilities to be acquired or constructed as part of the project; and

(*e*) A statement by an appropriate foundation manager (as defined in section 4946(b)) that the amounts to be set aside will actually be paid for the specific project within a specified period of time that ends not more than 60 months after the date of the first set-aside, or a statement showing good cause why the period for paying the amount set aside should be extended (including a showing that the proposed project could not be divided into two or more projects covering periods of no more than 60 months each) and setting forth the extension of time required.

(ii) *Cash distribution test.* If an amount is set aside under the cash distribution test of section 4942(g)(2)(B)(ii) and subparagraphs (3), (4), and (5) of this paragraph, then for taxable years ending after April 2, 1984, the private foundation must submit an attachment with the return required by section 6033 for the taxable year in which the amount is set aside and for certain subsequent taxable years. For the taxable year in which the amount is set aside the attachment must include:

(*a*) A statement describing the nature and purposes of the specific project for which amounts are to be set aside;

(*b*) A statement that the amounts set aside for the specific project will actually be paid for the specific project within a specified period of time that ends not more than 60 months after the date of the set-aside;

(*c*) A statement that the project will not be completed before the end of the taxable year of the private foundation in which the set-aside is made;

(*d*) A statement showing the distributable amounts determined under section 4942(d) for any past taxable years in the private foundation's start-up and full-payment periods; and

(*e*) A statement showing the aggregate amount of actual payments made in cash or its equivalent, for purposes described in section 170(c) (1) or (2)(B), during each taxable year in the private foundation's start-up and full-payment periods. This statement should include a detailed description of any payments that are to be treated, pursuant to the rules of subparagraphs (4)(iv) and (6)(ii) of this paragraph (b), as distributed during a taxable year prior to the taxable year in which such payments were actually made and, in addition, should explain the circumstances that justify the application of those rules.

For the five taxable years following the taxable year in which the amount is set aside (or, if longer, for each taxable year in the extended period for paying the amount set aside), the attachment must include the statements required by (*d*) and (*e*) of this subdivision (ii). The submission of the statement required by (*b*) of this subdivision (ii) will satisfy the requirement of section 4942(g)(2)(B) and subparagraph (1) of this paragraph (b) that the private foundation establish to the satisfaction of the Commissioner that the amount set aside will be paid for the specific project within 60 months after it is set aside.

(8) *Evidence of set-aside.* A set-aside that is approved by the Commissioner or which satisfies the cash distribution test shall be evidenced by the entry of a dollar amount on the books and records of a private foundation as a pledge or obligation to be paid at a future date or dates. Any amount which is set aside shall be taken into account for purposes of determining the private foundation's minimum investment return under § 53.4942(a)–2 (c)(1), and any income attributable to such set-aside shall be taken into account in computing adjusted net income under § 53.4942(a)–2(d).

(9) *Contingent set-aside.* In the event a private foundation is involved in litigation and may not distribute assets or

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income because of a court order, the private foundation may (except as provided in §53.4942(a)–2 (e)(1)(i) or (ii)) seek and obtain a set-aside for a purpose described in §53.4942(a)–3 (a)(2). The amount to be set aside shall be equal to that portion of the private foundation's distributable amount which is attributable to the assets or income that are held pursuant to court order and which, but for the court order precluding the distribution of such assets or income, would have been distributed. In the event that the litigation encompasses more than one taxable year, the private foundation may seek additional contingent set-asides. Such amounts must actually be distributed by the last day of the taxable year following the taxable year in which the litigation is terminated. Amounts not distributed by the close of the appropriate taxable year shall be treated as described in §53.4942(a)–2 (d)(2)(iii)(*c*) for the succeeding taxable year.

(c) *Certain contributions to section 501(c)(3) organizations*—(1) *In general.* For purposes of this section, the term ''qualifying distribution'' includes (in the year in which it is paid) a contribution to an exempt organization described in section 501(c)(3) and described in paragraph (a)(2)(i) (*a*) or (*b*) of this section if:

(i) Not later than the close of the first taxable year after the donee organization's taxable year in which such contribution is received, such donee organization makes a distribution equal to the full amount of such contribution and such distribution is a qualifying distribution (within the meaning of paragraph (a) of this section, without regard to this paragraph) which is treated under paragraph (d) of this section 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

(ii) The private foundation making the contribution obtains adequate records or other sufficient evidence from such donee organization (such as a statement by an appropriate officer, director, or trustee of such donee organization) showing (except as otherwise provided in this subparagraph) (*a*) that the qualifying distribution described in subdivision (i) of this subparagraph has been made by such organization, (*b*) the names and addresses of the recipients of such distribution and the amount received by each, and (*c*) that the distribution is treated as a distribution out of corpus under paragraph (d) of this section (or would be so treated if the donee organization were a private foundation which is not an operating foundation). Where a distribution is for an administrative expense which is part of a section 170(c) (1) or (2)(B) expenditure or is part of another section 170(c) (1) or (2)(B) expenditure that cannot reasonably be separately accounted for, the provisions of subdivision (ii) of this subparagraph may be satisfied by the submission by the donee organization of a statement setting forth the general purpose for which such expenditure was made and that the amount was distributed as a qualifying distribution described in subdivision (ii)(*c*) of this subparagraph.

(2) *Distribution requirements.* (i) In order for a donee organization to meet the distribution requirements of subparagraph (1)(i) of this paragraph, it must, not later than the close of the first taxable year after its taxable year in which any contributions are received, distribute (within the meaning of this subparagraph) an amount equal in value to the contributions received in such prior taxable year and have no remaining undistributed income for such prior taxable year. In the event that a donee organization redistributes less than an amount equal to the total contributions from donor organizations which are required to be redistributed by such donee organization by the close of the first taxable year following the taxable year in which such contributions were received, amounts treated as redistributions of such contributions shall be deemed to have been made pro rata out of all such contributions regardless of any earmarking or identification made by such donee organization with respect to the source of such distributions. See paragraph (d)(2)(ix) of §53.4942(a)–2 for the treatment of amounts deemed not to have been so redistributed. For purposes of this paragraph, the term *contributions* means all contributions, whether of

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cash or property, and the fair market value of contributed property determined as of the date of the contribution must be used in determining whether an amount equal in value to the contributions received has been redistributed.

(ii) For purposes of this paragraph, the characterization of qualifying distributions made during the taxable year (*i.e.*, whether out of the prior year's undistributed income, the current year's undistributed income, or corpus) is to be made as of the close of the taxable year in question, except to the extent that a different characterization is effected by means of the election provided for by paragraph (d)(2) of this section or by subdivision (iv) of this subparagraph. Once it is determined that a qualifying distribution is attributable to corpus, such distribution will first be charged to distributions which are required to be redistributed under this paragraph.

(iii) All amounts contributed to a specific exempt organization described in section 501(c)(3) and in paragraph (a)(2)(i) (*a*) or (*b*) of this section within any one taxable year of such organization shall be treated (with respect to the contributing private foundation) as one ''contribution''. If subparagraph (1) (i) or (ii) of this paragraph is not completely satisfied with respect to such contribution within the meaning of such subparagraph, only that portion of such contribution which was redistributed (within the meaning of subparagraph (1) (i) and (ii) of this paragraph) shall be treated as a qualifying distribution.

(iv) In order to satisfy distribution requirements under section 170(b)(1)(E)(ii) or this paragraph, a donee organization may elect to treat as a current distribution out of corpus any amount distributed in a prior taxable year which was treated as a distribution out of corpus under paragraph (d)(1)(iii) of this section provided that (*a*) such amount has not been availed of for any other purpose, such as a carryover under paragraph (e) of this section or a redistribution under this paragraph for a prior year, (*b*) such corpus distribution occurred within the preceding 5 years, and (*c*) such amount is not later availed of for any other purpose. Such election must be made by attaching a statement to the return the foundation is required to file under section 6033 with respect to the taxable year for which such election is to apply. Such statement must contain a declaration by an appropriate foundation manager (within the meaning of section 4946(b)(1)) that the foundation is making an election under this paragraph and it must specify that the distribution was treated under paragraph (d)(1)(iii) of this section as a distribution out of corpus in a designated prior taxable year (or years).

(3) *Examples.* The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples. It is assumed in these examples that all private foundations described use the calendar as the taxable year.

Example 1. In 1972 M, a private foundation, makes a contribution out of 1971 income to X, another private foundation which is not an operating foundation. The contribution is the only one received by X in 1972. In 1973 X makes a qualifying distribution to an art museum maintained by an operating foundation in an amount equal to the amount of the contribution received from M. X also distributes all of its undistributed income for 1972 and 1973 for other purposes described in section 170(c)(2)(B). Under the provisions of paragraph (d) of this section, such distribution to the museum is treated as a distribution out of corpus. Thus, M's contribution to X is a qualifying distribution out of M's 1971 income provided M obtains adequate records or other sufficient evidence from X showing the nature and amount of the distribution made by X, the identity of the recipient, and the fact that the distribution is treated as made out of corpus. If X's qualifying distributions during 1973 had been equal only to M's contribution to X and X's undistributed income for 1972, X could have made an election under paragraph (d)(2) of this section to treat the amount distributed in excess of its 1972 undistributed income as a distribution out of corpus and in that manner satisfied the requirements of this paragraph.

Example 2. Assume the facts stated in example (1), except that X is a private college described in section 170(b)(1)(A)(ii) which is controlled by disqualified persons with respect to M and that the records which X furnishes to M show that the distribution would have been treated as made out of corpus if X were a private nonoperating foundation. Under these circumstances, result is the same as in example (1).

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Example 3. Assume the facts stated in example (1), except that X makes a distribution to the museum equal only to one-half of the contribution from M, that the remainder of such contribution is added to X's funds and used to pay charitable administrative expenses, and that the records obtained by M from X are not sufficient to show the amounts distributed or the identities of the recipients of the distributions. The contribution by M to X will be a qualifying distribution only to the extent that M can obtain (i) other sufficient evidence (such as statements from officers or employees of X or from the museum) showing the facts required by subparagraph (1)(ii) (*a*), (*b*), and (*c*) of this paragraph and (ii) a statement from X setting forth that the remainder of the contribution was used for charitable administrative expenses which constituted qualifying distributions described in paragraph (a)(2)(i) of this section.

Example 4. X and Y are private nonoperating foundations. A is an exempt organization which is not described in section 501(c)(3) but which supervises and conducts a program described in section 170(c)(2)(B). Y, but not X, controls A within the meaning of paragraph (a)(3) of this section. In 1972, X and Y each makes a grant to A of $100, specifically designated for use in the operation of A's section 170(c)(2)(B) program. X has made a qualifying distribution to A because the distribution is one described in paragraph (a)(2)(i) of this section. However, because A is controlled by Y, Y's grant of $100 to A does not constitute a qualifying distribution within the meaning of such paragraph (a)(2)(i). Furthermore, because A is not an exempt organization described in section 501(c)(3), Y's grant to A does not constitute a qualifying distribution by operation of the provisions of this paragraph.

Example 5. N, a private nonoperating foundation, had distributable amounts of $100 in 1970 and $125 in 1971. In 1970 N received total contributions of $540: $150 from Y, a public charity; $70 from Z, a private foundation; $140 from Q, a private foundation, subject to the requirement that N earmark the amount and distribute it before distributing Z's contribution; and, $180 from R, also a private foundation. However, R specifically instructed N that such contribution did not have to be redistributed because R already had made enough qualifying distributions to avoid all section 4942 taxes. N is not controlled by Y, Z, Q, or R, and N made no qualifying distributions in 1970. By the close of 1971, N had made qualifying distributions of $420, earmarking $140 as having been a distribution of Q's contribution, but had made no election under paragraph (d)(2) of this section to have any amount distributed which was in excess of N's 1970 undistributed income treated as distributed out of corpus. Therefore, the first $225 of qualifying distributions made in 1971 (the sum of $100 and $125, N's distributable amounts for 1970 and 1971, respectively) are treated as amounts described in paragraph (d)(1) (i) and (ii) of this section. Since Y's contribution is a contribution from a public charity and does not have to be "redistributed" and since R specifically instructed N that its contribution need not be "redistributed", the remaining $195 of qualifying distributions will be treated as distributed pro rata from Z's and Q's contributions, regardless of N's earmarking. Accordingly, of Z's original qualifying distribution of $70 only $65 ($195 multiplied by $70, Z's contribution, over $210, the total ($70 plus $140) of Z's and Q's contributions) will be treated as redistributed by N. Similarly, of Q's original qualifying distribution of $140 only $130 ($195 multiplied by $140 over $210) will be treated as redistributed by N. Thus, Z's gross income for 1972 will be increased by $5 ($70 less the $65 actually redistributed), and Q's gross income for 1972 will be increased by $10 ($140 less the $130 actually redistributed).

(4) *Limitation.* A contribution by a private foundation to a donee organization which the donee uses to make payments to another organization (the secondary donee) shall not be regarded as a contribution by the private foundation to the secondary donee if the distributing foundation does not earmark the use of the contribution for any named secondary donee and does not retain power to cause the selection of the secondary donee by the organization to which such foundation has made the contribution. For purposes of this subparagraph, a contribution described herein shall not be regarded as a contribution by the foundation to the secondary donee even though such foundation has reason to believe that certain organizations would derive benefits from such contribution so long as the original donee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of such foundation.

(5) *Transitional rule.* (i) For purposes of this paragraph, a contribution to a private foundation which is not an operating foundation and which is not controlled (directly or indirectly) by the distributing foundation or one or more disqualified persons with respect to the distributing foundation will be treated as a contribution to an operating foundation if:

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(*a*) Such contribution is made pursuant to a written commitment which was binding on May 26, 1969, and at all times thereafter.

(*b*) Such contribution is made for one or more of the purposes described in section 170(c) (1) or (2)(B), and

(*c*) Such contribution is to be paid out to the donee private foundation on or before December 31, 1974.

(ii) For purposes of this subparagraph, a written commitment will be considered to have been binding prior to May 27, 1969, only if the amount and nature of the contribution and the name of the donee foundation were entered in the records of the distributing foundation, or were otherwise adequately evidenced, prior to May 27, 1969, or notice of the contribution was communicated in writing to such donee prior to May 27, 1969.

(d) *Treatment of qualifying distributions*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, any qualifying distribution made during a taxable year shall be treated as made:

(i) First out of the undistributed income (as defined in paragraph (a) of § 53.4942(a)–2) of the immediately preceding taxable year (if the private foundation was subject to the initial excise tax imposed by section 4942(a) for such preceding taxable year) to the extent thereof;

(ii) Second out of the undistributed income for the taxable year to the extent thereof; and

(iii) Then out of corpus.

(2) *Election.* In the case of any qualifying distribution which (under subparagraph (1) of this paragraph) is not treated as made out of the undistributed income of the immediately preceding taxable year, 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. Such election must be made by filing a statement with the Commissioner during the taxable year in which such qualifying distribution is made or by attaching a statement to the return the foundation is required to file under section 6033 with respect to the taxable year in which such qualifying distribution was made. Such statement must contain a declaration by an appropriate foundation manager (within the meaning of section 4946(b)(1)) that the foundation is making an election under this subparagraph, and it must specify whether the distribution is made out of the undistributed income of a designated prior taxable year (or years) or is made out of corpus. In any case where the election described in this subparagraph is made during the taxable year in which the qualifying distribution is made, such election may be revoked in whole or in part by filing a statement with the Commissioner during such taxable year revoking such election in whole or in part or by attaching a statement to the return the foundation is required to file under section 6033 with respect to the taxable year in which the qualifying distribution was made revoking such election in whole or in part. Such statement must contain a declaration by an appropriate foundation manager (within the meaning of section 4946(b)(1)) that the foundation is revoking an election under this subparagraph in whole or in part, and it must specify the election or part thereof being revoked.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. M, a private foundation which was created in 1968 and which uses the calendar year as the taxable year, has distributable amounts and qualifying distributions for 1970 through 1976 as follows:

	1970	1971	1972	1973
Distributable amount	$100	$100	$100	$100
Qualifying distribution	0	100	250	100
	1974	1975	1976	....
Distributable amount	$100	$100	$100	....
Qualifying distribution	100	100	100	....

In 1971 the qualifying distribution of $100 is treated under subparagraph (1)(i) of this paragraph as made out of the $100 of undistributed income for 1970. The qualifying distribution of $250 in 1972 is treated as made: (i) $100 out of the undistributed income for 1971 under subparagraph (1)(i) of this paragraph; (ii) $100 out of the undistributed income for 1972 under subparagraph (1)(ii) of this paragraph; and (iii) $50 out of corpus in 1972 under subparagraph (1)(iii) of this paragraph. The qualifying distribution of $100 in each of the years 1973 through 1976 is treated as made out of the undistributed income for

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each of those respective years under subparagraph (1)(ii) of this paragraph. See paragraph (e) of this section for rules relating to the carryover of qualifying distributions out of corpus.

Example 2 M, a private foundation which uses the calendar year as the taxable year, has undistributed income of $300 for 1981, $200 for 1982, and $400 for 1983. On January 14, 1983, *M* makes its first qualifying distribution in 1983 when it sets aside (within the meaning of paragraph (b) of this section) $700 for construction of a hospital. On February 24, 1983 a notice of deficiency with respect to the excise taxes imposed by section 4942 (a) and (b) in regard to *M*'s undistributed income for 1981 is mailed to *M* under section 6212(a). *M* notifies the Commissioner in writing on March 24, 1983, that it is making an election under subparagraph (2) of this paragraph to have its distribution of January 14th applied first against its undistributed income for 1982, next against its undistributed income for 1981, and last against its undistributed income for 1983. Thus, $200 of the $700 qualifying distribution is treated as made out of the undistributed income for 1982; $300, out of undistributed income for 1981; and $200 ($700 less the sum of $200 and $300), out of the undistributed income for 1983. Thus, an initial excise tax of $45 (15 percent of $300) is imposed under section 4942(a). Since *M* made the election described above, the $300 (treated as distributed out of undistributed income for 1981) corrects (within the meaning of section 4963(d)(2)) the taxable act because the undistributed income for 1981 is reduced to zero. Furthermore, correction is effected within the correction period (as defined in section 4963(e)(1) and § 53.4963–1(e)). Therefore, under the provisions of section 4961(a), the additional tax imposed by section 4942(b) will not be assessed.

(e) *Carryover of excess qualifying distributions*—(1) *In general*. If in any taxable year for which an organization is subject to the initial excise tax imposed by section 4942(a) there is created an excess of qualifying distributions (as determined under subparagraph (2) of this paragraph), such excess may be used to reduce distributable amounts in any taxable year of the adjustment period (as defined subparagraph (3) of this paragraph). For purposes of section 4942, including paragraph (d) of this section, the distributable amount for a taxable year in the adjustment period shall be reduced to the extent of the lesser of (i) the excess of qualifying distributions made in prior taxable years to which such adjustment period applies or (ii) the remaining undistributed income at the close of such taxable year after applying any qualifying distributions made in such taxable year to the distributable amount for such taxable year (determined without regard to this paragraph). If during any taxable year of the adjustment period there is created another excess of qualifying distributions, such excess shall not be taken into account until any earlier excess of qualifying distributions has been completely applied against distributable amounts during its adjustment period.

(2) *Excess qualifying distributions*. An excess of qualifying distributions is created for any taxable year beginning after December 31, 1969, if:

(i) The total qualifying distributions treated (under paragraph (d) of this section) as made out of the undistributed income for such taxable year or as made out of corpus with respect to such taxable year (other than amounts distributed by an organization in satisfaction of section 170(b)(1)(E)(ii) or paragraph (c) of this section, or applied to a prior taxable year by operation of the elections contained in paragraphs (c)(2)(iv) and (d)(2) of this section), exceeds

(ii) The distributable amount for such taxable year (determined without regard to this paragraph).

(3) *Adjustment period*. For purposes of this paragraph, the taxable years in the adjustment period are the 5 taxable years immediately following the taxable year in which the excess of qualifying distributions is created. Thus, an excess (within the meaning of subparagraph (2) of this paragraph) for any 1 taxable year cannot be carried over beyond the succeeding 5 taxable years. However, if during any taxable year in the adjustment period an organization ceases to be subject to the initial excise tax imposed by section 4942(a), any portion of the excess of qualifying distributions, which prior to such taxable year has not been applied against distributable amounts, may not be carried over to such taxable year or subsequent taxable years in the adjustment period, even if during any of such taxable years the organization again becomes subject to the initial excise tax imposed by section 4942(a).

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(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. (i) F, a private foundation which was created in 1967 and which uses the calendar year as the taxable year, has distributable amounts and qualifying distributions for 1970 through 1976 as follows:

Year	1970	1971	1972	1973
Distributable amount	$100	$100	$100	$100
Qualifying distribution	0	$250	$70	$140

Year	1974	1975	1976	
Distributable amount	$100	$100	$100	....
Qualifying distribution	$60	$75	$105	....

(ii) The qualifying distributions made in 1971 will be treated under paragraph (d) of this section as $100 made out of the undistributed income for 1970, then as $100 made out of the undistributed income for 1971, and finally as $50 out of corpus in 1971. Since the total qualifying distributions for 1971 ($150) exceed the distributable amount for 1971 ($100), there exists a $50 excess of qualifying distributions which F may use to reduce its distributable amounts for the years 1972 through 1976 (the taxable years in the adjustment period with respect to the 1971 excess). Therefore, the $100 distributable amount for 1972 is reduced by $30 (the lesser of the 1971 excess ($50) and the remaining undistributed income at the close of 1972 ($30), after the qualifying distributions of $70 for 1972 were applied to the original distributable amount for 1972 of $100). Since the distributable amount for 1972 was reduced to $70, there is no remaining undistributed income for 1972. Accordingly, the qualifying distributions made in 1973 will be treated as $100 made out of the undistributed income for 1973 and as $40 out of corpus in 1973. Since this amount ($140) exceeds the distributable amount for 1973 ($100), there exists a $40 excess which F may use to reduce its distributable amounts for the years 1974 through 1978 (the taxable years in the adjustment period with respect to the 1973 excess). However, in accordance with subparagraph (1) of this paragraph such excess may not be used to reduce F's distributable amounts for the years 1974 through 1976 until the excess created in 1971 has been completely applied against distributable amounts during such years. The distributable amount for 1974 is reduced by $40 (the lesser of the unused portion of the 1971 excess ($20) plus the 1973 excess ($40) and the remaining undistributed income at the close of 1974 ($40), after the qualifying distributions of $60 for 1974 were applied to the original distributable amount for 1974 of $100). The distributable amount for 1975 is reduced by $20 (the lesser of the unused portion of the 1973 excess of qualifying distributions ($20) and the remaining undistributed income at the close of 1975 ($25), after the qualifying distributions of $75 for 1975 were applied to the original distributable amount for 1975 of $100). Consequently, qualifying distributions made in 1976 will be treated as made first out of the $5 of remaining undistributed income for 1975 and then as $100 made out of the undistributed income for 1976.

Example 2. Assume the facts as stated in example (1), except that in 1974 F receives a contribution of $300 from G, a private foundation which controls F (within the meaning of paragraph (a)(3) of this section), and F distributes such contribution in 1975 in satisfaction of paragraph (c) of this section. Under these circumstances, there would be no excess of qualifying distributions for 1975 with respect to such distribution, since such distribution is excluded from the computation of an excess of qualifying distributions by operation of subparagraph (2)(i) of this paragraph.

Example 3. Assume the facts as stated in example (1), except that in 1972 F is treated as an operating foundation (as such term is defined in section 4942(j)(3)). In accordance with subparagraph (3) of this paragraph since F is not subject to the initial excise tax imposed by section 4942(a) for 1972, the 1971 excess cannot be carried forward to 1972 or any subsequent year in the adjustment period with respect to the 1971 excess, even if F is subsequently treated as a private nonoperating foundation for any year during the period 1973 through 1976.

(f) *Effective/applicability date and transition relief.* Paragraphs (a)(2)(i) and (a)(6) of this section are effective on and apply with respect to distributions made after September 25, 2015. However, foundations may continue to rely on the provisions of paragraph (a)(6) of this section as contained in 26 CFR part 53, revised April 1, 2015, with respect to distributions made on or before December 24, 2015 pursuant to a good faith determination made in accordance with such provisions. Also, foundations may continue to rely on the provisions of paragraph (a)(6) of this section as contained in 26 CFR part 53, revised April 1, 2015, with respect to distributions pursuant to a written commitment made on or before September 25, 2015 and pursuant to a good faith determination made on or before such date in accordance with such provisions if the committed

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amount is distributed within five years of such date.

[T.D. 7256, 38 FR 3323, Feb. 5, 1973, as amended by T.D. 7486, 42 FR 24265, May 13, 1977; T.D. 7849, 47 FR 50857, Nov. 10, 1982; T.D. 7938, 49 FR 3848, Jan. 31, 1984; T.D. 8084, 51 FR 16302, May 2, 1986; T.D. 9740, 80 FR 57715, Sept. 25, 2015]

§53.4942(b)–1 Operating foundations.

(a) *Operating foundation defined*—(1) *In general*. For purposes of section 4942 and the regulations thereunder, the term ''operating foundation'' means any private foundation which, in addition to satisfying the assets test, the endowment test or the support test set forth in §53.4942(b)–2 (a), (b) and (c), makes qualifying distributions (within the meaning of §53.4942(a)–3(a)(2)) directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose equal in value to:

(i) For taxable years beginning before January 1, 1982, substantially all of the foundation's adjusted net income (as defined in §53.4942(a)–2(d)); and

(ii) For taxable years beginning after December 31, 1981, substantially all of the lesser of the foundation's adjusted net income (as defined in §53.4942(a)–2(d)) or minimum investment return (as defined in §53.4942(a)–2(c)). If the foundation's qualifying distributions exceed its minimum investment return (but are less than the foundation's adjusted net income) substantially all of such qualifying distributions must be made directly for the active conduct of activities constituting its charitable, educational or other similar exempt purpose. However, if the foundation's minimum investment return is less than its adjusted net income and the foundation's qualifying distributions equal or exceed such adjusted net income, only that portion of the qualifying distributions equal to substantially all of the foundation's adjusted net income must be made directly for the active conduct of activities constituting its charitable, educational or other similar exempt purpose.

(2) *Certain elderly care facilities described in section 4942(j)(6)*—(i) *In general*. For purposes of the distribution requirements of section 4942 (but no other provision of the Internal Revenue Code) and for taxable years beginning after December 31, 1969, the term ''operating foundation'' includes a private foundation which:

(A) On or before May 26, 1969, and continuously thereafter to the close of the taxable year, operates and maintains, as its principal functional purpose, residential facilities for the long-term care, comfort, maintenance, or education of permanently and totally disabled persons, elderly persons, needy widows, or children, and

(B) Satisfies the endowment test set forth in §53.4942(b)–2 (b).

(ii) *Principal functional purpose*. For purposes of section 4942(j)(6) and this subparagraph (2), an organization's ''principal functional purpose'' is operating and maintaining residential facilities for the long-term care, comfort, maintenance, or education of permanently and totally disabled persons, elderly persons, needy widows, or children, if it is organized for the principal purpose of operating and maintaining such residential facilities and is primarily engaged directly in the operation and maintenance of those facilities. An organization will be treated as being primarily engaged directly in the operation and maintenance of the described residential facilities if at least 50% of the qualifying distributions (as defined in §53.4942(a)–3(a)(2)) normally made by the organization are expended for the operation and maintenance of the facilities.

(b) *Active conduct of activities constituting the exempt purpose*—(1) *In general*. For purposes of this section, except as provided in subparagraph (2) or (3) of this paragraph, qualifying distributions are not made by a foundation ''directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose'' unless such qualifying distributions are used by the foundation itself, rather than by or through one or more grantee organizations which receive such qualifying distributions directly or indirectly from such foundation. Thus, grants made to other organizations to assist them in conducting activities which help to accomplish their charitable, educational, or other similar exempt purpose are considered an indirect, rather than direct, means

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of carrying out activities constituting the charitable, educational, or other similar exempt purpose of the grantor foundation, regardless of the fact that the exempt activities of the grantee organization may assist the grantor foundation in carrying out its own exempt activities. However, amounts paid to acquire or maintain assets which are used directly in the conduct of the foundation's exempt activities, such as the operating assets of a museum, public park, or historic site, are considered direct expenditures for the active conduct of the foundation's exempt activities. Likewise, administrative expenses (such as staff salaries and traveling expenses) and other operating costs necessary to conduct the foundation's exempt activities (regardless of whether they are "directly for the active conduct" of such exempt activities) shall be treated as qualifying distributions expended directly for the active conduct of such exempt activities if such expenses and costs are reasonable in amount. Conversely, administrative expenses and operating costs which are not attributable to exempt activities, such as expenses in connection with the production of investment income, are not treated as such qualifying distributions. Expenses attributable to both exempt and nonexempt activities shall be allocated to each such activity on a reasonable and consistently applied basis. Any amount set aside by a foundation for a specific project, such as the acquisition and restoration, or construction, of additional buildings or facilities which are to be used by the foundation directly for the active conduct of the foundation's exempt activities, shall be deemed to be qualifying distributions expended directly for the active conduct of the foundation's exempt activities if the initial setting aside of the funds constitutes a set-aside within the meaning of paragraph (b) of § 53.4942(a)–3.

(2) *Payments to individual beneficiaries*—(i) *In general.* If a foundation makes or awards grants, scholarships, or other payments to individual beneficiaries (including program related investments within the meaning of section 4944(c) made to individuals or corporate enterprises) to support active programs conducted to carry out the foundation's charitable, educational, or other similar exempt purpose, such grants, scholarships, or other payments will be treated as qualifying distributions made directly for the active conduct of exempt activities for purposes of paragraph (a) of this section only if the foundation, apart from the making or awarding of the grants, scholarships, or other payments, otherwise maintains some significant involvement (as defined in subdivision (ii) of this subparagraph) in the active programs in support of which such grants, scholarships, or other payments were made or awarded. Whether the making or awarding of grants, scholarships, or other payments constitutes qualifying distributions made directly for the active conduct of the foundation's exempt activities is to be determined on the basis of the facts and circumstances of each particular case. The test applied is a qualitative, rather than a strictly quantitative, one. Therefore, if the foundation maintains a significant involvement (as defined in subdivision (ii) of this subparagraph) it will not fail to meet the general rule of subparagraph (1) of this paragraph solely because more of its funds are devoted to the making or awarding of grants, scholarships, or other payments than to the active programs which such grants, scholarships, or other payments support. However, if a foundation does no more than select, screen, and investigate applicants for grants or scholarships, pursuant to which the recipients perform their work or studies alone or exclusively under the direction of some other organization, such grants or scholarships will not be treated as qualifying distributions made directly for the active conduct of the foundation's exempt activities. The administrative expenses of such screening and investigation (as opposed to the grants or scholarships themselves) may be treated as qualifying distributions made directly for the active conduct of the foundation's exempt activities.

(ii) *Definition.* For purposes of this subparagraph, a foundation will be considered as maintaining a "significant

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involvement'' in a charitable, educational, or other similar exempt activity in connection with which grants, scholarships, or other payments are made or awarded if:

(A) An exempt purpose of the foundation is the relief of poverty or human distress, and its exempt activities are designed to ameliorate conditions among a poor or distressed class of persons or in an area subject to poverty or national disaster (such as providing food or clothing to indigents or residents of a disaster area), the making or awarding of the grants or other payments to accomplish such exempt purpose is direct and without the assistance of an intervening organization or agency, and the foundation maintains a salaried or voluntary staff of administrators, researchers, or other personnel who supervise and direct the activities described in this subdivision (A) on a continuing basis; or

(B) The foundation has developed some specialized skills, expertise, or involvement in a particular discipline or substantive area (such as scientific or medical research, social work, education, or the social sciences), it maintains a salaried staff of administrators, researchers, or other personnel who supervise or conduct programs or activities which support and advance the foundation's work in its particular area of interest, and, as a part of such programs or activities, the foundation makes or awards grants, scholarships, or other payments to individuals to encourage and further their involvement in the foundation's particular area of interest and in some segment of the programs or activities carried on by the foundation (such as grants under which the recipients, in addition to independent study, attend classes, seminars, or conferences sponsored or conducted by the foundation, or grants to engage in social work or scientific research projects which are under the general direction and supervision of the foundation).

(3) *Payment of section 4940 tax.* For purposes of section 4942(j)(3) (A) and (B)(ii), payment of the tax imposed upon a foundation under section 4940 shall be considered a qualifying distribution which is made directly for the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose.

(c) *Substantially all.* For purposes of this section, the term ''substantially all'' shall mean 85 percent or more. Thus, if a foundation makes qualifying distributions directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose in an amount equal to at least 85 percent of its adjusted net income, it will be considered as satisfying the income test described in this section even if it makes grants to organizations or engages in other activities with the remainder of its adjusted net income and with other funds. In determining whether the amount of qualifying distributions made directly for the active conduct of such exempt activities equals at least 85 percent of a foundation's adjusted net income, a foundation is not required to trace the source of such expenditures to determine whether they were derived from income or from contributions.

(d) *Examples.* The provisions of this section may be illustrated by the following examples. It is assumed that none of the organizations described in these examples is described in section 509(a) (1), (2), or (3).

Example 1. N, an exempt museum described in section 501(c)(3), was founded by the gift of an endowment from a single contributor. N uses 90 percent of its adjusted net income to operate the museum. If N satisfies one of the tests set forth in § 53.4942(b)–2 it may be classified as an operating foundation since substantially all of the qualifying distributions made by N are used directly for the active conduct of N's exempt activities within the meaning of paragraph (b)(1) of this section.

Example 2. M, an exempt organization described in section 501(c)(3), was created to improve conditions in a particular urban ghetto. M receives its funds primarily from a limited number of wealthy contributors interested in helping carry out its exempt purpose. M's program consists of making a survey of the problems of the ghetto to determine the areas in which its funds may be applied most effectively. Approximately 10 percent of M's adjusted net income is used to conduct this survey. The balance of its income is used to make grants to other nonprofit organizations doing work in the ghetto in those areas determined to have the greatest likelihood of resulting in improved conditions. Under these circumstances, since

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only 10 percent of M's adjusted net income may be considered as constituting qualifying distributions made directly for the active conduct of M's exempt activities, M cannot qualify as an operating foundation.

Example 3. Assume the facts as stated in example (2), except that M uses the remaining 90 percent of its adjusted net income for the following purposes: (1) M maintains a salaried staff of social workers and researchers who analyze its surveys and make recommendations as to methods for improving ghetto conditions; (2) M makes grants to independent social scientists who assist in these analyses and recommendations; (3) M publishes periodic reports indicating the results of its surveys and recommendations; (4) M makes grants to social workers and others who act as advisers to nonprofit organizations, as well as small business enterprises, functioning in the community (these advisers acting under the general direction of M attempt to implement M's recommendations through their advice and assistance to the nonprofit organizations and small business enterprises); and (5) M makes grants to other social scientists who study and report on the success of the various enterprises which attempt to implement M's recommendations. Under these circumstances, M satisfies the requirements of paragraph (b) (2) of this section, and the various grants it makes constitute qualifying distributions made directly for the active conduct of its exempt activities. Thus, if M satisfies one of the tests set forth in § 53.4942(b)–2 it may be classified as an operating foundation.

Example 4. P, an exempt educational organization described in section 501(c)(3), was created for the purpose of training teachers for institutions of higher education. Each year P awards a substantial number of fellowships to students for graduate study leading toward their M.A. or Ph. D. degrees. The applicants for these fellowships are carefully screened by P's staff, and only those applicants who indicate a strong interest in teaching in colleges or universities are chosen. P publishes and circulates various pamphlets encouraging a development of interest in college teaching and describing its fellowships. P also conducts annual summer seminars which are attended by its fellowship recipients, its staff, consultants, and other interested parties. The purpose of these seminars is to foster and encourage the development of college teaching. P publishes a report of the seminar proceedings along with related studies written by those who attended. Despite the fact that a substantial portion of P's adjusted net income is devoted to granting fellowships, its commitment to encouraging individuals to become teachers at institutions of higher learning, its maintenance of a staff and programs designed to further this purpose, and the granting of fellowships to encourage involvement both in its own seminars and in its exempt purpose indicate a significant involvement by P beyond the mere granting of fellowships. Thus, the fellowship grants made by P constitute qualifying distributions made directly for the active conduct of P's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 5. Q, an exempt organization described in section 501(c) (3), is composed of professional organizations interested in different branches of one academic discipline. Q trains its own professional staff, conducts its own program of research, selects research topics, screens and investigates grant recipients, makes grants to those selected, and sets up and conducts conferences and seminars for the grantees. Q has particular knowledge and skill in the given discipline, carries on activities to advance its study of that discipline, and makes grants to individuals to enable them to participate in activities which it conducts in carrying out its exempt purpose. Under these circumstances, Q's grants constitute qualifying distributions made directly for the active conduct of Q's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 6. R, an exempt medical research organization described in section 501 (c) (3), was created to study and perform research concerning heart disease. R has its own research center in which it carries on a broad number of research projects in the field of heart disease with its own professional staff. Physicians and scientists who are interested in special projects in this area present the plans for their projects to R. The directors of R study these plans and decide if the project is feasible and will further the work being done by R. If it is, R makes a grant to the individual to enable him to carry out his project, either at R's facilities or elsewhere. Reports of the progress of the project are made periodically to R, and R exercises a certain amount of supervision over the project. The resulting findings of these projects are usually published by R. Under these circumstances, the grants made by R constitute qualifying distributions made directly for the active conduct of R's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 7. S, an exempt organization described in section 501(c) (3), maintains a large library of manuscripts and other historical reference material relating to the history and development of the region in which the collection is located. S makes a limited number of annual grants to enable post-doctoral scholars and doctoral candidates to use its library. Sometimes S obtains the right to publish the scholar's work, although this is not a prerequisite to the receipt of a grant. The primary criterion for selection of grant recipients is the usefulness of the library's resources to the applicant's

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field of study. Under these circumstances, the grants made by S constitute qualifying distributions made directly for the active conduct of S's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 8. T, an exempt charitable organization described in section 501(c)(3), was created by the members of one family for the purpose of relieving poverty and human suffering. T has a large salaried staff of employees who operate offices in various areas throughout the country. Its employees make gifts of food and clothing to poor persons in the area serviced by each office. On occasion, T also provides temporary relief in the form of food and clothing to persons in areas stricken by natural disasters. If conditions improve in one poverty area, T transfers the resources of the office in that area to another poverty area. Under these circumstances, the gifts of food and clothing made by T constitute qualifying distributions made directly for the active conduct of T's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 9. U, an exempt scientific organization described in section 501(c) (3), was created for the principal purpose of studying the effects of early childhood brain damage. U conducts an active and continuous research program in this area through a salaried staff of scientists and physicians. As part of its research program, U awards scholarships to young people suffering mild brain damage to enable them to attend special schools equipped to handle such problems. The recipients are periodically tested to determine the effect of such schooling upon them. Under these circumstances, the scholarships awarded by U constitute qualifying distributions made directly for the active conduct of U's exempt activities within the meaning of paragraph (b) (2) of this section.

Example 10. O, an exempt charitable organization described in section 501(c) (3), was created for the purpose of giving scholarships to children of the employees of X Corporation who meet the standards set by O. O not only screens and investigates each applicant to make sure that he complies with the academic and financial requirements set for scholarship recipients, but also administers an examination which each applicant must take—90 percent of O's adjusted net income is used in awarding these scholarships to the chosen applicants. O does not conduct any activities of an educational nature on its own. Under these circumstances, O is not using substantially all of its adjusted net income directly for the active conduct of its exempt activities within the meaning of paragraph (b) of this section. Thus, O is not an operating foundation because it fails to satisfy the income test set forth in paragraph (a) of this section.

[T.D. 7249, 38 FR 768, Jan. 4, 1973, as amended by T.D. 7718, 45 FR 58520, Sept. 4, 1980; 46 FR 11254, Feb. 6, 1981; T.D. 7878, 48 FR 11943, Mar. 22, 1983]

§ 53.4942(b)–2 Alternative tests.

(a) *Assets test*—(1) *In general.* A private foundation will satisfy the assets test under the provisions of this paragraph if substantially more than half of the foundation's assets:

(i) Are devoted directly (A) to the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose, (B) to functionally related businesses (as defined in paragraph (c)(3)(iii) of § 53.4942(a)–2), or (C) to any combination thereof;

(ii) Are stock of a corporation which is controlled by the foundation (within the meaning of section 368(c)) and substantially all the assets of which (within the meaning of paragraph (c) of § 53.4942(b)–1) are so devoted; or

(iii) Are in part assets which are described in subdivision (i) of this subparagraph and in part stock which is described in subdivision (ii) of this subparagraph.

(2) *Qualifying assets*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, an asset is ''devoted directly to the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose'' only if the asset is actually used by the foundation directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose. Thus, such assets as real estate, physical facilities or objects (such as museum assets, classroom fixtures and equipment, and research facilities), and intangible assets (such as patents, copyrights, and trademarks) will be considered qualifying assets for purposes of this paragraph to the extent they are used directly for the active conduct of the foundation's exempt activities. However, assets which are held for the production of income, for investment, or for some other similar use (for example, stocks, bonds, interest-bearing notes, endowment funds, or, generally,

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leased real estate) are not devoted directly to the active conduct of the foundation's exempt activities, even though the income derived from such assets is used to carry out such exempt activities. Whether an asset is held for the production of income, for investment, or for some other similar use rather than being used for the active conduct of the foundation's exempt activities is a question of fact. For example, an office building used for the purpose of providing offices for employees engaged in the management of endowment funds of the foundation is not devoted to the active conduct of the foundation's exempt activities. However, where property is used both for exempt purposes and for other purposes, if such exempt use represents 95 percent or more of the total use, such property shall be considered to be used exclusively for an exempt purpose. Property acquired by a foundation to be used in carrying out the foundation's exempt purpose may be considered as devoted directly to the active conduct of such purpose even though the property, in whole or in part, is leased for a limited period of time during which arrangements are made for its conversion to the use for which it was acquired, provided such income-producing use of the property does not exceed a reasonable period of time. Generally, 1 year shall be deemed to be a reasonable period of time for purposes of the immediately preceding sentence. Similarly, where property is leased by a foundation in carrying out its exempt purpose and where the rental income derived from such property by the foundation is less than the amount which would be required to be charged in order to recover the cost of purchase and maintenance of such property (taking into account the deductions permitted by paragraph (d)(4) of § 53.4942(a)–2), such property shall be considered devoted directly to the active conduct of the foundation's exempt activities.

(ii) *Limitations.* (A) Assets which are held for the purpose of extending credit or making funds available to members of a charitable class (including any interest in a program related-investment, except as provided in paragraph (b)(2) of § 53.4942(b)–1) are not considered assets devoted directly to the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose. For example, assets which are set aside in special reserve accounts to guarantee student loans made by lending institutions will not be considered assets devoted directly to the active conduct of the foundation's exempt activities.

(B) Any amount set aside by a foundation within the meaning of paragraph (b) (1) of § 53.4942(b)–1 shall not be treated as an asset devoted directly to the active conduct of the foundation's exempt activities.

(3) *Assets held for less than a taxable year.* For purposes of this paragraph, any asset which is held by a foundation for part of a taxable year shall be taken into account for such taxable year by multiplying the fair market value of such asset (as determined pursuant to subparagraph (4) of this paragraph) by a fraction, the numerator of which is the number of days in such taxable year that the foundation held such asset and the denominator of which is the number of days in such taxable year.

(4) *Valuation.* For purposes of this paragraph, all assets shall be valued at their fair market value. Fair market value shall be determined in accordance with the rules set forth in paragraph (c)(4) of § 53.4942(a)–2, except in the case of assets which are devoted directly to the active conduct of the foundation's exempt activities and for which neither a ready market nor standard valuation methods exist (such as historical objects or buildings, certain works of art, and botanical gardens). In such cases, the historical cost (unadjusted for depreciation) shall be considered equal to fair market value unless the foundation demonstrates that fair market value is other than cost. In any case in which the foundation so demonstrates that the fair market value of an asset is other than historical cost, such substituted valuation may be used for the taxable year for which such new valuation is demonstrated and for each of the succeeding 4 taxable years if the valuation methods and procedures prescribed by paragraph (c)(4)(iv)(B) of § 53.4942 (a)–2 are followed.

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(5) *Substantially more than half.* For purposes of this paragraph, the term *substantially more than half* shall mean 65 percent or more.

(6) *Examples.* The provisions of this paragraph may be illustrated by the following examples. It is assumed that none of the organizations described in these examples is described in section 509(a) (1), (2), or (3).

Example 1. W, an exempt organization described in section 501(c)(3), is devoted to the maintenance and operation of a historic area for the benefit of the general public. W has acquired and erected facilities for lodging and other visitor accommodations in such area, which W operates through a wholly owned, separately incorporated, taxable entity. These facilities comprise substantially all of the subsidiary's assets. The operation of such accommodations constitutes a functionally related business within the meaning of paragraph (c)(3)(iii) of §53.4942(a)–2. Under these circumstances, the stock of the subsidiary will be considered as part of W's assets which may be taken into account by W in determining whether it satisfies the assets test described in this paragraph.

Example 2. M, an exempt conservation organization described in section 501(c)(3), is devoted to acquiring, preserving, and otherwise making available for public use geographically diversified areas of natural beauty. M has acquired and erected facilities for lodging and other visitor accommodations in national park areas. The operation of such accommodations constitutes a functionally related business within the meaning of paragraph (c)(3)(iii) of §53.4942(a)–2. Therefore, M's assets which are directly devoted to such visitor accommodations may be taken into account by M in determining whether it satisfies the assets test described in this paragraph.

Example 3. P, an exempt organization described in section 501(c)(3), is devoted to acquiring and restoring historic houses. To insure that the restored houses will be kept in the restored condition, and to make the houses more readily available for public display, P rents the houses rather than sells them once they have been restored. The rental income derived by P is substantially less than the amount which would be required to be charged in order to recover the cost of purchase, restoration, and maintenance of such houses. Therefore, such houses may be taken into account by P in determining whether it satisfies the assets test described in this paragraph.

Example 4. Z, an exempt organization described in section 501(c)(3), is devoted to improving the public's understanding of Renaissance art. Z's principal assets are a number of paintings of this period which it circulates on an active and continuing basis to museums and schools for public display. These paintings constitute 80 percent of Z's assets. Under these circumstances, although Z does not have a building in which it displays these paintings, such paintings are devoted directly to the active conduct of activities constituting Z's exempt purpose. Therefore, Z has satisfied the assets test described in this paragraph.

(b) *Endowment test*—(1) *In general.* A foundation will satisfy the endowment test under the provisions of this paragraph if it normally makes qualifying distributions (within the meaning of paragraph (a)(2) of §53.4942(a)–3) directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose in an amount not less than two-thirds of its minimum investment return (as defined in paragraph (c) of §53.4942(a)–2). In determining whether the amount of such qualifying distributions is not less than an amount equal to two-thirds of the foundation's minimum investment return, the foundation is not required to trace the source of such expenditures to determine whether they were derived from investment income or from contributions.

(2) *Definitions.* For purposes of this paragraph, the phrase *directly for the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose* shall have the same meaning as in paragraph (b) of §53.4942(b)–1.

(3) *Example.* This paragraph may be illustrated by the following example:

Example X, an exempt organization described in section 501(c)(3) and not described in section 509(a) (1), (2), or (3), was created on July 15, 1970. X uses the cash receipts and disbursements method of accounting. For 1971, the fair market value of X's assets not described in paragraph (c) (2) or (3) of §53.4942(a)–2 is $400,000. X makes qualifying distributions for 1971 directly for the active conduct of its exempt activities of $17,000. For 1971 two-thirds of X's minimum investment return is $16,000 (6 percent × $400,000 = $24,000; ⅔ × $24,000 = $16,000). Under these circumstances, X has satisfied the endowment test described in this paragraph for 1971. However, if X's qualifying distributions for 1971 directly for the active conduct of its exempt activities were only $15,000, X would not satisfy the endowment test for 1971, unless the fair market value of its assets not described in paragraph (c) (2) or (3) of §53.4942(a)–2 were no greater than $375,000 (6

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percent × $375,000 = $22,500; ⅔ × $22,500 = $15,000).

(c) *Support test*—(1) *In general.* A foundation will satisfy the support test under the provisions of this paragraph if:

(i) Substantially all of its support (other than gross investment income as defined in section 509(e)) is normally received from the general public and from five or more exempt organizations which are not described in section 4946(a)(1)(H) with respect to each other or the recipient foundation;

(ii) Not more than 25 percent of its support (other than gross investment income) is normally received from any one such exempt organization; and

(iii) Not more than half of its support is normally received from gross investment income.

(2) *Definitions and special rules.* For purposes of this paragraph:

(i) *Support.* The term *support* shall have the same meaning as in section 509(d).

(ii) *Substantially all.* The term *substantially all* shall have the same meaning as in paragraph (c) of § 53.4942(b)–1.

(iii) *Support from exempt organizations.* The support received from any one exempt organization may be counted towards satisfaction of the support test described in this paragraph only if the foundation receives support from no fewer than five exempt organizations. For example, a foundation which normally receives 20 percent of its support (other than gross investment income) from each of five exempt organizations may qualify under this paragraph even though it receives no support from the general public. However, if a foundation normally received 10 percent of its support from each of three exempt organizations and the balance of its support from sources other than exempt organizations, such support could not be taken into account in determining whether the foundation had satisfied the support test set forth in this paragraph.

(iv) *Support from the general public.* ''Support'' received from an individual, or from a trust or corporation (other than an exempt organization), shall be taken into account as support from the general public only to the extent that the total amount of the support received from any such individual, trust, or corporation during the period for determining the normal sources of the foundation's support (as set forth in § 53.4942 (b)–3) does not exceed 1 percent of the foundation's total support (other than gross investment income) for such period. In applying this 1-percent limitation, all support received by the foundation from any person and from any other person or persons standing in a relationship to such person which is described in section 4946(a)(1) (C) through (G) and the regulations thereunder shall be treated as received from one person. For purposes of this paragraph, support received from a governmental unit described in section 170(c)(1) shall be treated as support received from the general public, but shall not be subject to the 1-percent limitation.

§ 53.4942(b)–3 Determination of compliance with operating foundation tests.

(a) *In general.* A foundation may satisfy the income test and either the assets, endowment, or support test by satisfying such tests for any 3 taxable years during a 4-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 pertinent amounts of income or assets held, received, or distributed during such 4-year period. A foundation may not use one method for satisfying the income test described in paragraph (a) of § 53.4942(b)–1 and another for satisfying either the assets, endowment, or support test described in § 53.4942(b)–2. Thus, if a foundation satisfies the income test on the 3-out-of-4-year basis for a particular taxable year, it may not use the aggregation method for satisfying either the assets, endowment, or support test for such particular taxable year. However, the fact that a foundation has chosen one method for satisfying the tests under §§ 53.4942(b)–1 and 53.4942(b)–2 for 1 taxable year will not preclude it from satisfying such tests for a subsequent taxable year by the alternate method. If a foundation fails to satisfy the income test and either the assets, endowment, or support test for a particular taxable year under either the 3-out-of-4-year

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method or the aggregation method, it shall be treated as a nonoperating foundation for such taxable year and for all subsequent taxable years until it satisfies the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 for a taxable year occurring after the taxable year in which it was treated as a nonoperating foundation.

(b) *New organizations*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, an organization organized after December 31, 1969, will be treated as an operating foundation only if it has satisfied the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 for its first taxable year of existence. If an organization satisfies such tests for its 1st taxable year, it will be treated as an operating foundation from the beginning of such taxable year. If such is the case, the organization will be treated as an operating foundation for its 2d and 3d taxable years of existence only if it satisfies the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 by the aggregation method for all such taxable years that it has been in existence.

(2) *Special rule.* An organization organized after December 31, 1969, will be treated as an operating foundation prior to the end of its 1st taxable year if such organization has made a good faith determination that it is likely to satisfy the income test set forth in paragraph (a) of § 53.4942(b)–1 and one of the tests set forth in § 53.4942(b)–2 for such 1st taxable year pursuant to subparagraph (1) of this paragraph. Such a ''good faith determination'' ordinarily will be considered as made where the determination is based on an affidavit or opinion of counsel of such organization that such requirements will be satisfied. Such an affidavit or opinion must set forth sufficient facts concerning the operations and support of such organization for the Commissioner to be able to determine that such organization is likely to satisfy such requirements. An organization which, pursuant to this subparagraph, has been treated as an operating foundation for its 1st taxable year, but actually fails to qualify as an operating foundation under subparagraph (1) of this paragraph for such taxable year, will be treated as a private foundation which is not an operating foundation as of the 1st day of its 2d taxable year for purposes of making any determination under the internal revenue laws with respect to such organization. The preceding sentence shall not apply if such organization establishes to the satisfaction of the Commissioner that it is likely to qualify as an operating foundation on the basis of its 2d, 3d, and 4th taxable years. Thus, if such an organization fails to qualify as an operating foundation in its 2d, 3d, or 4th taxable year after having failed in its 1st taxable year, it will be treated as a private foundation which is not an operating foundation as of the 1st day of such 2d, 3d, or 4th taxable year in which it fails to qualify as an operating foundation, except as otherwise provided by paragraph (d) of this section. Such status as a private foundation which is not an operating foundation will continue until such time as the organization is able to satisfy the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 by either the 3-out-of-4-year method or the aggregation method. For the status of grants or contributions made to such an organization with respect to sections 170 and 4942, see paragraph (d) of this section.

(c) *Transitional rule for existing organizations.* An organization organized before December 31, 1969 (including organizations deemed to be so organized by virtue of the principles of paragraph (e)(2) of § 53.4942(a)–2), but which is unable to satisfy the tests under §§ 53.4942(b)–1 and 53.4942(b)–2 for its first taxable year beginning after December 31, 1969 on the basis of its operations for taxable years prior to such taxable year by either the 3-out-of-4-year method or the aggregation method, will be treated as a new organization for purposes of paragraph (b) of this section only if:

(1) The organization changes its methods of operation prior to its first taxable year beginning after December 31, 1972 to conform to the requirements of §§ 53.4942(b)–1 and 53.4942 (b)–2;

(2) The organization has made a good faith determination (within the meaning of paragraph (b) (2) of the section) that it is likely to satisfy the tests set forth in §§ 53.4942(b)–1 and 53.4942(b)–2 prior to its first taxable year beginning after December 31, 1972 on the basis of

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its income or assets held, received, or distributed during its taxable years beginning in 1970 through 1972; and

(3) Such good faith determination is attached to the return the organization is required to file under section 6033 for its taxable year beginning in 1972.

(d) *Treatment of contributions*—(1) *In general.* The status of grants or contributions made to an operating foundation with respect to sections 170 and 4942 will not be affected until notice of change of status of such organization is made to the public (such as by publication in the Internal Revenue Bulletin), unless the grant or contribution was made after:

(i) The act or failure to act that resulted in the organization's inability to satisfy the requirements of §§ 53.4942 (b)–1 and 53.4942(b)–2, and the grantor or contributor was responsible for, or was aware of, such act or failure to act, or

(ii) The grantor or contributor acquired knowledge that the Commissioner has given notice to such organization that it would be deleted from classification as an operating foundation.

(2) *Exception.* For purposes of subparagraph (1) (i) of this paragraph, a grantor or contributor will not be considered to be responsible for, or aware of, the act or failure to act that resulted in the grantee organization's inability to satisfy the requirements of §§ 53.4942 (b)–1 and 53.4942(b)–2 if such grantor or contributor has made his grant or contribution in reliance upon a written statement by the grantee organization that such grant or contribution would not result in the inability of such grantee organization to qualify as an operating foundation. Such a statement must be signed by a foundation manager (as defined in section 4946(b)) of the grantee organization and must set forth sufficient facts concerning the operations and support of such grantee organization to assure a reasonably prudent man that his grant or contribution will not result in the grantee organization's inability to qualify as an operating foundation.

Subpart D—Taxes on Excess Business Holdings

AUTHORITY: Secs. 4943 and 7805, Internal Revenue Code of 1954, 68A Stat. 917, 83 Stat. 507; 26 U.S.C. 4943, 7805.

SOURCE: T.D. 7496, 42 FR 46285, Sept. 15, 1977, unless otherwise noted.

§ 53.4943–1 General rule; purpose.

Generally, under section 4943, the combined holdings of a private foundation and all disqualified persons (as defined in section 4946(a)) in any corporation conducting a business which is not substantially related (aside from the need of the foundation for income or funds or the use it makes of the profits derived) to the exempt purposes of the foundation are limited to 20 percent of the voting stock in such corporation. In addition, the combined holdings of a private foundation and all disqualified persons in any unincorporated business (other than a sole proprietorship) which is not substantially related (aside from the need of the foundation for income or funds or the use it makes of the profits derived) to the exempt purposes of such foundation are limited to 20 percent of the beneficial or profits interest in such business. In the case of a sole proprietorship which is not substantially related (within the meaning of the preceding sentence), section 4943 provides that a private foundation shall have no permitted holdings. These general provisions are subject to a number of exceptions and special provisions which will be described in following sections.

§ 53.4943–2 Imposition of tax on excess business holdings of private foundations.

(a) *Imposition of initial tax*—(1) *In general*—(i) *Initial tax.* Section 4943(a)(1) imposes an initial excise tax (the ''initial tax'') on the excess business holdings of a private foundation for each taxable year of the foundation which ends during the taxable period defined in section 4943(d)(2). The amount of such tax is equal to 5 percent of the total value of all the private foundation's excess business holdings in each of its business enterprises. In determining the value of the excess business holdings of the foundation subject to

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tax under section 4943, the rules set forth in §§ 20.2031–1 through 20.2031–3 of this chapter (Estate Tax Regulations) shall apply.

(ii) *Disposition of certain excess business holdings within ninety days.* In any case in which a private foundation acquires excess business holdings, other than as a result of a purchase by the foundation, the foundation shall not be subject to the taxes imposed by section 4943, but only if it disposes of an amount of its holdings so that it no longer has such excess business holdings within 90 days from the date on which it knows, or has reason to know, of the event which caused it to have such excess business holdings. Similarly, a private foundation shall not be subject to the taxes imposed by section 4943 because of its purchase of holdings where it did not know, or have reason to know of prior acquisitions by disqualified persons, but only if the foundation disposes of its excess holdings within the 90-day period described previously, and its purchase would not have created excess business holding but for such prior acquisitions by disqualified persons. In determining whether for purposes of this (ii) the foundation has disposed of such excess business holdings during such 90-day period, any disposition of holdings, by a disqualified person during such period shall be disregarded.

(iii) *Extension of ninety day period.* The period described in paragraph (a)(1)(ii) of this section, during which no tax shall be imposed under section 4943, shall be extended to include the period during which a foundation is prevented by federal or state securities laws from disposing of such excess business holdings.

(iv) *Effect of disposition subject to material restrictions.* If a private foundation disposes of an interest in a business enterprise but imposes any material restrictions or conditions that prevent the transferee from freely and effectively using or disposing of the transferred interest, then the transferor foundation will be treated as owning such interest until all such restrictions or conditions are eliminated (regardless of whether the transferee is treated for other purposes of the Code as owning such interest from the date of the transfer). However, a restriction or condition imposed in compliance with federal or state securities laws, or in accordance with the terms or conditions of the gift or bequest through which such interest was acquired by the foundation, shall not be considered a material restriction or condition imposed by a private foundation.

(v) *Foundation knowledge of acquisitions made by disqualified persons.* (A) For purposes of paragraph (a)(1)(ii) of this section, whether a private foundation will be treated as knowing, or having reason to know, of the acquisition of holdings by a disqualified person will depend on the facts and circumstances of each case. Factors which will be considered relevant to a determination that a private foundation did not know or had no reason to know of an acquisition are: the fact that it did not discover acquisitions made by disqualified persons through the use of procedures reasonably calculated to discover such holdings; the diversity of foundation holdings; and the existence of large numbers of disqualified persons who have little or no contact with the foundation or its managers.

(B) The provisions of paragraph (a)(1)(v)(A) of this section may be illustrated by the following example:

Example. By the fifteenth day of the fifth month after the close of each taxable year, the F Foundation sends to each foundation manager, substantial contributor, person holding more than a 20% interest (as described in section 4946(a)(1)(C) in a substantial contributor, and foundation described in section 4946(a)(1)(H), a questionnaire asking such persons to list all holdings, actual or constructive, in each business enterprise in which F had holdings during the taxable year in excess of those permitted by the 2 percent de minimis rule of section 4943(c)(2)(C). In preparing the list of such enterprises, F takes into account its constructive holdings only if, during the taxable year, F (along with all related foundations described in section 4946(a)(1)(H)) owned over 2% of the voting stock, profits interest or beneficial interest in the entity actually owning the holdings constructively held by F. The questionnaire asks each such person to list the holdings in such enterprises of any persons who, because of their relationship to such disqualified person, were themselves disqualified persons (*i.e.*, members of the family (as defined in section 4946(d)), and any corporations, partnerships, trusts and estates described in section 4946(a)(1) (E)

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through (G) in which such person, or members of his family, had an interest). The questionnaire asks that constructive holdings be listed only if, during the taxable year, the disqualified person owned over 2% of the voting stock, profits interest or beneficial interest in the entity actually owning the holdings constructively held by such person. (Thus a disqualified person owning less than 2% of a mutual fund is not required to list his attributed share of all the securities in the portfolio of the fund.) If no response to the questionnaire is received, the foundation seeks the information requested by the questionnaire by mailing a second (but not a third) questionnaire. If a questionnaire which is returned to the foundation indicates that certain information was unavailable to the person completing the questionnaire, the foundation seeks that information directly. For example, if a disqualified person indicates that he could not find out whether a corporation described in section 4946(a)(1)(E) had holdings in the enterprise listed in the questionnaire, the foundation seeks to obtain this information directly from the corporation by mailing it a questionnaire. In such a case F may be found not to have reason to know of the acquisition of holdings by a disqualified person.

(vi) *Holdings acquired other than by purchases.* See section 4943(c)(6) and § 53.4943–6 for rules relating to the acquisition of certain holdings other than by purchase by the foundation or a disqualified person.

(2) *Special rules.* In applying subparagraph (1) of this paragraph, the tax imposed by section 4943(a)(1):

(i) Shall be imposed on the last day of the private foundation's taxable year, but

(ii) The amount of such tax and the value of the excess business holdings subject to such tax shall be determined with respect to the foundation's holdings (based upon voting power, profits or beneficial interest, or value, whichever is applicable) in any business enterprise as of that day during the foundation's taxable year when the foundation's excess holdings in such enterprise were the greatest.

In applying subdivision (ii) of this subparagraph, if a foundation's excess business holdings in a business enterprise which constitute such foundation's greatest excess holdings in such enterprise for any taxable year are maintained for 2 or more days during such taxable year, the value of such excess holdings which is subject to tax under section 4943(a)(1) shall be the greatest value of such excess holdings in such enterprise as of any day on which such greatest excess holdings are maintained during such taxable year.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. Y is a private foundation reporting on a calendar year basis. On January 1, 1973, Y has 20 shares of common stock in corporation N, of which five shares constitute excess business holdings. On June 1, 1973, Y disposes of such five shares; however, because of additional acquisitions of N common stock on such date by disqualified persons with respect to Y, the remaining 15 shares of N common stock held by Y now constitute excess business holdings. There are no further acquisitions or dispositions of N common stock during 1973 by Y or its disqualified persons. Although Y's greatest holdings in N during 1973 are held between January 1, 1973, and May 31, 1973, Y's greatest excess holdings in N during 1973 are held between June 1, 1973, and December 31, 1973. Therefore, the tax specified in section 4943(a)(1) shall be computed on the basis of the greatest value of such greatest excess holdings as of any day between June 1 and December 31, 1973.

Example 2. X is a private foundation reporting on a calendar year basis. On January 1, 1972, X has 100 shares of common stock in M corporation which are excess business holdings. On such date each share of M common stock has a fair market value of $100. On February 28, 1972, in an effort to dispose of such excess business holdings, X sells 70 shares of M common stock for $120 per share (the fair market value of each share on such date) to A, an individual who is not a disqualified person within the meaning of section 4946(a). The value of $120 per share is the highest fair market value between January 1 and February 28, 1972. X disposes of no more stock in M for the reminder of calendar year 1972. On December 31, 1972, the fair market value of each share of M common stock is $80. X calculates its tax on its excess business holdings in M for 1972 as follows:

100 shares of M common stock times $120 fair market value per share as of Feb. 28, 1972 ...	$12,000
$12,000 multiplied by rate of tax (percent)	5
Amount of tax on X foundation's excess business holdings for 1972	$600

Example 3. Assume the same facts as in Example (2) except that the sale of X to A occurs on January 7, 1973, when the fair market value of each share of M corporation common stock equals $70. A value of $100 per share is the highest fair market value of the M common stock between January 1 and January 7, 1973. On May 9, 1973, X for the first time has excess business holdings in N

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corporation in the form of 200 shares of N common stock. The value per share of N common stock on May 9, 1973, equals $200. X makes no disposition of the N common stock during 1973, and the value of each share of N common stock as of December 31, 1973 equals $250 (the highest value of N common stock during 1973). X calculates its tax on its excess business holdings in both M and N for 1973 as follows:

100 shares of M common stock times $100 fair market value per share	$10,000
$250 fair market value per share	$50,000
Total	$60,000
Total	$60,000
$60,000 multiplied by rate of tax (percent)	5
Amount of tax on X foundation's excess business holdings for 1973	$3,000

(b) *Additional tax.* In any case in which the initial tax is imposed under section 4943(a) with respect to the holdings of a private foundation in any business enterprise, if, at the close of the taxable period (as defined in section 4943(d)(2) and § 53.4943–9) with respect to such holdings the foundation still has excess business holdings in such enterprise, there is imposed a tax under section 4943(b) equal to 200 percent of the value of such excess holdings as of the last day of the taxable period.

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 8084, 51 FR 16302, May 2, 1986]

§ 53.4943–3 Determination of excess business holdings.

(a) *Excess business holdings*—(1) *In general.* For purposes of section 4943, the term ''excess business holdings'' means, with respect to the holdings of any private foundation in any business enterprise (as described in section 4943(d)(4)), the amount of stock or other interest in the enterprise which, except as provided in § 53.4943–2(a)(1), the foundation, or a disqualified person, would have to dispose of, or cause the disposition of, to a person other than a disqualified person (as defined in section 4946(a)) in order for the remaining holdings of the foundation in such enterprise to be permitted holdings (as defined in paragraphs (b) and (c) of this section). If a private foundation is required by section 4943 and the regulations thereunder to dispose of certain shares of a class of stock in a particular period of time and other shares of the same class of stock in a shorter period of time, any stock disposed of shall be charged first against those dispositions which must be made in such shorter period.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. Corporation X has outstanding 100 shares of voting stock, with each share entitling the holder thereof to one vote. F, a private foundation, possesses 20 shares of X voting stock representing 20 percent of the voting power in X. Assume that the permitted holdings of F in X under paragraph (b)(1) of this section are 11 percent of the voting stock in X. F, therefore, possesses voting stock in X representing a percentage of voting stock in excess of the percentage permitted by such paragraph. Such excess percentage is 9 percent of the voting stock in X, determined by subtracting the percentage of voting stock representing the permitted holdings of F in X (*i.e.*, 11 percent) from the percentage of voting stock held by F in X (I.E., 20 percent). (20% − 11% = 9%). The excess business holdings of F in X are an amount of voting stock representing such excess percentage, or 9 shares of X voting stock (9 percent of 100).

(b) *Permitted holdings in an incorporated business enterprise*—(1) *In general*—(i) *Permitted holdings defined.* Except as otherwise provided in section 4943(c) (2) and (4), the permitted holdings of any private foundation in an incorporated business enterprise (including a real estate investment trust, as defined in section 856) are:

(A) 20 percent of the voting stock in such enterprise reduced (but not below zero) by

(B) The percentage of voting stock in such enterprise actually or constructively owned by all disqualified persons.

(ii) *Voting stock.* For purposes of this section, the percentage of voting stock held by any person in a corporation is normally determined by reference to the power of stock to vote for the election of directors, with treasury stock and stock which is authorized but unissued being disregarded. Thus, for example, if a private foundation holds 20 percent of the shares of one class of stock in a corporation, which class is entitled to elect three directors, and such foundation holds no stock in the other class of stock, which is entitled to elect five directors, such foundation shall be treated as holding 7.5 percent

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of the voting stock because the class of stock it holds has 37.5 percent of such voting power, by reason of being able to elect three of the eight directors, and the foundation holds one-fifth of the shares of such class (20 percent of 37.5 percent is 7.5 percent). The fact that extraordinary corporate action (e.g., charter or by-law amendments) by a corporation may require the favorable vote of more than a majority of the directors, or of the outstanding voting stock, of such corporation shall not alter the determination of voting power of stock in such corporation in accordance with the two preceding sentences.

(2) *Nonvoting stock as permitted holdings*—(i) *In general.* In addition to those holdings permitted by paragraph (b)(1) of this section, the permitted holdings of a private foundation in an incorporated business enterprise shall include any share of nonvoting stock in such enterprise held by the foundation in any case in which all disqualified persons hold, actually or constructively, no more than 20 percent (35 percent where third persons have effective control as defined in paragraph (b)(3)(ii) of this section) of the voting stock in such enterprise. All equity interests which do not have voting power attributable to them shall, for purposes of section 4943, the classified as nonvoting stock. For this purpose, evidences of indebtedness (including convertible indebtedness), and warrants and other options or rights to acquire stock shall not be considered equity interests.

(ii) *Stock with contingent voting rights and convertible nonvoting stock.* Stock carrying voting rights which will vest only when conditions, the occurrence of which are indeterminate, have been met, such as preferred stock which gains such voting rights only if no dividends are paid thereon, will be treated as nonvoting stock until the conditions have occurred which cause the voting rights to vest. When such rights vest, the stock will be treated as voting stock that was acquired other than by purchase, but only if the private foundation or disqualified persons had no control over whether the conditions would occur. Similarly, nonvoting stock which may be converted into voting stock will not be treated as voting stock until such conversion occurs. For special rules where stock is acquired other than by purchase, see section 4943(c)(6) and the regulations thereunder.

(iii) *Example.* The provisions of this paragraph (2) may be illustrated by the following example:

Example. Assume that F, a private foundation, holds 10 percent of the single class of voting stock of corporation X, and owns 20 shares of nonvoting stock in X. Assume further that A and B, the only disqualified persons with respect to F, hold 10 percent of the voting stock of X. Under the provisions of paragraph (b)(1) of this section the 10 percent of X voting stock held by F will be classified as permitted holdings of F in X since 20 percent less the percentage of voting stock held by A and B in X is 10 percent. In addition, under the provisions of this (2), the 20 shares of X nonvoting stock will qualify as permitted holdings of F in X since the percentage of voting stock held by A and B in X is no greater than 20 percent.

(3) *Thirty-five-percent rule where third person has effective control of enterprise*—(i) *In general.* Except as provided in section 4943(c)(4), paragraph (b)(1) of this section shall be applied by substituting 35 percent for 20 percent if:

(A) The private foundation and all disqualified persons together do not hold, actually or constructively, more than 35 percent of the voting stock in the business enterprise, and

(B) The foundation establishes to the satisfaction of the Commissioner that effective control (as defined in paragraph (b)(3)(ii) of this section) of the business enterprise is in one or more persons (other than the foundation itself) who are not disqualified persons.

(ii) *''Effective control'' defined.* For purposes of this subparagraph, the term ''effective control'' means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise. It is the reality of control which is decisive and not its form or the means by which it is exercisable. Thus, where a minority interest held by individuals who are

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not disqualified persons has historically elected the majority of a corporation's directors, effective control is in the hands of those individuals.

(4) *Two percent de minimis rule*—(i) *In general.* Under section 4943(c)(2)(C), a private foundation is not treated as having excess business holdings in any incorporated business enterprise in which it (together with all other private foundations (including trusts described in section 4947(a)(2)) which are described in section 4946(a)(1)(H)) actually or constructively owns not more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock. If, however, the private foundation, together with all other private foundations which are described in section 4946(a)(1)(H), actually or constructively owns more than 2 percent of either the voting stock or the value of the outstanding shares of all classes of stock in any incorporated business enterprise, all the stock in such business enterprise classified as excess business holding under section 4943 is treated as excess business holdings. For purposes of this paragraph, any stock owned by a private foundation which is treated as held by a disqualified person under section 4943(c)(4)(B), (5), or (6) shall be treated as actually owned by the private foundation. See paragraph (b)(1) of §53.4941(d)–4 for the determination of excess business holdings without regard to section 4943(c)(2)(C) for purposes of applying section 101(C)(2)(B) of the Tax Reform Act of 1969 (83 Stat. 533).

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. F, a private foundation, owns 1 percent of the single class of voting stock and 1 percent in value of all the outstanding shares of all classes of stock in X corporation. No other private foundation described in section 4946(a)(1)(H) owns any stock in X. All of the stock owned by F in X would be excess business holdings under section 4943 (c)(1) if section 4943(c)(2)(C) were inapplicable. F owns no no other shares of stock in X. Since F owns more than 2 percent of the voting stock and no more than 2 percent in value of all outstanding shares of all classes of stock in X, under section 4943(c)(2)(C) none of the stock in X owned by F is treated as excess business holdings.

Example 2. Assume the facts as stated in Example (1), except that F and T, a controlled private foundation under section 4946 (a)(1)(H), together own 1 percent of all the voting stock and 1 percent in value of all the outstanding shares of all classes of stock in X. All of the stock in X owned by F and T would be excess business holdings under section 4943(c)(1) if section 4943(c)(2)(C) were inapplicable. Since F and T together owned no more than 2 percent of the voting stock and no more than 2 percent in value of all outstanding shares of all classes of stock in X, under section 4943(c)(2)(C) none of the stock in X owned by either F or T is treated as excess business holdings.

Example 3. Assume the facts as stated in Example (1), except that F owns 3 percent of the voting stock in X, 2 percent of which is treated as held by P, a disqualified person of F, under section 4943(c)(4)(B). Under subdivision (i) of this subparagraph, the 2 percent of the stock in X owned by F which is treated as held by P under section 4943(c)(4)(B) is treated as actually owned by F for purposes of section 4943(c)(2)(C). Consequently, all of the X stock owned by F is treated as excess business holdings under section 4943(c)(2)(C). However, only 1 percent of the stock in X is subject to tax under section 4943(a), since the other 2 percent is treated as owned by a disqualified person under section 4943(c)(4)(B) for purposes of determining the tax upon F under section 4943(a).

(c) *Permitted holdings in an unincorporated business enterprise*—(1) *In general.* The permitted holdings of a private foundation in any business enterprise which is not incorporated shall, subject to the provisions of subparagraphs (2), (3), and (4) of this paragraph, be determined under the principles of paragraph (b) of this section.

(2) *Partnership or joint venture.* In the case of a partnership (including a limited partnership) or joint venture. the terms ''profits interest'' and ''capital interest'' shall be substituted for ''voting stock'' and ''nonvoting stock,'' respectively, wherever those terms appear in paragraph (b) of this section. The interest in profits of such foundation (or such disqualified person) shall be determined in the same manner as its distributive share of partnership taxable income. See section 704(b) (relating to the determination of the distributive share by the income or loss ratio) and the regulations thereunder. In the absence of a provision in the partnership agreement, the capital interest of such foundation (or such disqualified person) in a partnership shall

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be determined on the basis of its interest in the assets of the partnership which would be distributable to such foundation (or such disqualified person) upon its withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

(3) *Sole proprietorship*. For purposes of section 4943, a private foundation shall have no permitted holdings in a sole proprietorship. In the case of a transfer by a private foundation of a portion of a sole proprietorship, see paragraph (c)(2) of this section (relating to permitted holdings in partnerships). For the treatment of a private foundation's ownership of a sole proprietorship prior to May 26, 1969, see § 53.4943–4.

(4) *Trusts and other unincorporated business enterprises*—(i) *In general*. In the case of any unincorporated business enterprise which is not described in paragraph (c) (2) or (3) of this section, the term ''beneficial interest'' shall be substituted for ''voting stock'' wherever the term appears in paragraph (b) of this section. Any and all references to nonvoting stock in paragraph (b) of this section shall be inapplicable with respect to any unincorporated business enterprise described in this subparagraph.

(ii) *Trusts*. For purposes of section 4943, the beneficial interest of a private foundation or any disqualified person in a trust shall be the beneficial remainder interest of such foundation or person determined as provided in paragraph (b) of § 53.4943–8.

(iii) *Other unincorporated business enterprises*. For purposes of section 4943, the beneficial interest of a private foundation or any disqualified person in an unincorporated business enterprise (other than a trust or an enterprise described in paragraph (c) (2) or (3) of this section) includes any right to receive a portion of distributions of profits of such enterprise, and, if the portion of distributions is not fixed by an agreement among the participants, any right to receive a portion of the assets (if any) upon liquidation of the enterprise, except as a creditor or employee. For purposes of this subparagraph, a right to receive distributions of profits includes a right to receive any amount from such profits (other than as a creditor or employee), whether as a sum certain or as a portion of profits realized by the enterprise. Where there is no agreement fixing the rights of the participants in such enterprise, the interest of such foundation (or such disqualified person) in such enterprise shall be determined by dividing the amount of all equity investments or contributions to the capital of the enterprise made or obligated to be made by such foundation (or such disqualified person) by the amount of all equity investments or contributions to capital made or obligated to be made by all participants in the enterprise.

(d) *Examples*. The provisions of this section may be illustrated by the following examples:

Example 1. Corporation X has outstanding 100 shares of voting stock, with each share entitling the holder thereof to one vote. Assume that F, a private foundation, possesses 30 shares of X voting stock, and that A and B, the only disqualified persons with respect to F, together own 10 shares of X voting stock. The excess business holdings of F in X are 20 shares of X voting stock, determined as follows:

(*i*) *Determination of voting stock percentages*	
(a) Total number of outstanding votes in X	100
(b) Total number of votes in X held by F	30
(c) Total number of votes in X held by A and B	10
(d) Percentage of voting stock in X held by F (item (b) divided by item (a)) (percent)	30
(e) Percentage of voting stock in X held by A and B (item (c) divided by item (a)) (percent)	10
(*ii*) *Determination of permitted holdings of voting stock*	
(a) Percentage of voting stock in X held by A and B (percent)	10
(b) Permitted holdings of voting stock by F in X (20 pct less item (a)) (percent)	10
(*iii*) *Determination of excess business holdings*	
(a) Percentage of voting stock in X held by F (percent)	30
(b) Permitted holdings of voting stock by F in X (percent)	10
(c) Item (a) less item (b) (percent)	20
(d) Excess business holdings of F in X (*i.e.*, an amount of X voting stock representing a percentage of voting stock equivalent to that in item (c)) (shares)	20

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Example 2. F, a private foundation, is a partner in P partnership. In addition, A and B, the only disqualified persons with respect to F, are partners in P. The partnership agreement of P contains no provisions regarding the sharing of profits by, and the respective capital interests of, the partners.

(i) assume that, under section 704(b), F's distributive share of P taxable income is determined to be 20 percent. In addition, assume that under such section, A and B are determined to have a 4-percent distributive share each of P taxable income. Accordingly, F holds a 20-percent profits interest in P, and A and B hold an 8-percent profits interest in P. Assuming that the provisions of section 4943(c)(2)(B) do not apply, the permitted holdings of F in P are 12 percent of the profits interest in P, determined by subtracting the percentage of the profits interest held by A and B in P (*i.e.*, 8 percent) from 20 percent. (20 percent − 8 percent = 12 percent.) F, therefore, holds a percentage of the profits interest in P in excess of the percentage permitted by § 53.4943–3(b)(1). The excess business holdings of F in P are a percentage of the profits interest in P equivalent to such excess percentage, or 8 percent of the profits interest in P, determined by subtracting the permitted holdings of F in P (*i.e.*, 12 percent) from the percentage of the profit interest held by F in P (*i.e.*, 20 percent) (20 percent − 12 percent = 8 percent.)

(ii) Assume that, under the partnership agreement, F would be entitled to a distribution of 20 percent of P's assets upon F's withdrawal from P and to a distribution of 30 percent of P's assets upon the liquidation profits interest held by F in P (*i.e.*, 20 percent) (20 percent − 12 percent = 8 percent), of P. F, therefore, holds a 30-percent capital percentage of the assets of P distributable to F upon F's withdrawal from P, or the percentage of such assets distributable to F upon the liquidation of P. Since the percentage of the profits interest held by A and B in P is less than 20 percent, such 30-percent capital interest will be included in the permitted holdings of F in P.

§ 53.4943–4 Present holdings.

(a) *Introduction*—(1) *Section 4943 (c)(4) in general.* (i) Paragraph (4) of section 4943(c) prescribes transition rules for a private foundation which, but for such paragraph, would have excess business holdings on May 26, 1969. Section 4943(c)(4) provides such a foundation with protection from the initial tax on excess business holdings in two ways. First, the entire interest of such a foundation in any business enterprise in which such a foundation, but for section 4943(c)(4), would have had excess business holdings on May 26, 1969, is treated under section 4943(c)(4)(B) as held by disqualified persons for a certain period of time (the ''first phase''). The effect of such treatment is to prevent a private foundation from being subject to the initial tax with respect to its May 26, 1969, interest during the first phase holding period and also to prevent the foundation from purchasing any additional business holdings in such business enterprise during such period (unless the combined holdings of the foundation and all disqualified persons fall below the 20 percent (or 35 percent, if applicable) figure prescribed by section 4943(c)(2)). Second, section 4943(c)(4)(A)(i) initially increases the percentage of permitted holdings of such a foundation to a percentage equal to the difference between:

(A) The percentage of combined holdings of the foundation and all disqualified persons in such business enterprise on May 26, 1969 (subject to a 50 percent maximum), and

(B) The percentage of holdings of all disqualified persons.

The percentage referred to in paragraph (a)(1)(i)(A) of this section is referred to in this section as the ''substituted level''. This ''substituted level'' is then reduced by the ''downward ratchet rule'' prescribed by section 4943(c)(4)(A)(ii) and paragraph (d)(3) of this section for certain dispositions by such foundation or by disqualified persons. The primary purpose of the substituted level is to indicate what the permitted holdings in such business enterprise will be immediately after the expiration of the first phase holding period. Thereafter, the permitted holdings of a private foundation itself are further limited to a maximum 25 percent interest in such business enterprise by section 4943(c)(4)(D) as soon as the combined holdings of all disqualified persons in such business enterprise exceed 2 percent (of the voting stock). If the combined holdings of all disqualified persons at no time exceed 2 percent (of the voting stock) during the 15 years following the first phase (the ''second phase''), then the substituted level is reduced to a 35 percent maximum after the second phase.

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(ii) Paragraph (a)(1)(i) of this section may be illustrated by the following example:

Example. On May 26, 1969, private foundation P held a 5 percent interest in corporation X (voting stock and value). On such date disqualified persons held a 16 percent interest in X (voting stock and value). Assume that except for section 4943(c)(4), P would have had a 1 percent interest in X which would have constituted excess business holdings. Therefore, section 4943(c)(4)(B) applies and P's 5 percent interest in X is treated as held by a disqualified person during the 10-year period beginning May 26, 1969. Since the entire 21 percent held by P and disqualified persons is now treated as held by disqualified persons, P's substituted level is 21 percent and its permitted holdings are zero (21% − 21%). However, P has no excess business holdings in X, because during the 10-year period P is not treated as holding such interest. The only change in the interest in X occurs on January 2, 1972, when P disposes of 2 percent of its interest in X to A, an unrelated person. Since the interest held by P and all disqualified persons (21% − 2% = 19%) has decreased below 20 percent, P's substituted level is reduced to 20 percent and its permitted holdings are 1 percent (20% − 19%) on such date. Therefore, if the other interests in X do not change, P will not have excess business holdings if P purchases no more than an additional 1 percent interest in X.

(2) *Interaction of provisions of section 4943(c) (4), (5), and (6).* During the first phase, a private foundation may acquire additional interests in a business enterprise, other than by purchase, which are entitled to be treated as held by disqualified persons for varying holding periods under section 4943(c) (5) or (6) (relating respectively to certain holdings acquired pursuant to the terms of a trust or will in effect on May 26, 1969, and to the 5-year period to dispose of certain gifts, bequests, etc.). In any case holdings which the private foundation disposes of shall be charged first against those holdings which it must dispose of in the shortest period in order to avoid the initial tax thereon. Further, acquisitions of a private foundation under a pre-May 27, 1969, will or trust described in section 4943(3)(5) are treated in a manner similar to the treatment of interests actually held by a private foundation on May 26, 1969. See §§ 53.4943–5 and 53.4943–6.

(b) *Present holdings in general.* (1) Section 4943(c)(4)(B) provides that any interest in a business enterprise held by a private foundation on May 26, 1969, if the foundation on such date has excess business holdings (determined without regard to section 4943(c)(4)), shall (while held by the foundation) be treated as held by a disqualified person during a first phase. Therefore, no interest of a private foundation shall be treated as held by a disqualified person under section 4943(c)(4)(B) and this section unless:

(i) The private foundation was an entity (not including a revocable trust) in existence on May 26, 1969, even though it was not then treated as a private foundation under section 509 or section 4947;

(ii) Such interest was actually or constructively owned by such entity on such date; and

(iii) Without regard to section 4943(c)(4) such entity had on such date an interest (considered in connection with the interests actually or constructively owned by all disqualified persons with respect to such entity on that date in the same business enterprise, determined as if the entity were then a private foundation) which exceeded the permitted holdings prescribed by section 4943(c) (2) or (3).

(See, however, section 4943(c)(5) and § 53.4943–5 for similar treatment for certain interests acquired by a private foundation under the terms of a trust or a will which were in effect on May 26, 1969.) If a private foundation owns an interest described by section 4943(c)(4)(B), then the length of the first phase for such an interest is prescribed by paragraph (c) of this section and shall not be affected by any interest acquired by the private foundation or any disqualified person in such business enterprise after May 26, 1969. In addition, the amount of permitted holdings in such business enterprise is prescribed by paragraph (d) of this section. An interest constructively held by a private foundation (or a disqualified person) on May 26, 1969, shall not cease to be an interest to which section 4943(c)(4) applies merely because it is later distributed to such foundation (or to such disqualified person). Nor shall an interest directly held by a private

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foundation (or to such disqualified person) on May 26, 1969, cease to be treated as an interest to which section 4943(c)(4) applies to the extent it remains actually or constructively held by such foundation (or such disqualified person) upon transfer of such interest, such as upon the incorporation of a sole proprietorship.

(2) The provision of this paragraph may be illustrated by the following example:

Example. A, a nonprofit research organization described in section 501(c)(3), was organized in 1966. On May 26, 1969, A held 50 percent of the stock of corporation B. For its taxable years 1970, 1971, and 1972, A is classified as an organization described in section 509(a)(2). However, for 1973 and subsequent years, A fails to satisfy the gross investment income limitation of section 509(a)(2)(B), and is thus classified as a private foundation. In such a case, section 4943(c)(4) applies, and a disqualified person shall be treated as holding A's stock in B during a first phase that begins on May 26, 1969.

(c) *First Phase holding periods*—(1) *In general.* If, on May 26, 1969, a private foundation has excess business holdings in any business enterprise (determined with regard to the 20 or 35 percent permitted holdings of section 4943(c)(2)), then all interest which such foundation holds, actually or constructively, in such enterprise on May 26, 1969, shall (while held by such foundation) be deemed held by a disqualified person during the following periods:

(i) The 20-year period beginning on May 26, 1969, if the private foundation holds, actually or constructively, more than 95 percent of the voting stock (or more than a 95 percent profits or beneficial interest in the case of an unincorporated enterprise) in such enterprise on such date;

(ii) Except as provided in paragraph (c)(1)(i) of this section, the 15-year period beginning on May 26, 1969, if the private foundation and all disqualified persons hold, actually or constructively on such date more than 75 percent of the voting stock (or more than a 75 percent profits or beneficial interest in the case of any unincorporated enterprise) or 75 percent of the value of all outstanding shares of all classes of stock in such enterprise (or more than a 75 percent profits and capital interest in the case of a partnership or joint venture); or

(iii) The 10-year period beginning on May 26, 1969, in any case not described in paragraph (c)(1) (i) or (ii) of this section.

The 20-year, 15-year, or 10-year period described in this subdivision (whichever applies) shall, for purposes of section 4943 and this section, be known as the "first phase."

(2) *Sole proprietorships.* The 20-year period described in paragraph (c)(1) of this section shall apply with respect to any interest which a private foundation holds in a sole proprietorship on May 26, 1969. See paragraph (b) of this section for the effect of converting such an enterprise to a corporate, partnership, or other form.

(3) *Suspension of first-phase periods.* The 20-year, 15-year, or 10-year period described in paragraph (c)(1) of this section shall be suspended during the dependency of any judicial proceeding which is brought and diligently litigated by the private foundation and which is necessary to reform, or to excuse the foundation from compliance with, its governing instrument or any other instrument (as in effect on May 26, 1969) in order to allow disposition of any excess business holdings held by the foundation on May 26, 1969.

(4) *Election to shorten the period during which certain holdings of private foundations are treated as held by disqualified persons.* If, on May 26, 1969, the combined holdings of a private foundation and all disqualified persons in any one business enterprise are such as to make applicable the 15-year period referred to in paragraph (c)(1)(ii) of this section, and if, on such date, the foundation's holdings do not exceed 95 percent of the voting stock in such enterprise, then such 15-year period is shortened to the 10-year period referred to in paragraph (c)(1)(iii), if at any time before January 1, 1971, one or more individuals:

(i) Who are substantial contributors (as described in section 507(d)(2)), or members of the family within the meaning of section 4946(d) of one or more substantial contributors, to such private foundation, and

(ii) Who on May 26, 1969, held in the aggregate more than 15 percent of the voting stock in the enterprise, made an

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election in the manner described in 26 CFR 143.6 (rev. as of Apr. 1, 1974).

(5) *Examples.* The provisions of this paragraph (c) may be illustrated by the following examples:

Example 1. Assume that F, a private foundation, owns, on May 26, 1969, 50 shares of voting stock in corporation X representing 50 percent of the voting power in X and 25 percent of the value of all outstanding shares of all classes of stock in X. Assume further that A and B, the only disqualified persons with respect to F, own five shares each of voting stock in X on such date. The 10 shares of voting stock in X owned by A and B together represent 10 percent of the voting power in X and 5 percent of the value of all outstanding shares of all classes of stock in X. Under the provisions of § 53.4943–3, the excess business holdings of F, in X (determined without regard to section 4943(c)(4)) as of such date are, therefore, 40 percent of X voting stock. Accordingly, since the combined holdings of F, A, and B in X are, on such date, less than 75 percent of the voting stock in X and less than 75 percent of the value of all outstanding shares of all classes of stock in X, under the provisions of section 4943(c)(4)(B)(iii), all holdings of F in X (*i.e.*, 50 percent of X voting stock) will be treated as held by a disqualified person through May 25, 1979.

Example 2. Assume the facts as stated in Example (1), except that F, on December 15, 1969, purchases an additional 10 shares of voting stock in X representing 10 percent of X voting power. Assume, further, that there were no other transactions in the stock in X during 1969. While the 50 percent of X voting stock held by F on May 26, 1969, will be deemed held by a disqualified person through May 25, 1979, the additional 10 shares of X voting stock acquired by purchase by F on December 15, 1969, will no be deemed to be so held. Accordingly, since, under the provisions of § 53.4943–3, such 10 shares represent excess business holding of F in X, such 10 shares will be subject to the imposition of tax under the provisions of section 4943(a).

Example 3. Assume the facts as stated in Example (1), except that F, on December 15, 1971 acquires an additional 10 shares of voting stock in X (representing 10 percent of X voting power) under the terms of a will which was executed before May 26, 1969, to which section 4943(c)(5) applies. While the 50 percent of X voting stock held by F on May 26, 1969, will be deemed held by a disqualified person through May 25, 1979, the additional 10 percent of X voting stock acquired by F on December 15, 1971, will, under the provisions of section 4943(c)(5), be deemed held by a disqualified person through December 14, 1981. See § 53.4943–5.

Example 4. Assume that F, a private foundation, owns on May 26, 1969, 50 shares of voting stock in corporation Y representing 50 percent of the voting power in Y. Assume further that C and D, the only disqualified persons with respect to F, own on such date 15 shares each of Y voting stock and that the 30 shares of Y voting stock owned by C and D together represent 30 percent of the voting power in Y. Under the provisions of § 53.4943–3 the excess business holdings of F in Y (determined without regard to section 4943(c)(4)) as of such date are, therefore, 50 percent of Y voting stock. Accordingly, since the combined holdings of F, C, and D in Y represent, on such date, more than 75 percent of the voting stock in Y, under the provisions of section 4943(c)(4)(B)(ii), all holdings of F in Y (*i.e.*, 50 percent of Y voting stock will be treated as held by a disqualified person through May 25, 1984.

Example 5. M, a private foundation, owns on May 26, 1969, sole proprietorship S. Since, under the provisions of § 53.5954–3, M's ownership of S constitutes excess business holdings (determined without regard to section 4943(c)(4) as of May 26, 1969, and since M's interest in S is greater than 95 percent on such date, under the provisions of this paragraph a disqualified person will be treated as the owner of S for the 20-year period beginning on such date. If S is later incorporated, that percentage of the interest in S retained by M, even though less than a 95-percent interest, shall continue to be treated as held by a disqualified person through May 25, 1989.

Example 6. A and B, individuals, together own on May 26, 1969, 40 shares of voting stock in corporation X representing 40 percent of the voting power in X and 20 percent of the value of all outstanding shares of all classes of stock in X. A and B are both disqualified persons with respect to F, a private foundation, which owns no stock in X on May 26, 1969. On January 1, 1973, A and B donate the 40 shares of X voting stock held by them to F. Since F had no excess business holdings on May 26, 1969, section 4943(c)(4) does not apply. See however, section 4943(c)(6) and § 53.4943–6.

Example 7. Assume the facts as stated in Example (6), except that F, on May 26, 1969, owns 50 shares of voting stock in X, representing 50 percent of the voting power in X and 25 percent of the value of all outstanding shares of all classes of stock in X. Under the provisions of this paragraph, the 50 shares of X voting stock held by F on May 26, 1969 shall be treated in accordance with the provisions of section 4943(c)(4), while the 40 shares of X voting stock acquired by F on January 1, 1973 shall be treated in accordance with the provisions of section 4943(c)(6). See § 53.4943–6.

(d) *Permitted holdings under section 4943(c)(4)*—(1) *In general.* The permitted holdings of a private foundation to

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which section 4943 (c)(4) applies in a business enterprise shall be as follows:

(i) The excess of the substituted combined voting level over the disqualified person voting level, and separately,

(ii) The excess of the substituted combined value level over the disqualified person value level.

(2) *Definitions.* For purposes of paragraph (d) of this section:

(i) The term *disqualified person voting level* on any given date means the percentage of voting stock held by all disqualified persons together on such date (including stock deemed held by such a person by reason of section 4943(c)(4), (5), or (6)).

(ii) The term *disqualified person value level* on any given date means the percentage of the total value of all outstanding shares of all classes of stock in a business enterprise held by all disqualified persons together on such date (including stock deemed held by such a person by reason of section 4943(c)(4), (5), or (6)).

(iii) The term *foundation voting level* prior to the second phase is equal to zero. After the first phase, such term on any given date means the lowest percentage of voting stock held by a private foundation (without regard to section 4943(c)(4)(B)) in a business enterprise on May 26, 1969, and at all times thereafter up to such date. See section 4943(c)(5) and § 53.4943–5 for the effect of the interests acquired pursuant to the terms of certain wills or trusts in effect on May 26, 1969.

(iv) The term *foundation value level* prior to the second phase is equal to zero. After the first phase, such term on any given date means the lowest percentage of the total value of all outstanding shares of all classes of stock held by a private foundation (without regard to section 4943(c)(4)(B)) in a business enterprise on May 26, 1969, and at all times thereafter up to such date. See section 4943(c)(5) and § 53.4943–5 for the effect of interests acquired pursuant to the terms of certain wills or trusts in effect on May 26, 1969.

(v) The term *substituted combined voting level* means the lowest percentage to which the sum of the foundation voting level plus the disqualified person voting level has been reduced since May 26, 1969, by paragraph (d)(4) of this section to the following modifications (the ‘‘downward ratchet rule’’), subject;

(A) In no event shall such substituted level exceed 50 percent; and

(B) Such substituted level shall be increased (but not above 50 percent) in accordance with section 4943(c)(5) and § 53.4943–5 for certain interests acquired by such foundation pursuant to the terms of a will or trust in effect on May 26, 1969.

(vi) The term *substituted combined value level* means the lowest percentage to which the sum of the foundation value level plus the disqualified person value level has been reduced since May 26, 1969, by paragraph (d)(4) of this section (the ‘‘downward ratchet rule’’), subject to the following modifications:

(A) In no event shall such substituted level exceed 50 percent; and

(B) Such substituted level shall be increased (but not above 50 percent) in accordance with section 4943(c)(5) and § 53.4943–5 for certain interests acquired by such foundation pursuant to the terms of a will or trust in effect on May 26, 1969.

(vii) In the case of an interest in a partnership or joint venture, definitions (i) through (iv) of this subparagraph shall be applied by substituting ‘‘profit interests’’ for ‘‘voting stock’’ and ‘‘all partnership interests’’ for ‘‘all outstanding shares of all classes of stock.’’

(viii) In the case of an interest in a business enterprise other than a corporation, partnership or joint venture, definitions (i) through (iv) of this subparagraph shall be applied by substituting ‘‘beneficial remainder interests’’ for ‘‘voting stock’’ and ‘‘all beneficial remainder interests’’ and ‘‘all outstanding shares of all classes of stock.’’

(ix) Each level defined in paragraph (d)(2)(iii), (iv) and (v) and (vi) as of any date shall be carried over to the subsequent date subject to any adjustments prescribed for such level.

(3) *Permitted holdings—First phase.* Since during the first phase the substituted combined voting level generally does not exceed the disqualified person voting level, and the substituted combined value level generally does not exceed the disqualified person value level, the permitted holdings

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during the first phase are generally equal to zero. The permitted holdings during the first phase exceed zero only where the 20 percent (or 35 percent) limitation on the downward ratchet rule contained in paragraph (d)(4)(ii)(B) of this section applies.

(4) *Downward ratchet rule*—(i) *In general.* Except as provided in paragraph (d)(4)(ii) of this section and section 4943(c)(5):

(A) *Scope of rule.* In general, when the percentage of the holdings in a business enterprise held by a private foundation and all disqualified persons together to which section 4943(c)(4) applies decreases, or when the percentage of the holdings of the private foundation alone in such business enterprise decreases, such holdings may not be increased (except as provided under section 4943(c) (5) or (6)). This so-called ''downward ratchet rule'' is designed to prevent the private foundation from purchasing additional holdings in the business enterprise until the substituted combined voting level reduced to the 20-percent (or 35 percent) figure prescribed by section 4943(c)(2).

(B) *Levels affected.* Under the downward ratchet rule any decrease after May 26, 1969, in the percentage of holdings comprising either the substituted combined voting level, the substituted combined value level, the foundation voting level or the foundation value level shall cause the respective level to be decreased to such decreased percentage for purposes of determining the foundation's permitted holdings.

(C) *Implementation of reductions.* Thus, if at any time the sum of the foundation voting level and the disqualified person voting level is less than the immediately preceding substituted combined voting level, the substituted level shall be decreased so that it equals such sum. For example, if on May 26, 1969, a foundation and all disqualified persons together have holdings in a business enterprise equal to 50 percent, on such date the substituted combined voting level and the disqualified person voting level equal 50 percent (since such holdings of the foundation are treated as held by a disqualified person). If the private foundation or a disqualified person on May 27, 1969, sold 2 percent of such holdings to a nondisqualified person, the disqualified person voting level would be decreased to 48 percent (50% − 2%), causing the substituted combined voting level to be decreased to 48 percent. As a further example, assume that on May 26, 1969, a foundation and all disqualified persons together have holdings in a business enterprise equal to 50 percent, and when the first phase expires on May 26, 1979, the substituted combined voting level is still 50 percent, the foundation voting level is 10 percent, and the disqualified person voting level is 40 percent. If a disqualified person thereafter sells 2 percent to a nondisqualified person so that the sum of the disqualified person voting level (40% − 2% = 38%) and the foundation voting level (10%) equals 48 percent (38% + 10%), then the substituted combined voting level is decreased to 48 percent. Similarly, if at any time the sum of the foundation value level and the disqualified person value level is less than the immediately preceding substituted combined value level, the substituted combined value level shall be decreased so that it equals such sum.

(D) *Restrictions on increases in levels.* In addition, none of the four levels referred to in paragraph (d)(4)(i)(B) of this section may be adjusted upward to reflect any increase in the holdings comprising such level, except as provided in section 4943(c)(5) and § 53.4943–5. As a result, any transfer of May 26, 1969, holdings from a disqualified person to a private foundation shall not increase the foundation voting level or the foundation value level (unless the transfer qualifies under section 4943(c)(5)), and thus may reduce the substituted combined value level (and where appropriate, the substituted combined voting level). Thus, in the last preceding example, if the disqualified person, instead of selling the 2 percent interest to a nondisqualified person, had sold such interest to the foundation, the substituted combined voting level would still be reduced to 48 percent, since the disqualified person voting level would be reduced by 2 percent (to 38%) but the foundation voting level would not be increased by 2 percent (remaining at 10%). However, any transfer of May 26, 1969, holdings from a private foundation to a disqualified

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person under section 101(l)(2)(B) of the Tax Reform Act of 1969, shall reduce the foundation value level (and, where appropriate, the foundation voting level), but will not reduce the substituted combined value level or the substituted combined voting level. The disqualified person voting level and disqualified person value level are correspondingly increased, not being limited to interest held since May 26, 1969. In addition, a transfer of May 26, 1969, holdings from one disqualified person to another, for example, by bequest, shall not reduce the substituted combined voting level nor the substituted combined value level.

(ii) *Exceptions*—(A) *One percent de minimis rule*. If after May 26, 1969, there are one or more decreases in the holdings comprising any of the four levels referred to in paragraph (d)(4)(i)(B) of this section during any taxable year of a private foundation, and if such decreases are attributable to issuances of stock (or such issuances coupled with redemptions), then, unless the aggregate of such decreases equals or exceeds 1 percent, the determination of whether there is a decrease in such level for purposes of this paragraph (d)(4) shall be made only at the close of such taxable year. If, however, the aggregate of such decreases equals or exceeds 1 percent, such level shall be decreased at that time as if the previous sentence has never applied.

(B) *Twenty percent (or 35 percent) floor*. In no event shall the downward rachet rule contained in paragraph (d)(4)(i) of this section decrease the substituted combined voting level or the substituted combined value level below 20 percent, or, for purposes of section 4943(c)(2)(B), below 35 percent.

(iii) *Special rules*—(A) *Change of foundation managers*. In the case of a foundation manager (as defined in section 4946(b)) who on May 26, 1969, owns holdings in a business enterprise and who is replaced by another foundation manager, the decrease in the substituted combined voting or value levels shall be limited to the excess, if any, of the departing foundation manager's holdings over his successor's holdings.

(B) *Termination of private foundation status under section 507*. If an organization gives the notification described in section 507(b)(1)(B)(ii) of the commencement of a 60-month termination period and fails to meet the requirements of section 509(a)(1), (2) or (3) for the entire period, then such organization will be treated as a private foundation during the entire 60-month period for purposes of this paragraph (d)(4) and section 4946(a)(1)(H). For example, X, a private foundation gives notification of the commencement of a 60-month termination commencing on January 1, 1972. X and Y, another private foundation, are effectively controlled by the same persons within the meaning of section 4946(a)(1)(H). X and Y hold 25 percent each of the voting stock of Z corporation on May 26, 1969, so that the substituted combined voting level for X or Y is 50 percent on such date. If X meets the requirements of section 509(a) (1), (2), or (3) for the entire 60-month period, section 4946(a)(1)(H) is inapplicable to X, and, under the downward ratchet rule, the substituted combined voting level for Y is decreased by 25 percent. On the other hand, if X meets the requirements of section 509(a)(2) for its taxable years 1972 and 1973, but fails to meet the requirements of section 509(a)(1), (2), or (3) in 1974, 1975, and 1976, then solely for purposes of section 4943(c)(4)(A)(ii) and this paragraph (d)(4), X will be treated as a disqualified person with respect to Y, and Y will be treated as a disqualified person with respect to X, for taxable years 1972 through 1976 pursuant to section 4946(a)(1)(H). Thus, for purposes of section 4943(c)(4)(A)(ii) the substituted combined voting level for X or Y will not be decreased by reason of the fact that X was attempting to terminate under section 507(b)(1)(B), and assuming no other transportations, such level; will remain at 50 percent.

(iv) *Examples*. The provisions of this paragraph (d)(4) may be illustrated by the following examples:

Example 1. F, a private foundation, owns on May 26, 1969, 50 shares of voting stock in corporation X representing to 50 percent of the voting stock in X and 25 percent of the value of all outstanding shares of all classes of stock in X. A and B, the only disqualified persons with respect to F, together own, on such date, 2 shares of voting stock in X representing 2 percent of the voting shock in X and 1 percent of the value of all outstanding

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shares of all classes of stock in X. In addition, on such date, F owns 30 shares of nonvoting stock in X, representing 30 percent of the value of all outstanding shares of all classes of stock in X, and A and B together own 15 shares of nonvoting stock in X representing 15 percent of the value of all outstanding shares of classes of stock in X. The provisions of section 4943(c)(4)(B)(iii) apply and during the 10-year period beginning on May 26, 1969, a disqualified person is deemed to hold all interests of F in X. Assume that on February 1, 1972, F sells to C, unrelated in individual, 12 shares of voting stock in X representing 12 percent of the voting stock in X and 6 percent of the value of all outstanding shares of all classes of stock in X.

(i) Beginning on May 26, 1969, the disqualified person voting level is 52 percent, the foundation voting level is zero, and the substituted combined voting level is 50 percent; the disqualified person value level is 71 percent, the foundation value level is zero, and the substituted combined value level is 50 percent.

(ii) Beginning on February 1, 1972, the disqualified person voting level is 40 percent (52% − 12%), the foundation voting level is zero, and the substituted combined voting level is 40 percent; the disqualified person value level is 65 percent (71% − 6%), the foundation value level is zero and the substituted combined value level is 50 percent.

Example 2. F, a private foundation on the calendar year basis, holds, on May 26, 1969, 30 percent of the voting stock in corporation Y. C and D, the only disqualified persons with respect to F, together hold, on such date, 10 percent of the voting stock in Y. The provisions of section 4943(c)(4)(B)(iii) apply with respect to F, and disqualified persons are deemed to hold all interests of F in Y for the 10-year period beginning on May 26, 1969, so that the substituted combined voting level as of such date is 40 percent. On February 1, 1973, a stock issuance by Y causes the combined holdings of voting power by F, C, and D in Y to decrease by 0.3 percent. on June 1, 1973, another such issuance causes such combined holdings to decrease by 0.5 percent. In September 1, 1973, an unrelated stock redemption by Y causes such combined holdings to increase by 0.4 percent. Under this paragraph the determination whether there is a decrease in the substituted combined voting level for purposes of the downward ratchet rule shall not be made before January 1, 1974, since the aggregate of the decreases occurring on February 1 and June 1 of 1973 is less than 1 percent (0.3% + 0.5%). Therefore, the substituted combined voting level as of January 1, 1974, is 39.6 percent (40% − [(0.3% + 0.5%) − 0.4%].)

Example 3. Assume the facts as stated in Example (2), except that, on October 1, 1973, a stock issuance by Y causes the combined holdings of voting power by F, C, and D in Y to decrease by 0.3 percent. Since the aggregate of the decreases occurring on February 1, June 1, and October 1 of 1973 exceeds 1 percent, the determination whether there is a decrease in the substituted combined voting level shall be made as of October 1, 1973. At that time the substituted combined voting level shall be reduced to 39.2 percent (40% − 0.3% − 0.5%), the lowest actual combined holdings during the period that the de minimis rule was in effect.

(5) *Permitted holdings—Second phase*—(i) *In general.* For purposes of section 4943 and this section, the term ''second phase'' means the 15-year period immediately following the first phase. Upon the expiration of the first phase with respect to an interest to which section 4943(c)(4) applies, such interest shall no longer be treated as held by a disqualified person under section 4943(c)(4)(B). During the second phase, the manner of determining the permitted holdings of a private foundation to which section 4943(c)(4) applies shall be the same as applicable to the first phase, except that a 25 percent maximum shall apply under certain conditions specified in paragraph (d)(5)(ii) of this section. For these purposes the substituted combined voting level and the substituted combined value level in effect for the foundation at the end of the first phase shall be carried over to the second phase. The substituted levels are carried over because although there is a decrease in the disqualified person levels (since holdings are no longer treated as held by disqualified persons under section 4943(c)(4)(B)), a corresponding increase in the foundation levels occurs. For example, if a private foundation on May 26, 1969, held 10 percent of the voting stock in a corporation and disqualified persons held 40 percent of the voting stock, both the disqualified person voting level and the substituted combined voting level equal 50 percent (10% + 40%). Assuming no transactions during the first phase, on May 26, 1979, the disqualified person voting level would be decreased to 40 percent (50% − 10%), but the foundation voting level would be increased to 10 percent so that the substituted combined voting level would remain at 50 percent. In addition, the downward ratchet rule of paragraph (d)(4) of this section shall continue to apply, to prevent the foundation and disqualified persons from

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purchasing any additional interest in the same enterprise until the substituted combined voting level decreases below 20 percent.

(ii) *25 percent maximum on foundation holdings.* If, or as soon as, the disqualified person voting level exceeds 2 percent after the expiration of the first phase, the permitted holdings shall not thereafter exceed 25 percent of the voting stock or 25 percent of the value of all outstanding shares of all classes of stock, even though the holdings of the foundation and all disqualified persons combined do not exceed the substituted level. Solely for purposes of determining whether the 25 percent limitation of this subdivision (ii) applies, the disqualified person voting level shall not be treated as exceeding 2 percent solely as a result of the holdings of a private foundation which are treated as held by a disqualified person by reason of section 4943(c) (5) or (6). For example, where under the constructive ownership rules for trusts in § 53.4943–8(b), a private foundation is deemed to own more than 2 percent of the voting stock of a business enterprise but such stock is treated as held by a disqualified person under section 4943(c)(5), the determination of the substituted percentage for permitted holdings in the second phase will be as if the foundation owned the stock held by the trust. Similarly, where a private foundation is the only remainder beneficiary of a trust that is a disqualified person under section 4946(a)(1)(H), the disqualified person voting level shall not be treated as exceeding 2 percent solely as a result of the holdings of such a trust.

(6) *Permitted holdings—Third phase.* For purposes of section 4943 and this section, the term ''third phase'' means the entire period following the second phase. During the third phase the manner of determining the permitted holdings of a private foundation to which section 4943(c)(4) applies shall be the same as applicable to the second phase under paragraph (d)(5) of this section (including the carryover of levels from the earlier phase). However, if the 25 percent limit of paragraph (d)(5)(ii) of this section never applied during the second phase, the substituted combined voting level and the substituted combined value level each shall not exceed 35 percent during the third phase.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. F, a private foundation, owns on May 26, 1969, 30 shares of voting stock in corporation Z representing 30 percent of the voting power in Z and 15 percent of the value of all outstanding shares of all classes of stock in Z, and owns, on such date, 10 shares of nonvoting stock in Z representing 10 percent of the value of all outstanding shares of all classes of stock in Z. E and G, the only disqualified persons with respect to F, own, on such date, 5 shares each of nonvoting stock in Z. The 10 shares of nonvoting stock in Z owned by E and G together represent 10 percent of the value of all outstanding shares of all classes of stock in Z. Assume further that F cannot meet the requirements for the 35 percent test of section 4943(c)(2)(B). For purposes of applying section 4943(c)(4)(B) and this paragraph, F has excess business holdings in Z (determined without regard to section 4943(c)(4)), because under section 4943(c)(2)(A) F's permitted holdings are 20 percent (20% − 0%) of the voting stock since disqualified persons have no holdings of voting stock. Therefore, section 4943(c)(4)(B) and this paragraph apply, and a disqualified person is treated as holding F's shares of both voting and nonvoting stock in Z for the 10-year period through May 25, 1979. Thus, since all holdings by F in Z are treated as held by a disqualified person during the first phase, F cannot be subject to tax under section 4943(a) on its May 26, 1969, holdings prior to the termination of the first phase, regardless of whether or not disqualified persons purchase additional shares of Z during the first phase.

Example 2. Assume the same facts as in Example (1), and further assume that there were no transactions in the stock of Z during the first phase (May 26, 1969 through May 25, 1979). During the first phase the permitted holdings by F in Z for both the voting stock and the value is zero. The disqualified person voting level and the substituted combined voting level are each 30 percent, and the disqualified person value level and the substituted combined value level are each 35 percent (15% + 10% + 10%). The substituted levels are carried over into the second phase. The disqualified person voting level on May 26, 1979, the beginning of the second phase, is zero, because the voting shares held by F are no longer treated as held by a disqualified person. Therefore, F's permitted holdings on such date are 30 percent of the voting stock, because such percentage is equal to the excess of the substituted combined voting level (30%) over the disqualified person voting level (0%). The disqualified person value

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level on May 26, 1979, is 10 percent, because the voting and nonvoting shares held by F are no longer treated as held by a disqualified person. Therefore, F's permitted holdings on such date are 25 percent of the value of Z stock, because such percentage is equal to the excess of the substituted combined value level (35%) over the disqualified person value level (10%) as of such date.

Example 3. Assume the facts as stated in Example (2), except that E and G acquire, on February 1, 1970, 10 shares of Z voting stock representing 10 percent of the voting power in Z and 5 percent of the value of all outstanding shares of all classes of stock in Z. During the first phase such permitted holdings remain zero, and prior to May 25, 1979, the substituted combined voting level and substituted combined value level remain 30 and 35 percent, respectively, because such levels may not be increased by acquisitions by disqualified persons. However, the disqualified person voting level and the disqualified person value level are each increased to 40 percent (30% + 10%) and 40 percent (35% + 5%) respectively. During the first phase the excess of the disqualified person voting level over the substituted combined voting level (40% − 30%) and the excess of the disqualified person value level over the substituted combined value level (40% − 35%) indicate how much stock F must dispose of during the first phase to avoid the initial tax when it expires. On May 25, 1979, the last day of the first phase, F disposes of 12 shares of Z voting stock, representing 12 percent of the voting power in Z and 6 percent of the value of all such outstanding shares. The disposition by F reduces the interest F owns to 18 percent (30% − 12%) of the voting power, and 19 percent (25% − 6%) of the value of all outstanding shares of all classes of stock, in Z. Since the disqualified person voting level decreases to 28 percent (40% − 12%), the substituted combined voting level as of May 25, 1979, accordingly is decreased to 28 percent under the downward ratchet rule. Similarly, the substituted combined value level is decreased to 34 percent, as the disqualified person value level as of such date is 34 percent (40% − 6%). On May 26, 1979, the disqualified person voting level is 10 percent (28% − 18%), and the disqualified person value level is 15 percent (34% − 19%), since the shares owned by F are no longer treated as held by a disqualified person as of such date. Accordingly, on May 26, 1979, the permitted holdings by F and Z are 18 percent of the voting power in Z, because such percentage is equal to the excess of the substituted combined voting level (28%) over the disqualified person voting level (10%) as of such date. Similarly, the permitted holdings of F in Z by value are 19 percent (34% − 15%). If F had not disposed of the 12 shares, then on May 26, 1979, F's permitted holdings in voting power and value would be 20 percent (30% − 10%) and 20 percent (35% − 15%), respectively.

Example 4. F, a private foundation, owns on May 26, 1969, 35 shares of voting stock in corporation Y representing 35 percent of the voting stock in Y and 17.5 percent of the value of all classes of stock in Y, and owns on such date 45 shares of nonvoting stock representing 22.5 percent of the value of all outstanding shares of all classes of stock in Y. No disqualified person with respect to F owns, on such date, any stock in Y. Assume further that Y cannot meet the requirements of the 35 percent test of section 4943(c)(2)(B). For purposes of applying section 4943(c)(4)(B) and this paragraph, F has excess business holdings in Y (determined without regard to section 4943(c)(4)), because under section 4943(c)(2)(A) F's permitted holdings are 20 percent (20% − 0%) of the voting stock since disqualified persons have no holdings of voting stock. Therefore, section 4943(c)(4)(B) and this paragraph apply, and a disqualified person is treated as holding F's shares of both voting and nonvoting stock in Y for the 10-year period through May 25, 1979. During the first phase the permitted holdings by F in Y of both the voting stock and of value are zero. The disqualified person voting level and the substituted combined voting level are each 35 percent, and the disqualified person value level and the substituted combined value level are each 40 percent (17.5% + 22.5%). The substituted levels are carried over into the second phase. The disqualified person voting level and value level on May 26, 1979, are both zero, because the shares held by F are no longer treated as held by a disqualified person. Therefore, F's permitted holdings on such date are 35 percent of the voting power (35% − 0%) and 40 percent of the value (40% − 0%). Assume that on February 1, 1981, A, a disqualified person, acquires 6 percent of the voting stock in Y representing 3 percent of the value of all outstanding shares of all classes of stock in Y. The permitted holdings by F in Z on February 1, 1981, are thus reduced to 25 percent of the voting stock (the lesser of the separate 25% second phase limitation or 29% (35% substituted combined voting level minus 6% disqualified person voting level)) and 25 percent of the value (the lesser of the separate 25% second phase limitation or 37% (40% substituted combined value level minus 3% disqualified person value level)). But see paragraph (d)(8) of this section for limitations on restrictions with respect to nonvoting stock.

Example 5. Assume the same facts as in Example (4) except that A does not acquire the 6 shares of voting stock until February 1, 1996 (in the third phase), rather than on February 1, 1981. Thus, F's permitted holdings in Y would remain at 35 percent of the voting stock and 40 percent of the value during the second phase, which expired on May 25, 1994. Assume that on May 25, 1994, the last day of

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the second phase, F disposes of 10 shares of nonvoting stock representing 5 percent of the value of all outstanding shares in Y to meet the 35 percent third phase limit. In accordance with the downward ratchet rule, the substituted combined value level and F's permitted holdings in Y would be reduced to 35 percent of value. On February 1, 1996, F's permitted holdings in Y would be reduced to 25 percent of the voting stock (the lesser of the separate 25% third phase limitation or 29% (35% substituted combined voting level minus 6% disqualified person level)) and 25 percent of the value (the lesser of the separate 25% third phase limitation or 32% (35% substituted combined value level minus 3% disqualified person value level)). But see paragraph (d)(8) of this section for limitations on restrictions with respect to nonvoting stock.

(8) *Special rule where all holdings are permitted under section 4943(c)(2).* (i) Since section 4943(c)(4) and this paragraph provide transitional rules for foundations which would otherwise have had excess business holdings on May 26, 1969, no holdings shall cease to be permitted holdings under this paragraph where such holdings would be permitted holdings under section 4943(c)(2) and § 53.4943–3. Thus, for example, where the substituted combined voting level had been reduced to 20 percent, the provisions of § 53.4943–3(b)(2) concerning nonvoting stock as permitted holdings generally apply.

(ii) The provisions of this paragraph (d)(8) may be illustrated by the following example:

Example. (A) F, a private foundation, owns, on May 26, 1969, 40 shares of voting stock in corporation X representing 40 percent of the voting stock in X and 20 percent of the value of all outstanding shares of all classes of stock in X, and owns, on such date, 60 shares of nonvoting stock in X, representing 30 percent of the value of all outstanding shares of all classes of stock in X. A, the only disqualified person with respect to F, owns, on such date, 10 shares of voting stock in X, representing 10 percent of the voting stock in X and 5 percent of the value of all outstanding shares of all classes of stock in X. Under section 4943(c)(4)(B)(iii), a disqualified person is deemed the owner of all holdings by F in X for the 10–year period beginning on May 26, 1969.

(B) Assume that the only transaction in X stock during the first phase is the disposition of 30 shares of voting stock by F on May 1, 1975. The voting stock held by F is permitted holdings under § 53.4943–3 and under such section since all disqualified persons together do not own more than 20 percent of the voting stock in X, all nonvoting stock held by F shall also be treated as permitted holdings. Therefore, all the stock held by F is permitted holdings.

(C) Assume that on May 1, 1975, F had disposed of only 15 shares of voting stock and also had disposed of 35 shares of nonvoting stock. On May 26, 1979, at the beginning of the second phase, this paragraph (d)(8) would not apply since F would have excess business holdings under § 53.4943–3. Under the provisions of this section, the permitted holdings by F in X on such date are 25 percent of the voting stock (35% substituted combined voting level minus 10% disqualified person voting level) and 25 percent of the value (30% substituted combined value level minus 5% disqualified person value level).

(9) *Special rule for certain private foundations.* In the case of a private foundation:

(i) Which was incorporated before January 1, 1951.

(ii) Substantially all of the assets of which on May 26, 1969, consisted of more than 90 percent of the stock of an incorporated business enterprise which is licensed and regulated, the sales or contracts of which are regulated, and the professional representatives of which are licensed, by State regulatory agencies in at least 10 States;

(iii) Which acquired such stock solely by gift, devise, or bequest;

(iv) Which does not purchase any stock or other interest in such enterprise after May 26, 1969, and does not acquire any stock or other interest in any other business enterprise which constitutes excess business holdings under § 53.4943–3; and

(v) Which, in the last 5 taxable years ending on or before December 31, 1970, expended substantially all of its adjusted net income (as defined in section 4942(f)) for the purpose or function for which it is organized and operated;

paragraph (d) (1) through (5) of this section (permitted holdings during the first and second phase) shall be applied with respect to the holdings of such foundation in such incorporated business enterprise by substituting ''51 percent'' for ''50 percent,'' and section 4943(c)(4)(D) (third phase) shall not apply with respect to such holdings. For purposes of the preceding sentence, stock of such enterprise in a trust created before May 27, 1969, of which the

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foundation is the remainder beneficiary shall be deemed to be held by such foundation on May 26, 1969, if such foundation held (without regard to such trust) more than 20 percent of the stock of such enterprise on May 26, 1969.

(10) *Special rule for changes in the relative values of stock of different classes.* (i) In the case of a corporation that has more than one class of stock outstanding, if the percentage of value held by the private foundation, its disqualified persons, or both, increases over a period of time solely as a result of changes in the relative values of the stock of different classes, then the foundation value level, the disqualified person value level, and the substituted combined value level, as defined in paragraph (d)(2) of this section, shall be adjusted to reflect such increase. An increase in the percentage of value held shall not be considered to have occurred solely as a result of changes in the relative values of the stock of different classes if:

(A) There has been any increase during the period in the percentage of any class of stock held by the private foundation, its disqualified persons, or both, or

(B) There has been any issuance, redemption, or purchase by the issuing corporation of any stock during the period.

See § 53.4943–6(d) for rules relating to increases caused by readjustments.

(ii) *Example.* The provisions of this paragraph (b)(10) may be illustrated by the following example:

Example. (i) At all times since May 26, 1969, F, a private foundation, has held 25% (500,000 shares) of the outstanding class of voting stock of X corporation. No disqualified person with respect to F holds any voting stock of X. In addition X has had outstanding since May 26, 1969, a class of non-voting preferred stock, none of which is held by F or a disqualified person. X is an active business corporation and third parties do not have effective control of X. On May 26, 1969, the voting stock (2 million shares outstanding) was trading for $5 a share on the New York Stock Exchange. The non-voting preferred stock, not publicly traded, was valued at $1 million. The total value of all outstanding stock was $11 million ($10 million voting stock plus $1 million non-voting preferred). On May 26, 1969, F held 22.73% of the value of X's outstanding stock ($2.5 million/$11 million).

(ii) On October 31, 1982, X's voting stock is trading for $20 a share and the nonvoting stock is valued at $3 million. At all times during the period May 26, 1969, through October 31, 1982, F has held 25 percent of the voting stock and none of the nonvoting stock of X. No stock of X is owned by disqualified persons. No stock of X has been issued, redeemed or purchased by X during this period. On October 13, 1982, the total value of X's outstanding stock (is $43 million ($40 million voting stock and $3 million nonvoting stock) and F holds 23.26 percent of the value of X's outstanding stock ($10 million/$43 million). F's foundation value level and the substituted combined value level are increased from 22.73 percent to 23.26 percent to reflect this change.

(iii) On November 1, 1982, X corporation distributes the stock of Y corporation, a wholly-owned subsidiary, to X's shareholders. Y is a business enterprise. Under this paragraph (d)(10), all of F's stock in X is permitted holdings under section 4943 (c)(4) even though the percentage of value held by F has increased from 22.73 percent on May 26, 1969, to 23.26 percent on November 1, 1982. F's permitted holdings in Y will be determined by reference to F's permitted holdings in X under § 53.4943–7. Therefore, assuming no prohibited transaction occurs, F's permitted holdings in Y stock equal 25 percent of Y's voting stock and, separately, 23.26 percent of the value of all of Y's outstanding stock.

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6478, Feb. 22, 1984]

§ 53.4943–5 Present holdings acquired by trust or a will.

(a) *Interests to which section 4943(c)(5) applies—(1) In general.* Section 4943(c)(5) provides that section 4943(c)(4) (other than the 20-year first phase holding period) applies to an interest in a business enterprise acquired after May 26, 1969 by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before May 26, 1969, which were in effect on May 26, 1969, and at all times thereafter, as if such interest were held on May 26, 1969. However the first phase holding period prescribed by § 53.4943–4(c)(1) (ii) or (iii) shall commence for such an interest on the date of distribution to the foundation. Unlike section 4943(c)(4) and § 53.4943–4, section 4943(c)(5) and this section treat only the interest so acquired (and not the entire interest held by the foundation in such enterprise on the date of distribution) as held by a

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disqualified person during a first phase holding period. (See, however, section 4943(c)(6) and paragraph (b)(2) of §53.4943–6 for the treatment of other holdings of the foundation in the same enterprise if an interest to which section 4943(c)(5) applies is acquired from a person who was not a disqualified person prior to the acquisition.) In addition, section 4943(c)(5) and this section shall not apply if after the acquisition of such an interest the foundation would not have excess business holdings (determined without regard to section 4943(c) (4), (5), or (6)).

(2) *After-acquired interests.* Section 4943(c)(5) and this section shall not apply to any interest acquired after May 26, 1969, by an estate or trust, other than by reason of the death of the decedent. For example, where a foundation is a residuary beneficiary under the terms of a will executed before May 26, 1969, and the residue of the estate consists of cash, then stock subsequently purchased with cash for distribution to the foundation will not be treated as an interest acquired under the terms of a will executed on or before May 26, 1969.

(3) *Certain revocable trusts.* If an interest in a business enterprise actually passes to a private foundation under a trust which would have met the tests referred to in paragraph (a)(1) of this section but for the fact that the trust was revocable (even though it was not in fact revoked) and such interest would have passed to such foundation under a will that meets those tests but for the fact that the grantor died without having revoked the trust, then for purposes of section 4943(c)(5) and this section, such an interest shall be treated as having been acquired by the foundation under the will.

(4) *Modification of will*—(i) *In general.* For purposes of section 4943(c)(5) and this section, an amendment or republication of a will which was executed on or before May 26, 1969, does not prevent any interest in a business enterprise which was to pass under the terms (which were in effect on May 26, 1969, and at all times there- after) of such will from being treated as a present holding under section 4943(c) (4) or (5):

(A) Solely because there is a reduction in the interest in the business enterprise which the foundation was to receive under the terms of the will (for example, if the foundation is to receive the residuary estate, and if one class of stock is disposed of by the decedent during his lifetime or by a subsequent codicil);

(B) Solely because such amendment or republication is necessary in order to comply with section 508(e) and the regulations thereunder;

(C) Solely because there is a change in the executor of the will; or

(D) Solely because of any other change which does not otherwise change the rights of the foundation with respect to such interest in the business enterprise.

However, if under such amendment or republication there is an increase in the interest in the business enterprise which the foundation was to receive under the terms of the will in effect on May 26, 1969, such increase shall not be treated as present holdings under section 4943(c) (4) or (5). Under such circumstances the interest which would have been acquired before such increase shall remain present holdings. See section 4943(c)(6) and §53.4943–6 with respect to the treatment of such increase in holdings of a private foundation.

(ii) *Examples.* The provisions of this paragraph (a)(4) may be illustrated by the following examples:

Example 1. On May 9, 1985, A modifies by codicil his will which was in effect on May 26, 1969, and was unchanged until such modification. The purpose of the codicil was, in the event of A's death, to increase the number of shares in X Corporation that would pass to the W foundation from 70 percent of all the voting power and value to 80 percent. Under these facts, if A dies without further modifying the terms of the will which apply to W's interest in X, section 4943(c)(5) will apply to 70 percent of the X voting power and value and section 4943(c)(6) will apply to 10 percent of the X voting power and value, since 10 percent of the X voting power and value would not pass under a provision of the will which was in effect on May 26, 1969, and at all times thereafter. Accordingly, if the stock is distributed to W on July 6, 1988, then, assuming that on May 26, 1969, W and all disqualified persons owned less than 75% of the voting stock in X, an amount of such stock representing 70 percent of X voting power and value shall be treated as held by a disqualified person through July 5, 1998,

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and an amount of such stock representing 10 percent of X voting power and value shall be treated as held by a disqualified person through July 5, 1993.

Example 2. Assume the facts as stated in Example (1), except that the sole purpose of the codicil was to change the executor of the will. Under paragraph (a)(4)(i) of this section, such codicil will not prevent the X voting stock which was bequeathed to W from being treated as held by a disqualified person through July 5, 1998.

(b) *Holding periods*—(1) *In general.* An interest to which section 4943(c)(5) applies shall be entitled to a 15-year holding period starting on the date of distribution only if the interests actually or constructively owned by a private foundation and all disqualified persons on May 26, 1969, in a business enterprise exceed 75 percent of the voting stock (or of the profits or beneficial interest) or 75 percent of the value of all outstanding shares of all classes of stock (or of the profits and capital interest) in such enterprise. For purposes of the preceding sentence, interests held by the foundation on May 26, 1969, shall be deemed to include an interest to which section 4943(c)(5) applies and which has been acquired (on or before the date of distribution for the interest in question) from a person who was not a disqualified person on May 26, 1969. Therefore, if under the terms of a will in effect on May 26, 1969, and at all times thereafter, a private foundation is created on July 1, 1975, and receives 76 percent of the voting stock of a business enterprise on that date, such stock shall be treated as held by a disqualified person until June 30, 1990. Any interest to which section 4943(c)(5) applies but which is not entitled to a 15-year holding period shall be entitled to a 10-year holding period starting on the date of distribution. For purposes of this paragraph the date of distribution shall be deemed to occur no later than the date on which the trust or estate is considered to be terminated under § 1.641(b)–(3) of this chapter (Income Tax Regulations).

(2) *Constructive ownership prior to date of distribution.* To the extent that an interest to which section 4943(c)(5) applies is constructively held by a private foundation under section 4943(d)(1) and § 53.4943–8 prior to the date of distribution, it shall be treated as held by a disqualified person prior to such date by reason of section 4943(c)(5). In addition, in the case of a foundation's interest in a trust which was irrevocable on May 26, 1969, and to which both sections 4943 (c)(4) and (c)(5) apply, the first phase holding period for such interest shall end with whichever such period under section 4943(c) (4) or (5) ends later. For example, if under the terms of such a trust, 96 percent of the voting stock in a business enterprise was constructively held by a private foundation on May 26, 1969, and was distributed to such foundation on June 30, 1970, such interest is entitled to a 20-year holding period beginning on May 26, 1969.

(c) *Permitted holdings*—(1) *In general.* The permitted holdings of a private foundation which has an interest in a business enterprise to which section 4943(c)(5) applies shall be determined in accordance with the rules of paragraph (d) of § 53.4943–4. The levels referred to in such paragraph shall be adjusted to take into account the acquisition of such an interest as if it were treated as held by a disqualified person from May 26, 1969, until the date of acquisition. See also § 53.4943–6(b)(2) for the special rule for interests held by a private foundation at the time it acquires a section 4943(c)(5) interest from a nondisqualified person. Thus, for example, if on June 30, 1975, the disqualified person voting level and the substituted combined voting level in corporation X with respect to foundation F are 45 percent, and a nondisqualified person's 10 percent voting interest in X is acquired by F on July 1, 1975, in a transaction to which section 4943(c)(5) applies, the above-mentioned levels shall be increased to 55 and 50 percent respectively, on July 1, 1975. However, if such interest had been acquired from a person who was a disqualified person on May 26, 1969, rather than from a nondisqualified person, no adjustments in such levels would have taken place on July 1, 1975. In such a case, though, at the beginning of the second phase on July 1, 1985, the foundation voting level would be increased by 10 percent, and the disqualified person voting level decreased by 10 percent (assuming that none of the acquired stock had been disposed of prior to such date).

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(2) *Separate phases*. The phases for each interest to which section 4943(c)(5) applies start independently from those for any other interest of the foundation in the same enterprise to which section 4943(c) (4) or (5) applies. Therefore, until an interest enters its own second phase, the 25 percent limit described in paragraph (d)(5) of § 53.4943–4 shall not apply to such interest since such interest (and any subsequently acquired section 4943(c)(5) interest in the first phase) is still treated as held by a disqualified person for purposes of that 25 percent limit. In addition, if such an interest enters its second phase and at such time all disqualified persons together do not have holdings in excess of 2 percent of the voting stock in the same business enterprise, then the 25 percent limit of section 4943(c)(4)(D)(i) shall not then apply to such interest, even though such limit may have been applicable to an interest with an earlier second phase. Moreover, the 35 percent limit of section 4943(c)(4)(D)(ii) shall cause only interests which have entered the third phase to become excess business holdings, taking into account, however, interests in prior phases in determining the holdings subject to such limit.

(3) *Examples*. The provisions of this paragraph may be illustrated by the following examples: (After each example is a chart setting forth the chronological changes in the various levels referred to in paragraph (d) of § 53.4943–4.)

Example 1. On May 26, 1969, F, a private foundation, owns no stock in M Corporation, and A, a disqualified person owns 40 percent of the voting stock (voting power and value) in M. A dies on May 1, 1971, leaving 30 percent of the voting stock in M to F and leaving the other 10 percent to a disqualified person. Distribution is made on June 1, 1972, and assume that section 4943(c)(5) applies. No transactions in the stock of M, other than those described in this example, occur. On May 26, 1969, the substituted combined voting level is 40 percent, the disqualified person voting level is deemed to be 40 percent, and the permitted holdings by F in M is deemed to be 0 percent (40% − 40%). On May 1, 1971 (the date that F acquired the M stock by reason of its constructive ownership of A's estate), the various levels remain unchanged. On May 1, 1971, the 30 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982. On June 1, 1981, F disposes of 6 percent of the voting stock to a nondisqualified person. The substituted combined voting level and the disqualified person voting level thereby are reduced to 34 percent (40% − 6%) each. On June 1, 1982, at the beginning of the second phase, the foundation voting level increases to 24 percent (30% − 6%) and the disqualified person voting level is reduced to 10 percent (34% − 10%). The substituted combined voting level as of June 1, 1982, remains at 34 percent. The permitted holdings as of such date are 24 percent (34% − 10%). If F had not disposed of any holdings prior to June 1, 1982, F's permitted holdings would have been 25 percent, the lesser of 25 percent (the limitation of section 4943(c)(4)(D)(i)), or 30 percent (40% − 10%). Since on such date the 30 percent interest would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 5 percent (30% − 25%).

Date	F owns (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969	0	0	40	0	40	40	0	
May 1, 1971	*+ 30*	*+ 30*	*− 30*					A dies.
Do	30	30	10	0	40	40	0	
June 1, 1972	30	30	10	0	40	40	0	Distribution.
June 1, 1981	*− 6*	*− 6*			*− 6*	*− 6*		F sells 6 pct.
Do	24	24	10	0	34	34	0	
June 1, 1982		*− 24*		*+ 24*		*− 24*	*+ 24*	2d phase begins.
Do	24	0	10	24	34	10	24	

Example 2. (i) On May 26, 1969, F, a private foundation, owns 30 percent of the voting stock of N Corporation (voting power and value) and disqualified persons own 20 percent of the voting stock of N Corporation. On May 1, 1971, B, a disqualified person, dies leaving 15 percent of the voting stock to F. Assume the distribution was made on June 1, 1972, and that section 4943(c)(5) applies. On

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00151 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

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May 26, 1969, the substituted combined voting level and the disqualified person voting levels are each 50 percent and the permitted holdings are 0 percent (50% − 50%). On May 1, 1971, and June 1, 1972, these levels remain unchanged. On May 1, 1971, the 15 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982.

(ii) On July 1, 1978, F sells 6 percent of the F stock to a nondisqualified person, thereby reducing the disqualified person voting level and the substituted combined voting level to 44 percent (50% − 6%). On May 26, 1979, at the beginning of the second phase for F's 1969 holdings, the foundation voting level is 24 percent (30% − 6%), the substituted combined voting level is still 44 percent, and the disqualified person voting level is 20 percent (44% − 24%). The permitted holdings are 24 percent (44% − 20%). In addition F's 24 percent holdings do not exceed the 25 percent limitation of section 4943(c)(4)(D)(i) and paragraph (d)(5)(ii) of § 53.4943–4.

(iii) On August 1, 1981, F sells 16 percent of the N stock to a nondisqualified person, thereby reducing the foundation voting level to 8 percent (24% − 16%), and reducing the substituted combined voting level to 28 percent (44% − 16%). The disqualified person voting level remains at 20 percent. On June 1, 1982, at the beginning of the second phase for F's holdings acquired by will, the substituted combined voting level is still 28 percent, the foundation voting level is 23 percent (8% + 15%), the disqualified person voting level is 5 percent (20% − 15%), and the permitted holdings are 23 percent (28% − 5%).

(iv) If F had not disposed of the 6 percent on July 1, 1978, then on May 26, 1979, at the beginning of the second phase for F's 1969 holdings, F's permitted holdings would have been 25 percent, the lesser of 25 percent (the limitation of section 4943(c)(4)(D)(i), or 30 percent (50% − 20%). Since F's 30 percent interest would no longer have been treated as held by a disqualified person on May 26, 1979, F would have had excess business holdings of 5 percent (30% − 25%). Similarly, if F had not disposed of the 16 percent interest on August 1, 1981 (but had disposed of the 6 percent interest), on July 1, 1982, at the beginning of the second phase for F's holdings acquired by will, F's permitted holdings would have been 25 percent, the lesser of 25 percent (under section 4943(c)(4)(D)(i)), or 39 percent (44% − 5%). Since as of such date F's entire holdings of 39 percent would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 14 percent (39% − 25%).

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969.	30	30	....	30	20	0	50	50	0	
May 1, 1971	*+ 15*	....	*+ 15*	*+ 15*	*− 15*	....	....	....	....	B dies.
Do	45	30	15	45	5	0	50	50	0	
June 1, 1972.	45	30	15	45	5	0	50	50	0	Distribution.
July 1, 1978	*− 6*	*− 6*	....	*− 6*	....	....	*− 6*	*− 6*	....	F sells 6 pct.
Do	39	24	15	39	5	0	44	44	0	
May 16, 1979.	....	....	....	*− 24*	....	*+ 24*	....	*− 24*	*+ 24*	2d phase for 24 pct.
Do	39	24	15	15	5	24	44	20	24	
Aug. 1, 1981.	*− 16*	*− 16*	....	....	....	*− 16*	*− 16*	....	*− 16*	F sells 16 pct.
D0	23	8	15	15	5	8	28	20	8	
July 1, 1982	....	....	....	*− 15*	....	*+ 15*	....	*− 15*	*+ 15*	All in 2d phase.
Do	23	8	15	0	5	23	28	5	23	

Example. (3). (i) On May 26, 1969, F, a private foundation owns 5 percent of the voting stock of O Corporation (voting power and value), and disqualified persons own 45 percent of the voting stock. C, a disqualified person, dies on May 1, 1971, and leaves 41 percent of the voting stock of O to F. Assume that distribution is made on June 1, 1972, and that section 4943(c)(5) applies. On May 26, 1969, the substituted combined voting level and the disqualified person voting level are 50 percent and the permitted holdings are 0 percent (50% − 50%). On May 1, 1971, and June 1, 1972, the various levels remain unchanged. On May 1, 1971, the 41 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982. On May 26, 1979, at the beginning of the second phase for F's 1969 holdings of 5 percent, the 5 percent is no longer treated as held by a disqualified person, the foundation voting level is 5 percent, the disqualified person

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00152 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

voting level is reduced to 45 percent (50% − 5%), and the substituted combined voting level remains at 50 percent. On such date F's permitted holdings are 5 percent (50% − 45%). Since the 41 percent interest is treated as held by a disqualified person, the interest treated as held by F (5%) does not exceed the 25 percent limitation of section 4943(c)(4)(D)(i).

(ii) On August 1, 1981, F sells 22 percent of the O stock to a nondisqualified person, thereby reducing the foundation voting level to 0 percent. Since the reductions are first applied to the 1969 holdings of 5 percent, 17 percent (22% − 5%) applies to the 41 percent interest, reducing such interest to 24 percent (41% − 17%), and reducing the disqualified person voting level to 28 percent (45% − 17%). The substituted combined voting level is reduced to 28 percent (0% + 28%). On June 1, 1982, at the beginning of the second phase for F's holdings acquired by will, the substituted combined voting level remains at 28 percent, the foundation voting level is 24 percent, the disqualified person voting level is reduced to 4 percent (28% − 4%).

(iii) If F had not disposed of the 22 percent interest prior to June 1, 1982, F's permitted holdings would have been 25 percent, the lesser of 25 percent, (under section 4943(c)(4)(D)(i)), or 46 percent (50% − 4%). Since as of such date, F's entire holdings of 46 percent would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 21 percent (46% − 25%).

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969.	5	5	....	5	45	0	50	50	0	
May 1, 1971	*+ 41*	....	*+ 41*	*+ 41*	*− 41*	....	....	....	....	C dies.
Do	46	5	41	46	4	0	50	50	0	
June 1, 1972.	46	5	41	46	4	0	50	50	0	Distribution.
May 26, 1979.	....	....	....	*− 5*	....	*+ 5*	....	*− 5*	*+ 5*	2d phase for 5 pct.
Do	46	5	41	41	4	5	50	45	5	
Aug. 1, 1981.	*− 22*	*− 5*	*− 17*	*− 17*	....	*− 5*	*− 22*	*− 17*	*− 5*	F sells 22 pct.
Do	24	0	24	24	4	0	28	28	0	
June 1, 1982.	....	....	....	*− 24*	....	*+24*	....	*− 24*	*+24*	2d phase for 24 pct.
Do	24	0	24	0	4	24	28	4	24	

Example 4. (i) On May 26, 1969, F, a private foundation, owns 30 percent of the voting stock in P Corporation (voting power and value), and disqualified persons own 20 percent. On May 1, 1971, D, a disqualified person, dies leaving 18 percent of the voting stock to F. Assume that distribution was made on June 1, 1972, and that section 4943 (c)(5) applies. On May 26, 1969, the substituted combined voting level and the disqualified person voting level are each 50 percent and the permitted holdings are 0 percent (50% − 50%). On May 1, 1971, and June 1, 1972, these levels remain unchanged. On May 1, 1971, the 18 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982. On May 26, 1979, the foundation voting level increases to 30 percent, the disqualified person voting level decreases to 20 percent (50% − 30%), and the permitted holdings are 30 percent (50% − 20%). On June 1, 1982, the foundation voting level increases to 48 percent, the disqualified person voting level decreases to 2 percent and the permitted holdings are 48 percent (50% − 2%). Since at no time during the second phase for F's 1969 holdings did all disqualified persons together have holdings in excess of 2 percent of the voting stock of P, the 25 percent limitation of section 4943(c)(4)(D)(i) did not apply to F's 1969 holdings.

(ii) On July 1, 1993, F disposes of 16 percent of the stock in P, thereby reducing the substituted combined voting level to 34 percent (50% − 16%), and reducing the permitted holdings to 32 percent (34% − 2%). If F had not disposed of the 16 percent of the stock of P prior to May 26, 1994, on such date, under section 4943(c)(4)(D)(ii), F's substituted combined voting level for its 1969 holdings would have been 35 percent, and the permitted holdings would have been 33 percent (35% − 2%). Since none of F's holdings of 48 percent would have been treated as held by a disqualified person on such date (the beginning of the third phase for F's 1969 holdings), F would have had excess business holdings of

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00153 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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15 percent, the lesser of 30 percent (F's 1969 holdings in the third phase), of 15 percent (the excess of F's 48 percent holdings over the permitted holdings of 33 percent).

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969.	30	30	....	30	20	0	50	50	0	
May 1, 1971	*+ 18*	....	*+ 18*	*+ 18*	*− 18*	....	....	....	....	D dies.
Do	48	30	18	48	2	0	50	50	0	
June 1, 1972.	48	30	18	48	2	0	50	50	0	Distribution.
May 26, 1979.	....	....	....	*− 30*	....	*+ 30*	....	*− 30*	*+ 30*	2d phase for 30 pct.
Do	48	30	18	18	2	30	50	20	30	
June 1, 1982.	....	....	....	*− 18*	....	*+ 18*	....	*− 18*	*+ 18*	2d phase for 18 pct.
Do	48	30	18	0	2	48	50	2	48	
July 1, 1993	*− 16*	*− 16*	....	....	....	*− 16*	*− 16*	....	*− 16*	F disposes of 16 pct.
Do	32	14	18	0	2	32	34	2	32	
May 26, 1994.	32	14	18	0	2	32	34	2	32	3d phase for 14 pct.
June 1, 1997.	32	14	18	0	2	32	34	2	32	3d phase for 18 pct.

Example 5. (i) On May 26, 1969, F, a private foundation, owns 5 percent of the voting stock in Q Corporation (voting power and value), and disqualified persons own 45 percent. On May 1, 1971, E, a disqualified person, dies leaving 43 percent of the voting stock to F. Assume that distribution was made on June 2, 1972, and that section 4943(c)(5) applies. On May 26, 1969, the substituted combined voting level and the disqualified person voting level are each 50 percent and the permitted holdings are 0 percent (50% − 50%). On May 1, 1971, and June 1, 1972, these levels remain unchanged. On May 1, 1971, the 43 percent interest is treated as held by a disqualified person for a period extending through May 31, 1982. On May 26, 1979, the foundation voting level increases to 5 percent, the disqualified person voting level decreases to 45 percent, and the permitted holdings are 5 percent (50% − 45%). On June 1, 1982, the foundation voting level increases to 48 percent, the disqualified person voting level decreases to 2 percent, and the permitted holdings are 48 percent (50% − 2%). At no time during the second phase for F's 1969 holdings did all disqualified persons together have holdings in excess of 2 percent of the voting stock of Q. Therefore, the 25 percent limitation of section 4943(c)(4)(D)(i) did not apply.

(ii) On July 1, 1993, F sells 6 percent of the stock in Q to a nondisqualified person. This reduces the substituted combined voting level to 44 percent and reduces the permitted holdings to 42 percent (44% − 2%). If F had not disposed of the 6 percent of the stock in 1993, on May 26, 1994, at the beginning of the third phase for F's 1969 holdings, F would have had 5 percent excess business holdings. The excess business holdings are 5 percent because although the excess business holdings computed for the third phase are 15 percent (the excess of F's actual holdings (48%) over the permitted holdings of 33 percent (35% − 2%)), only 5 percent of the holdings are in this phase and subject to the 35 percent combined holdings limitation.

(iii) On July 1, 1995, F sells 10 percent of the stock in Q, thereby reducing the substituted combined voting level to 34 percent and reducing the permitted holdings to 32 percent (34% − 2%). If F had not disposed of the 10 percent of the stock, on June 1, 1997, at the beginning of the third phase for F's acquired holdings, F would have had 9 percent excess business holdings (the excess of F's total holdings in the third phase (42%) over the permitted holdings of 33 percent (35% − 2%)).

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00154 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

Date	F's owns (percent)	F's interest 1969 (percent)	F's interest 1971 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969.	5	5	....	5	45	0	50	50	0	
May 1, 1971	*+43*	....	*+43*	*+43*	*−43*	....	....	....	....	E dies.
Do	48	5	43	48	2	0	50	50	0	
June 1, 1972.	48	5	43	48	2	0	50	50	0	Distribution.
May 26, 1979.	....	....	....	*−5*	....	*+5*	....	*−5*	*+5*	2d phase for 5 pct
Do	48	5	43	43	2	5	50	45	5	
June 1, 1982.	....	....	....	*−43*	....	*+43*	....	*−43*	*+43*	2d phase for 43 pct.
Do	48	5	43	0	2	48	50	2	43	
July 1, 1993	*−6*	*−5*	*−1*	....	....	*−6*	*−6*	....	*−6*	F sells 6 pct.
Do	42	0	42	0	2	42	44	2	42	
July 1, 1995	*−10*	....	*−10*	....	....	*−10*	*−10*	....	*−10*	F sells 10 pct.
Do	32	0	32	0	2	32	34	2	32	
June 1, 1997.	32	0	32	0	2	32	34	2	32	3d phase for 32 pct.

Example 6. (i) On May 26, 1969, F, a private foundation, owns 30 percent of the voting stock in R Corporation (voting power and value), and disqualified persons own 20 percent. On August 1, 1978, F disposes of 6 percent of the stock to a nondisqualified person. On May 1, 1981, G, a disqualified person, dies leaving 15 percent of the voting stock to F. Assume that distribution was made on June 1, 1982, and that section 4943(c)(5) applies. On May 26, 1969, the substituted combined voting level and the disqualified person voting level are each 50 percent, and the permitted holdings are 0 percent (50% − 50%). On August 1, 1978, these levels decrease to 44 percent (50% − 6%). On May 26, 1979, the foundation voting level increases to 24 percent (30% − 6%), the disqualified person voting level decreases to 20 percent (44% − 24%), and the permitted holdings are 24 percent (44% − 20%). If F had not disposed of the 6 percent of the stock prior to May 26, 1979, on May 26, 1979, the beginning of the second phase for F's 1969 holdings, F's permitted holdings would have been 25 percent, the lesser of 25 percent (under section 4943(c)(4)(D)(i)) or 30 percent (50% − 20%). Since the 30 percent interest would no longer have been treated as held by a disqualified person on such date, F would have had excess business holdings of 5 percent (30% − 25%).

(ii) On May 1, 1981, and June 1, 1982 (assuming F had disposed of the 6 percent holdings), the foundation voting level, the disqualified person voting level, the substituted combined voting level and permitted holdings remain respectively 24 percent, 20 percent, 44 percent and 24 percent. On May 1, 1981, the 15 percent interest is treated as held by a disqualified person for a period extending through May 31, 1992. On July 1, 1991, F sells 16 percent of the voting stock in R to a nondisqualified person, thereby reducing the substituted combined voting level to 28 percent (44% − 16%), and reducing the foundation voting level to 8 percent (24% − 16%). The disqualified person voting level remains at 20 percent. On June 1, 1992, at the beginning of the second phase for F's holdings acquired by will, the substituted combined voting level remains at 28 percent, the foundation voting level increases to 23 percent (8% + 15%) and the disqualified person voting level decreases to 5 percent (20% − 15%). The permitted holdings on such date are 23 percent (28% − 5%). If F had not disposed of the 16 percent interest prior to June 1, 1992, F's permitted holdings would have been 25 percent, the lesser of 25 percent (under section 4943 (c)(4)(D)(i)) or 39 percent (44% − 5%). Since as of such date, F's entire holdings of 39 percent would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 14 percent (39% − 25%).

Date	F's owns (percent)	F's interest 1969 (percent)	F's interest 1981 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent)	Comments
May 26, 1969	30	30	....	30	20	0	50	50	0	
Aug. 1, 1978	*−6*	*−6*	....	*−6*	....	....	*−6*	*−6*	....	F disposes of 6 pct.
Do	24	24	....	24	20	0	44	44	0	
May 26, 1979	....	....	....	*−24*	....	*+24*	....	*−24*	*+24*	2d phase for 24 pct.
Do	24	24	....	0	20	24	44	20	24	
May 1, 1981	*+15*	....	*+15*	*+15*	*−15*	....	....	....	....	G dies.
Do	39	24	15	15	5	24	44	20	24	
June 1, 1982	39	24	15	15	5	24	44	20	24	Distribution.
July 1, 1991	*−16*	*−16*	....	....	....	*−16*	*−16*	....	*−16*	F disposes of 16 pct.
Do	23	8	15	15	5	8	28	20	8	
June 1, 1992	....	....	....	*−15*	....	*+15*	....	*−15*	*+15*	2d phase for 15 pct.
Do	23	8	15	0	5	23	28	5	23	

Example 7. (i) On May 26, 1969, F, a private foundation, owns 5 percent of the voting stock in S Corporation (voting power and value), and disqualified persons own 45 percent. On May 1, 1980, H, a disqualified person, dies leaving 41 percent of the voting stock to F. Assume that distribution is made on June 1, 1981, and that section 4943(c)(5) applies. On May 26, 1969, the substituted combined voting level and disqualified person voting levels are each 50 percent. On May 26, 1979, the disqualified person voting level decreases to 45 percent, the foundation voting level increases to 5 percent, and the permitted holdings are 5 percent (50% − 45%). On May 1, 1980, and June 1, 1981, the levels remain the same. Since the 41 percent holdings are treated as held by a disqualified person for the period beginning on May 1, 1980, and extending through May 31, 1991, F's remaining holdings of 5 percent do not exceed the 25 percent limitation of section 4943(c)(4)(D)(i).

(ii) On August 1, 1990, F sells 22 percent of the voting stock of S to a nondisqualified person, reducing the 5 percent foundation voting level to zero, leaving 17 percent (22% − 5%) to reduce the disqualified person voting level to 28 percent (45% − 17%) so that the substituted combined voting level equals 28 percent (50% − 22%). On June 1, 1991, the beginning of the second phase for the remaining 24 percent (41% − 17%) of F's holdings acquired by will, the foundation voting level increases from zero to 24 percent, the disqualified person voting level decreases to 4 percent (28% − 24%), the substituted combined voting level remains at 28 percent, and the permitted holdings equal 24 percent (28% − 4%).

(iii) If F had not disposed of the 22 percent holdings prior to June 1, 1991, F's permitted holdings would have been 25 percent, the lesser of 25 percent (under section 4943(c)(4)(D)(i)) or 46 percent (50% − 4%). Since as of such date, F's entire holdings of 46 percent would no longer have been treated as held by a disqualified person, F would have had excess business holdings of 21 percent (46% − 25%).

Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1980 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent	Comments
May 26, 1969.	5	5	....	5	45	0	50	50	0	
Do	....	....	....	*−5*	....	*+ 5*	....	*−5*	*+ 5*	2d phase for 5 pct.
May 26, 1969.	5	5	....	0	45	5	50	45	5	
May 1, 1980	*+ 41*	....	*+ 41*	*+ 41*	*−41*	....	....	....	....	H dies.
Do	46	5	41	41	4	5	50	45	5	
June 1, 1981.	46	5	41	41	4	5	50	45	5	Distribution.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00156 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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Date	F owns (percent)	F's interest 1969 (percent)	F's interest 1980 (percent)	Interest treated as held by disqualified person (percent)	Disqualified persons own (percent)	Foundation voting level (percent)	Substituted combined voting level (percent)	Disqualified person voting level (percent)	Permitted holdings (percent	Comments
Aug. 1, 1990.	*−22*	*−5*	*−17*	*−17*	....	*−5*	*−22*	*−17*	*−5*	F disposes of 22 pct.
Do	24	0	24	24	4	0	28	28	0	
June 1, 1991.	....	....	....	*−24*	....	*+24*	....	*−24*	*+24*	2d phase for 24 pct.
Do	24	0	24	0	4	24	28	4	24	

§53.4943–6 Five-year period to dispose of gifts, bequests, etc.

(a) *In general*—(1) *Application*. (i) Paragraph (6) of section 4943(c) prescribes transition rules for a private foundation, which, but for such paragraph, would have excess business holdings as a result of a change in the holdings in a business enterprise after May 26, 1969 (other than by purchase by such private foundation or by a disqualified person) to the extent that section 4943(c)(5) (relating to certain holdings acquired under a pre-May 27, 1969, will on trust) does not apply.

(ii) Subparagraph (A) of section 4943(c)(6) applies where, immediately prior to a change in holdings described in paragraph (a)(1)(i) of this section, the foundation has no excess business holdings in such enterprise (determined without regard to section 4943(c) (4), (5), or (6)). In such a case, the entire interest of the foundation in such enterprise (immediately after such change) shall (while held by the foundation) be treated as held by a disqualified person (rather than by the foundation) during the five-year period beginning on the date of such change.

(iii) Subparagraph (B) of section 4943(c)(6) applies where the foundation has excess business holdings in such enterprise (determined without regard to section 4943(c) (4), (5), or (6)) immediately prior to a change in holdings described in paragraph (a)(1)(i) of this section. In such a case, the interest of the foundation in such enterprise (immediately after such change) shall (while held by the foundation) be treated as held by a disqualified person (rather than the foundation) during the five-year period beginning on the date of such change, except that if and as soon as any holdings in such enterprise become excess business holdings during such period (determined without regard to such change (and the resulting application of section 4943(c)(6) to the foundation's interest in such enterprise)), such holdings shall no longer be treated as held by a disqualified person under this section, but shall constitute excess business holdings subject to the initial tax. In applying the preceding sentence, if holdings of the foundation which (but for such change in holdings (and the resulting application of section 4943(c)(6) to the foundation's interest in such enterprise)) would be subject to the 25 percent limit prescribed by section 4943(c)(4)(D) after the expiration of the first phase, such holdings shall be treated as subject to such percentage limitation for purposes of determining excess business holdings. For example, if a private foundation in 1978 has present holdings of 28 percent in a business enterprise to which section 4943(c)(4) applies, and such holdings would exceed the 25 percent limit of section 4943(c)(4)(D)(i) on May 26, 1979, a gift of 5 percent to the foundation in 1978 of an interest in such enterprise shall not prevent the 3 percent (28%−25%) excess over the 25 percent limit from constituting excess business holdings on May 26, 1979, if on such date disqualified persons hold more than a 2 percent interest in such enterprise (and no other transaction has taken place).

(2) *Acquisitions that are not purchases*. Section 4943(c)(6) does not apply if a change in holdings in a business enterprise is the result of a purchase by the private foundation or a disqualified person. For purposes of subparagraph

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(a) of this paragraph, the term ''purchase'' shall not include any acquisition by gift, devise, bequest, legacy, or interstate succession. Paragraph (d) of this section provides rules for the treatment of increases in holdings received in a readjustment (as defined in § 53.4943–7(d)(1)).

(3) *Examples*. The provisions of paragraph (a) of this section may be illustrated by the following examples:

Example 1. On January 4, 1985, A, an individual, makes a contribution to F, a private foundation, of 200 shares of X Corporation common stock. Assume that F had no X stock before January 4, 1985, and under section 4943(c)(1) the receipt of the X stock by F would cause some or all of the 200 shares of the X stock to be classified as excess business holdings. Under the provisions of section 4943(c)(6)(A) and this paragraph (a), since the contribution of the X stock to F is a gift and not a purchase, the X stock in F's hands is treated as held by disqualified persons and not by F through January 3, 1990.

Example 2. Assume the facts as stated in Example (1) except that F receives the X stock as a bequest pursuant to the terms of A's will executed on April 1, 1980. A dies on June 3, 1984, and the stock is distributed to F on February 16, 1985. As in Example (1), the bequest of X to F is not a purchase under this paragraph (a). Consequently, the X stock in F's hands is treated as held by disqualified persons and not by F through February 15, 1990.

Example 3. On February 1, 1980, F, a private foundation, owns 15 percent of the voting stock of X Corporation, and disqualified persons own 4 percent of the voting stock of X Corporation. On February 2, 1980, B, a nondisqualified person, contributes 8 percent of the voting stock of X to F in a transaction to which section 4943(c)(5) does not apply. Assuming that the 35 percent limit of section 4943(c)(2)(B) does not apply, under the provisions of section 4943(c)(6)(A) and paragraph (a) of this section the 23 percent voting stock owned by F on such date is treated as held by a disqualified person through February 1, 1985, since F would have had excess business holdings of 7 percent as a result of the contribution (23% actual holdings less 16% (20% − 4%) permitted holdings). On March 1, 1984, C, another nondisqualified person, contributes 6 percent of the voting stock of X Corporation to F. But for this second contribution and the resulting application of section 4943(c)(6) to F's interest in X, F would have excess business holdings of 7 percent (23% − 16%) within the five-year period beginning on the date of such contribution. Accordingly, under section 4943(c)(6)(B) and paragraph (a) of this section, all 29 percent (6% + 23%) of the stock held by F on March 1, 1984, will be treated as held by a disqualified person until March 1, 1989, except that 7 percent will cease to be so treated on February 2, 1985. If prior to February 2, 1985, no further transactions occurred in the stock of X, F would have excess business holdings of 7 percent subject to the initial tax, since the amount still treated as held by disqualified persons (29% − 7%) plus the amount actually held by disqualified persons (4%) already exceed 20 percent.

(b) *Special rules for acquisitions by will or trust*—(1) *In general*. In the case of an acquisition of holdings in a business enterprise by a private foundation pursuant to the terms of a will or trust, the five-year period described in section 4943(c)(6) and in this section shall not commence until the date on which the distribution of such holdings from the estate or trust to the foundation occurs. See § 53.4943–5(b)(1) for rules relating to the determination of the date of distribution under the terms of a will or trust. For purposes of this subparagraph, holdings in a business enterprise will not be treated as acquired by a private foundation pursuant to the terms of a will where the holdings in the business enterprise were not held by the decedent. Thus, in the case of after-acquired property, this subparagraph shall not apply, the five-year period described in section 4943(c)(6) and this section shall commence on the date of acquisition of such holdings by the estate, and such five-year period may expire prior to the date of distribution of such holdings from the estate. To the extent that an interest to which section 4943(c)(6) and this paragraph (b)(1) apply is constructively held by a private foundation under section 4943(d)(1) and § 53.4943–8 prior to the date of distribution, it shall be treated as held by a disqualified person prior to such date by reason of section 4943(c)(6). See § 53.4943–8 for rules relating to constructive holdings held in an estate or trust for the benefit of the foundation.

(2) *Special rule for section 4943(c)(5) interests acquired from a nondisqualified person*. (i) In the case of holdings of a private foundation in a business enterprise to which section 4943(c)(5) (relating to certain holdings acquired under a pre-May 27, 1969, will or trust) applies

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which are acquired from a nondisqualified person, the interest of the foundation in such enterprise (immediately after such acquisition) shall (while held by the foundation) be treated as held by a disqualified person (rather than the foundation) under section 4943(c)(6)(B) and paragraph (a)(1)(iii) of this section from the date of acquisition until the end of the fifth year following the date of distribution of such holdings. Thereafter, only the holdings to which section 4943(c)(5) and § 53.4943–5(a)(1) apply shall continue to be treated as held by a disqualified person until the end of the first phase with respect thereto.

(ii) The provisions of paragraph (b)(2)(i) of this section may be illustrated by the following examples:

Example 1. On May 26, 1969, F, a private foundation, owns 5 percent of the voting stock of Corporation X and no disqualified persons own any stock in X. On June 30, 1977, a nondisqualified person bequeaths to F 33 percent of the voting stock in X to which section 4943(c)(5) applies. This 33 percent interest is distributed to F on August 17, 1978. Under section 4943(c)(6)(A) the entire 38 percent (5% + 33%) of the X voting stock shall be treated as held by a disqualified person from June 30, 1977 (the date the 33 percent interest is constructively acquired by F) until August 17, 1983 (five years after the date of distribution of the 33 percent interest to F). However, assuming that the 35 percent limit of section 4943(c)(2)(B) does not apply, the substituted combined voting level on June 30, 1977 is only 33 percent because there was no interest to which section 4943(c) (4) or (5) applied immediately before that date and thus there was no substituted combined voting level at that time. In that case, since the 3-phase holding period is only available for the interest acquired by will (33%) under section 4943(c)(5), the substituted combined voting level on June 30, 1977 is only 33 percent, not 38 percent. Assuming that the substituted combined voting level remains 33 percent at all relevant times, and prior to August 17, 1983, no further transactions occur in the stock of X, F on that date would have excess business holdings of 5 percent subject to the initial tax. The amount treated as held by disqualified persons at that time (33%) would equal the substituted combined voting level at that time (33%), and thus permitted holdings would be zero. Under section 4943(c)(5) the 33 percent interest will continue to be treated as held by a disqualified person until August 17, 1988 (10 years after the date of distribution).

Example 2. On May 26, 1969, F, a private foundation, owns 29 percent of the stock (voting power and value) of Corporation X, and on June 30, 1977, a nondisqualified person bequeaths to F 23 percent of the stock (voting power and value) in X to which section 4943(c)(5) does apply. This 23 percent interest is distributed to F on August 17, 1978. Disqualified persons hold no stock of X. Although the substituted combined voting and value levels cannot exceed 50 percent on May 26, 1979 (at the start of the second phase with respect to the 29 percent interest), under section 4943(c)(6)(B) the entire 52 percent (29% + 23%) of the X voting stock shall be treated as held by a disqualified person from June 30, 1977 (the date the 23% interest is constructively acquired by F) until August 17, 1983 (five years after the date of distribution of the 23% interest to F). On June 1, 1980, during such second phase, D, a disqualified person, purchases 3 percent of the X stock (voting power and value). On such date, but for the acquisition by F of the 23 percent interest, F would have had excess business holdings of 4 percent. The purchase by D of more than 2 percent of the voting stock of X causes the 25 percent limit of section 4943(c)(4)(D)(i) to apply to the 29 percent interest (29% − 25% = 4%). Thus, on June 1, 1980, 4 percent of the X voting stock held by F since May 27, 1969, shall cease to be treated as held by a disqualified person under section 4943(c)(6)(B) and become excess business holdings subject to the initial tax. See § 53.4943–2(a)(1)(ii) for the 90-day period in which to dispose of these excess business holdings resulting from the purchase by the disqualified person.

(c) *Exceptions.* (1) Section 4943(c)(6) and this section shall not apply to any transfer of holdings in a business enterprise by one private foundation to another private foundation which is related to the first foundation within the meaning of section 4946(a)(1)(H).

(2) Section 4943(c)(6) and this section shall not apply to an increase in the holdings of a private foundation in a business enterprise that is part of a plan whereby disqualified persons will purchase additional holdings in the same enterprise during the five-year period beginning on the date of such change, e.g., to maintain control of such enterprise, since such increase shall be treated as caused in part by the purchase of such additional holdings.

(3) The purchase of holdings by an entity whose holdings are treated as constructively owned by a foundation, its disqualified persons, or both, under section 4943(d)(1) shall be treated as a purchase by a disqualified person if the

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foundation, its disqualified persons or both have effective control of the entity or otherwise can control the purchase. For example, if a foundation is the beneficiary of a specific bequest of $20,000 and its consent is required for the estate to make a purchase using such cash, then a purchase by the estate using such cash would be treated as a purchase by a disqualified person. Similarly, if an executor of an estate is a disqualified person with respect to a private foundation, any purchase by the estate would be treated as a purchase by a disqualified person.

(4) If a private foundation, its disqualified persons, or both, hold an interest in specific property under the terms of a will or trust, and if the private foundation, its disqualified persons, or both, consent or otherwise agree to the substitution of holdings in a business enterprise for such specific property, such holdings shall be treated as acquired by purchase by a disqualified person. For example, if a private foundation is the beneficiary of a specific bequest of $20,000 and the private foundation agrees to accept certain of the estate's holdings in a business enterprise in satisfaction of such specific bequest, such holdings will be treated as acquired by purchase by a disqualified person even if such holdings were held by the decedent.

(d) *Readjustments and distributions*—(1) *General rule*. Except as otherwise provided in subparagraph (2) of this paragraph, any increase in holdings in a business enterprise that is the result of a readjustment (as defined in § 53.4943–7(d)(1)) shall be treated as acquired other than by purchase. However, holdings that are attributable to holdings owned by the private foundation that would have been excess business holdings except for the fact that such holdings were treated as held by a disqualified person prior to the readjustment shall in no event be treated as held by a disqualified person after the date on which the holdings to which the change is attributable would have ceased to be treated as held by a disqualified person.

(2) *Exceptions*. Any increase in holdings in a business enterprise that is the result of a readjustment (as defined in § 53.4943–7(d)(1)), including any change resulting from application of the rule in § 53.4943–8(c)(3), shall be treated as occurring by purchase by a disqualified person:

(i) To the extent the increase is attributable to holdings that were excess business holdings prior to the readjustment, and separately

(ii) To the full extent of the increase if the readjustment includes a prohibited transaction, unless the foundation establishes to the satisfaction of the Commissioner that effective control of all parties to the transaction was, at the time of the transaction, in one or more persons (other than the foundation) who are not disqualified persons with respect to the foundation. See § 53.4943–7(d)(2) for the definition of prohibited transaction.

(3) *Section 4943(c)(6) holdings*. If, immediately prior to a readjustment (as defined in § 53.4943–7(d)(1)), a private foundation has holdings in a business enterprise that are treated under section 4943(c)(6) as held by a disqualified person, then any holdings in a business enterprise that are received in the readjustment in exchange for such section 4943(c)(6) holdings shall be treated as the holdings surrendered in the exchange to the same extent as provided in § 53.4943–7 with respect to exchanges involving holdings to which section 4943(c) (4) or (5) applies. Rules similar to those in § 53.4943–7(a)(2) shall be applied to determine when holdings are treated as surrendered or received in a readjustment for purposes of this paragraph.

(4) *Redemption by a corporation that is a disqualified person*. If a foundation holds an interest in a corporation that is a disqualified person, an increase in the holdings of the private foundation, its disqualified person, or both, as a result of a redemption or a purchase of stock of the disqualified person corporation by such corporation shall not be treated as acquired by purchase by a disqualified person based solely on the status of the corporation as a disqualified person.

(5) *One percent rule for redemptions*. If the holdings of a foundation, its disqualified persons, or both, in a business enterprise are increased as a result of one or more redemptions during any taxable year then, unless the aggregate

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of such increases equals or exceeds one percent of the outstanding voting stock or one percent of the value of all outstanding shares of all classes of stock, the determination of whether such increases cause the foundation to have excess business holdings shall be made only at the close of the private foundation's taxable year. The five-year period described in section 4943(c)(6) or the 90-day period described in § 53.4943–2(a)(1)(ii), whichever is applicable, shall begin on the last day of such taxable year. If, however, the aggregate of such increases equals or exceeds one percent of the outstanding voting stock or one percent of the value of all outstanding shares of all classes of stock, the determination of whether such increases cause the foundation to have excess business holdings shall be made, and the applicable five-year or 90-day period shall begin, as of the date the increases, in the aggregate, equal or exceed one percent.

(6) *Examples.* The provisions of this paragraph are illustrated in § 53.4943–7(f) and by the following examples:

Example 1. (i) F, a private foundation, holds 20% of the voting stock of X corporation, an active business enterprise. No disqualified person with respect to F holds any X stock. In 1980, X redeems 10% of its outstanding shares, increasing F's holdings to 22% of the X stock. Assume the redemption by X is not a prohibited transaction.

(ii) All of F's holdings before the redemption are permitted holdings under section 4943(c)(2). There is no effective control of X by third parties so the 35% permitted holdings rule is inapplicable. F's holdings after the redemption exceed the permitted holdings under section 4943 (c)(2) (20%). Because the increase is attributable to stock that was permitted holdings prior to the readjustment, and the readjustment does not involve a prohibited transaction, the 2% increase in F's holdings of X stock is treated as acquired other than by purchase. Therefore, under section 4943(c)(6) and this section, F will have 5 years from the date of the redemption to dispose of the 2% excess.

Example 2. (i) Assume the same facts as in *Example (1)* except that the 20% of X stock held by F was donated by X corporation, was worth more than $5,000 and represented 20% of the contributions received by the foundation through the end of the taxable year in which the gift of stock was made.

(ii) X corporation is a disqualified person with respect to F under section 4946(a)(1)(A). Under subparagraph (4), the redemption of X stock is not treated as a purchase by a disqualified person merely because X is a disqualified person with respect to F. Therefore the rules of this paragraph apply as if the redemption were made by a corporation which is not a disqualified person. The analysis and result are the same as in *Example (1).*

Example 3. (i) On May 1, 1990, F, a private foundation, received a donation of 40% of the stock of X corporation, a business enterprise. Neither F nor any disqualified person with respect to F holds any other interest in X. On June 1, 1992, the X corporation redeemed F's 40% interest in exchange for 100% of the stock of Y corporation, a wholly-owned subsidiary of X. Assume the redemption by X is not a prohibited transaction.

(ii) Under section 4943(c)(6), the X stock acquired by gift is treated as held by disqualified persons through April 30, 1995. Under subparagraph (3) of this paragraph (d), 40% of the 100% interest in Y received in exchange for F's 40% interest in X is treated as F's 40% interest in X and is therefore treated as held by disqualified persons through April 30, 1995. In addition, under subparagraph (1) of this paragraph (d), the 60% interest in Y that represents an increase in holdings above the 40% held before the readjustment will be treated as acquired other than by purchase. However, F's 20% interest in X in excess of 20% permitted holdings under 4943(c)(2) would have been excess business holdings if such interest had not been treated as held by as disqualified person on June 1, 1992. Therefore, to the extent of a 30% interest in Y, (*i.e.* , the portion of the increased holdings in *Y* attributable to F's 20% holdings in X) the increased holdings will be treated as held by disqualified person only through April 30, 1995, since this is the latest date on which F's original 40% interest in X would have been treated as held by disqualified persons. The remaining 30% interest in Y will be treated as held by disqualified persons for five years from the date of the exchange (through May 31, 1997).

(e) *Constructive holdings.* Any change in holdings in a business enterprise that occurs because a corporation ceases to be actively engaged in a trade or business, thus causing its holdings to be constructively owned by its shareholders, shall be treated as acquired other than by purchase.

(f) *Certain transactions treated as purchases; cross references.* For the application of section 4943(c)(6) to holdings that were not an interest in a business enterprise when acquired but that subsequently become holdings in a business enterprise, see § 53.4943–10(d)(2).

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6479, Feb. 22, 1984]

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§ 53.4943–7 Special rules for readjustments involving grandfathered holdings.

(a) *General rules*—(1) *Readjustments.* Except to the extent provided in paragraph (b) of this section, if a private foundation, its disqualified persons, or both together have holdings in a corporation to which section 4943(c) (4) or (5) applies, stock of a corporation received by the foundation, its disqualified persons, or both together in a readjustment (as defined in paragraph (d)(1) of this section) in exchange for such holdings to which section 4943 (c) (4) or (5) applies shall be treated, for purposes of section 4943 (c) (4) or (5), as the stock surrendered in the exchange.

(2) *No exchange necessary.* Paragraph (a)(1) of this section shall apply to all readjustments even if no exchange occurs. For purposes of this section, all stock held (directly or indirectly) before a readjustment in any corporation involved in the readjustment shall be treated as stock surrendered in the readjustment and all stock held (directly or indirectly) after the readjustment in any corporation involved in the readjustment shall be treated as stock received in the readjustment in exchange for the stock treated as surrendered.

(b) *Exceptions and limitations*—(1) *Limitation on increases in percentage of voting stock.* (i) If the percentage of voting stock in a business enterprise owned (directly or indirectly) by a private foundation by reason of its ownership of stock received in an exchange described in paragraph (a) of this section exceeds the greatest percentage of voting stock in any business enterprise owned (directly or indirectly) by the private foundation prior to such exchange by reason of its ownership of the stock surrendered by it in the exchange, then:

(A) That portion of the stock received by the private foundation in the exchange which represents such excess is to be treated as an increase in the holdings of the private foundation in accordance with § 53.4943–6 (d), and

(B) Only the remaining portion of the stock received by the private foundation in the exchange shall be treated as the stock surrendered by the private foundation in the exchange.

(ii) If the sum of the percentage of voting stock in a business enterprise owned (directly or indirectly) by disqualified persons by reason of their ownership of stock received in an exchange described in paragraph (a) of this section plus the percentage of voting stock in the business enterprise owned (directly or indirectly) by the private foundation by reason of its ownership of stock received in the exchange and treated as the stock surrendered under paragraph (b) (1) (i) of this section exceeds the greatest percentage of voting stock in any business enterprise owned (directly or indirectly) by the private foundation and its disqualified person in combination by reason of their ownership of the stock surrendered by them in the exchange, then:

(A) That portion of the stock received by the disqualified persons in the exchange which represents such excess is to be treated as an increase in the holdings of the disqualified persons in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by the disqualified persons in the exchange is to be treated as the stock surrendered by the disqualified persons in the exchange.

(2) *Limitation on increase in percentage of value.* (i) If the percentage of value of all outstanding shares of all classes of stock in a business enterprise owned (directly or indirectly) by a private foundation by reason of its ownership of stock received in an exchange described in paragraph (a) of this section exceeds the greatest percentage of such value in any business enterprise owned (directly or indirectly) by the private foundation prior to such exchange by reason of its ownership of the stock surrendered by it in the exchange, then:

(A) That portion of the stock received by the private foundation in the exchange which represents such excess is to be treated as an increase in the holdings of the private foundation in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by the private foundation in the exchange shall be treated as the stock surrendered by the private foundation in the exchange.

(ii) If the sum of the percentage of value of all outstanding shares of all

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classes of stock in a business enterprise owned (directly or indirectly) by disqualified persons by reason of their ownership of stock received in an exchange described in paragraph (a) of this section plus the percentage of such value in the business enterprise owned (directly or indirectly) by the private foundation by reason of its ownership of stock received in the exchange and treated as the stock surrendered under paragraph (b)(2)(i) of this section exceeds the greatest percentage of such value in any business enterprise owned (directly or indirectly) by the private foundation and its disqualified persons in combination prior to the exchange by reason of their ownership of the stock surrendered by them in the exchange, then:

(A) That portion of the stock received by the disqualified persons in the exchange which represents such excess is to be treated as an increase in the holdings of the disqualified persons in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by the disqualified persons in the exchange is to be treated as the stock surrendered by the disqualified persons in the exchange.

(3) *Increases in percentage of both voting stock and value.* (i) If, as the result of an exchange described in paragraph (a) of this section, a private foundation has excesses determined under both paragraphs (b)(1)(i) and (b)(2)(i) of this section, then:

(A) That portion of the stock received by the private foundation in the exchange that represents the larger excess is to be treated as an increase in the holdings of the private foundation in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by the private foundation in the exchange is to be treated as the stock surrendered by the private foundation in the exchange.

(ii) If as the result of an exchange described in paragraph (a) of this section, disqualified persons have excesses determined under both paragraphs (b)(1)(ii) and (b)(2)(ii) of this section, then:

(A) That portion of the stock received by the disqualified persons in the exchange that represents the larger excess is to be treated as an increase in the holdings of the disqualified persons in accordance with § 53.4943–6(d), and

(B) Only the remaining portion of the stock received by disqualified persons in the exchange is to be treated as the stock surrendered by disqualified persons in the exchange.

(4) *Exception for prohibited transactions.* If a readjustment includes a prohibited transaction, as defined in paragraph (d)(2) of this section, then this paragraph shall be applied substituting, for purposes of paragraph (b)(1) and (b)(2), the lowest percentage of voting power or value owned prior to the exchange in any business enterprise involved in the readjustment to which the exchange relates for the greatest percentage of voting power or value in any business enterprise owned by reason of ownership of the stock surrendered in the exchange.

(5) *Voting and value levels.* After an exchange described in paragraph (a) of this section, the private foundation voting and value levels, and the substituted combined voting and value levels (as defined in § 53.4943–4(d)(2)) shall be the lesser of each respective level immediately prior to the exchange with respect to the stock surrendered in the exchange and each such respective level determined immediately after the exchange by taking into account only the stock received in the exchange that is treated under this paragraph as the stock surrendered in the exchange. If the stock of more than one corporation is surrendered in exchange for stock of one corporation, the highest of each voting or value level determined immediately prior to the exchange with respect to the stock of the corporations surrendered in the exchange shall be treated as such level immediately prior to the exchange.

(6) *Determination of phases*—(i) *In general.* Stock received in an exchange described in paragraph (a) of this section that is treated as stock surrendered in the exchange under this paragraph shall be treated as subject to the same first, second, and third phases that were applicable to the stock surrendered for it. For purposes of determining the applicable phases, stock received in an exchange shall be treated as received in exchange for particular holdings of stock surrendered based on

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the terms of the exchange. Where only a portion of the stock received is treated as the stock surrendered, such portion of the stock received shall be treated as exchanged for particular holdings of stock surrendered in the same proportions as the total stock received was exchanged for particular holdings of stock surrendered. For example, if 20 shares of X stock owned by a private foundation, subject to a first phase beginning on January 1, 1978 and ending on December 31, 1987, are exchanged for 20 shares of Y stock, and 40 shares of X stock owned by the private foundation, subject to a first phase beginning on June 1, 1980 and ending on May 31, 1990, are exchanged for 40 shares of Y stock, then ⅓ of the Y stock received by the private foundation is treated as received in exchanged for X stock having the January 1, 1978–December 31, 1987 first phase and ⅔ of the Y stock received by the private foundation is treated as received in exchange for the X stock having the June 1, 1980–May 31, 1990 first phase. If only 30 shares of the Y stock received by the private foundation are treated as the stock surrendered, then ⅓ (10 Y shares) will be subject to the January 1, 1978–December 31, 1987 first phase and ⅔ (20 Y shares) will be subject to the June 1, 1980–May 31, 1990 first phase.

(ii) *Transitional rule.* In any case in which holdings subject to section 4943(c)(4) or 4943(c)(5) have been consolidated prior to May 22, 1984, then the longest first phase applicable to any of the holdings surrendered in the consolidation shall be applied to the holdings received by the foundation in the consolidation that are treated as the holdings surrendered in the consolidation. For purposes of this clause, a consolidation is any readjustment that results in a reduction in the number of entities in which the foundation has direct holdings.

(c) *Plan to dispose of excess business holdings.* (1) Notwithstanding § 53.4943–4(d)(i)(4)(D) (relating to restrictions on increases in levels) and paragraphs (a) and (b) of this section, if a readjustment occurs under an approved plan to dispose of stock to which section 4943(c) (4) or (5) applies, in order to meet the requirements of section 4943(c)(4) (*i.e.*, to meet the reduced limits that will be applicable after the first phase holding period described in § 53.4943–4(c)) or to meet the requirements of section 4943(c)(2), all of the stock received in the readjustment shall be treated as held by disqualified persons through the end of the longest first phase holding period applicable to stock surrendered in the readjustment. The foundation and substituted combined voting and value levels shall not be increased on account of the readjustment.

(2) For purposes of this paragraph, a plan is an approved plan only if it is approved by the Commissioner and may be subject to such conditions as the Commissioner determines. A plan must be approved prior to any exchange or distribution pursuant to the plan except for a showing of good cause such as a business emergency.

(d) *Definitions*—(1) *Readjustments.* For purposes of this section, the term ''readjustment'' includes, but is not limited to:

(i) A merger or consolidation;

(ii) A recapitalization;

(iii) An acquisition of stock or assets;

(iv) A transfer of assets;

(v) A change in identity, form, or place of organization, however effected;

(vi) A redemption;

(vii) A distribution of assets or of stock, including a distribution to which section 301, 302, 331, or 355 applies or a distribution of stock of the distributing corporation.

(2) *Prohibited transaction.* A prohibited transaction is any transaction involving a private foundation that has holdings in a business enterprise which:

(i) Acquires stock (or similar interest in the case of an unincorporated entity) or assets of a business enterprise or redeems its own stock (or similar interest in the case of an unincorporated entity) using cash or other property transferred to the acquiring business enterprise (e.g., as a contribution to capital) by the private foundation, its disqualified persons, or both;

(ii) Acquires stock (or similar interest in the case of an unincorporated entity) or assets of a business enterprise or redeems its own stock (or similar interest in the case of an unincorporated entity) using the proceeds of a loan

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made to, or guaranteed by, the private foundation, its disqualified persons, or both;

(iii) Acquires 40 percent or more of the voting stock (or similar interest in the case of an unincorporated entity), 40 percent or more of the value of all outstanding shares of all classes of stock (or similar interest in the case of an unincorporated entity), or 40 percent or more of the assets of a business enterprise if the acquiring business enterprise's net assets used in its trade or business prior to such acquisition are insubstantial when compared to the net assets acquired or when compared to the net assets of the business enterprise, the stock (or similar interest in the case of an unincorporated entity) of which was acquired. For this purpose, an insubstantial ratio means a ratio that is 15% or less; or

(iv) Is used as a device to acquire or expand excess business holdings. The determination of whether a business enterprise is used as a device to acquire or expand excess business holdings shall be determined based on all the facts and circumstances. A business enterprise shall be presumed to have been used as a device to acquire or expand excess business holdings if it acquires 40 percent or more of the voting stock (or similar interest in the case of an unincorporated entity), 40 percent or more of the value of all outstanding shares of all classes of stock (or similar interest in the case of an unincorporated entity), or 40 percent or more of the assets of a business enterprise if the consideration for the acquisition consists primarily of nonvoting stock (or similar interest in the case of an unincorporated entity) of the acquiring business enterprise.

(3) *Corporation involved in a readjustment.* A corporation shall be treated as involved in a readjustment if, as part of the readjustment, any stock of the corporation is issued or redeemed, or any stock or assets of the corporation are distributed, exchanged, purchased, sold, acquired, or otherwise transferred.

(e) *Application to unincorporated business enterprise.* The rules of this section shall apply equally to partnerships and other unincorporated business enterprises, applying the rules and substitutions provided in §53.4943–3(c)(2), (3), and (4).

(f) *Examples.* The provisions of this section and §53.4943–6(d) are illustrated by the following examples, which assume no prohibited transactions are involved unless otherwise stated:

Example 1. (i) F, a private foundation, has owned 80% of the one outstanding class of stock of X corporation since 1965. The X is subject to section 4943(c)(4) with a first phase ending on May 25, 1984. On January 1, 1982, X merges with Y corporation to form Z corporation. X, Y, and Z are active business corporations. F owns no Y stock. No disqualified person with respect to F owns any stock in Y.Y, or Z. After the merger, F owns 25% of the one outstanding class of Z stock. Third parties do not control Z so that the 35% permitted holdings rule under section 4943(c)(2) is inapplicable

(ii) F's percentage of voting power and value in Z after the merger (25%) are less than F's percentages of voting power and value in X before the merger (80%). Therefore, under paragraph (a)(1) of this section, all of F's holdings in Z are treated as the X stock surrendered. Therefore, the Z stock is treated as subject to section 4943(c)(4) with a first phase ending on May 25, 1984. Under downward ratchet of paragraph (a)(5) of this section, the foundation voting and value levels and the substituted combined voting and value levels are reduced to 25%.

Example 2. (i) F, a private foundation, owns 100% of the one outstanding class of stock in X corporation and 30% of the one outstanding class of stock in Y corporation. F has held this stock continuously since 1960, and no disqualified person has even owned any stock in X or Y. Under section 4943(c)(4), F's holdings in X are treated as held by disqualified persons through the end of the first phase on May 25, 1989, and F's holdings in Y are permitted holdings during the second phase, which began on May 25, 1989, and F's holdings in Y are permitted holdings during the second phase, which began on May 26, 1979. On January 1, 1985, X and Y consolidate, forming a new corporation Z. In the consolidation, F acquires 50% of the one class of outstanding stock of Z, 40% in exchange for F's 100% interest in X and 10% in exchange for F's 30% interest in Y. Unrelated parties hold the remaining 50% of Z.

(ii) F's percentage of voting power and value in Z after the merger (50%) are less than F's percentages of voting power and value in X before the merger (100%). Thus, under paragraph (a)(1) of this section, the 50% interest in Z held by F is treated as the stock surrendered in the exchange for purposes of section 4943(c)(4). Under paragraph (b)(6) of this section, the 10% interest in Z received for the Y stock is subject to the

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same second phase period as the surrendered Y stock. The 40% interest first phase period as the surrendered X stock.

Example 3. (i) F, a private foundation, owns 50% of the one class of outstanding stock in X corporation which F has held continuously since 1935. No disqualified person with respect to F owns any stock in X. Neither F nor any disqualified person with respect to F owns any stock in Y corporation. On July 1, 1982, X and Y enter into an agreement to consolidate their businesses in a reorganization to which section 368(a)(1)(A) will apply. As a result of the contemplated consolidation, F will own 60% of the voting stock in Z, the resulting corporation. In addition, parties unrelated to F will own the remaining 40% of the Z voting stock and 100% of a new issue of nonvoting preferred stock in Z. Assume for purposes of this example, that the 60% of the voting stock to be held by F in Z will represent 50% of the fair market value of the outstanding Z stock.

(ii) Under the provisions of paragraph (b)(1) of this section, that portion of the Z stock held by F which represents a percentage of voting power equivalent to that held by F in X immediately prior to the consolidation (*i.e.*, 50%) will be treated as the X stock held by F on May 26, 1969, for purposes of section 4943(c)(4). Therefore, 50% of the Y stock will be treated as subject to a second phase ending on May 25, 1994. The remaining portion of the Z voting stock held by F (10%) is subject to the provisions of §53.4943–6(d)(1). F will have five years from the date of the merger in which to dispose of 10% of the Z stock without incurring the tax on excess business holdings.

Example 4. (i) F, a private foundation, owns 80% of the one class of outstanding stock in X corporation, an active business corporation. F has held this stock continuously since 1960 and no disqualified person with respect to F owns any stock in X. X has two operating divisions, one which manufacturers shoes and the other which manufactures refrigerators. On January 1, 1978, in a section 351(a) exchange, X transferred all of the assets of its shoe manufacturing division to Y, a corporation which X has formed for this purpose, and receives 100% of the stock of Y so that Y is a wholly-owned subsidiary of X. X then transfers all of the Y stock to F in exchange for all of F's holdings of X stock in a distribution to which section 355 applies.

(ii) Under paragraph (b)(1) of this section, 80% of the Y stock is treated as the X stock surrendered in the exchange for purposes of section 4943(c)(4). The 80% is treated under §53.4943–4(c) as held by disqualified persons through May 25, 1984, which constitutes the 15-year first phase holding period applicable to the 80% holding in X. The 80% of the Y stock must be reduced to the permitted holdings allowed during the second and third phase as provided by section 4943(c)(4)(D) in the same manner as F's holdings of X stock would have had to have been reduced.

(iii) Under §53.4943–6(d)(1), the remaining 20% of Y stock is treated as held by a disqualified person for five years from the date of the exchange. F will have five years from the date of the exchange in which to dispose of 20% of the Y stock without incurring the tax on excess business holdings.

Example 5. (i) X corporation, an active business corporation, has outstanding 1,000 shares of one class of stock, of which 600 shares have been held by F1, a private foundation; 100 shares have been held by F2, another private foundation; and 100 shares have been held by D, a disqualified person with respect to both F1 and F2. Unrelated parties hold the remaining 200 shares. F1 and F2 are disqualified persons with respect to each other under section 4946(a)(1)(H). Thus, F1 holds 60% of the X stock (600/1000); F2 and D each hold 10% (100/1000); and the foundation group (F1, F2 and D) holds 80% of X (800/1000). The holdings of F1 and F2 were acquired on January 1, 1980 pursuant to a pre-1969 will and are subject to section 4943(c)(5). There have been no changes in holdings since January 1, 1980.

(ii) On January 1, 1985, pursuant to a plan to dispose of excess business holdings approved by the Commissioner under paragraph (c) of this section, X redeems for cash the 600 shares held by F1. After the redemption, D and F2 each hold 25% of X (100/400). F1 no longer holds any X stocks. The foundation group's holdings (F1, F2 and D) have decreased from 80% to 50% while holdings of unrelated parties have increased from 20% to 50%. At the same time F2's and D's holdings each have increased from 10% to 25%.

(iii) Notwithstanding the increase in F2's and D's holdings, under paragraph (c) of this section, all of the X stock held by F2 will be treated as held by a disqualified person through the end of the first phase (December 31, 1994). However, the foundation voting and value levels do not increase. Therefore, after the end of the first phase, F2's holdings in X may not exceed 10 percent (if the combined holdings of F1, F2 and D exceed the permitted holdings under section 4943(c)(2)).

Example 6. (i) X corporation, an active business corporation, has outstanding 1,000 shares of its one class of stock. Since 1960, 100 shares (10%) have been held by F, a private foundation and 350 shares (35%) have been held by D, a disqualified person with respect to F. All of the stock held by F is permitted holdings under section 4943(c)(4) and the substituted combined voting and value levels are 45% (10% + 35%). Because of disagreements concerning management of X between D and A, an unrelated party who holds 300 shares (30%) of the X stock, X redeems all of A's shares on December 1, 1981.

(ii) After the redemption, F holds 14.3% (100/700) of the X stock and D holds 50% (350/

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700), for combined holdings of 64.3%. Because the combined holdings exceed the substituted combined voting level (45%) by more than F's entire holdings, all of the F stock is excess business holdings. However, all of F's stock will be treated as acquired other than by purchase under § 53.4943–6(d)(1) and therefore will be treated under section 4943(c)(6) and this section, as held by a disqualified person for five years from the date of the redemption (through November 30, 1986). If the combined holdings of F and its disqualified person are reduced to 45 percent by the end of the five year period, F may retain a portion of its holdings in X (limited to no more than the foundation voting and value level of 10 percent).

Example 7. Assume the same facts as in *Example (6)*, except that D loaned the money to X that was used to redeem A's shares. Under these facts, the increased holdings result from a prohibited transaction described in paragraph (d)(2) of this section. Therefore, all of F's stock will be treated as acquired by purchase by a disqualified person under § 53.4943–6(d)(2). F will have 90 days after the redemption in which to dispose of its holdings or to reduce its holdings and the combined holdings to the levels held prior to the redemption as discussed in *Example (6)*.

Example 8. (i) F, a private foundation, has held 100% of the outstanding stock of X corporation since 1960. F also holds 15% of the voting stock of Y corporation. Both X and Y are active business corporations. X has $1 million in net assets used in its trade or business and Y has $6.7 million used in its trade or business. On June 1, 1985, Y is merged into X. After the merger F holds 25% of the voting stock of X. No person other than F controls X after the merger.

(ii) Because more than 40% of Y was acquired and the net assets of X, the acquiring corporation, used in its trade or business prior to the merger represent less than 15% of the net assets of Y used in its trade or business, the merger is a prohibited transaction described in paragraph (d)(2)(iii). Therefore, only 15% of the stock X is treated, pursuant to paragraph (b), as the stock held by F prior to the redemption. F's holding of 5% (the excess of F's 25% holdings over the 20% permitted holdings in X (determined under section 4943(c)(2)) are treated as purchased by a disqualified person pursuant to § 53.4943–6(d)(2). F will have 90 days after June 1, 1985, in which to dispose of the 5% excess holdings.

[T.D. 7944, 49 FR 6480, Feb. 22, 1984]

§ 53.4943–8 Business holdings; constructive ownership.

(a) *Constructive ownership*—(1) *In general.* For purposes of section 4943, in computing the holdings in a business enterprise of a private foundation, or a disqualified person (as defined in section 4946), any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries except as otherwise provided in paragraphs (b), (c) and (d) of this section. Any interest in a business enterprise actually or constructively owned by a shareholder of a corporation, a partner of a partnership, or beneficiary of an estate or trust shall not be considered as constructively held by the corporation, partnership, trust or estate. Further, if any corporation, partnership, estate or trust has a warrant or other option to acquire an interest in a business enterprise, such interest is not deemed to be constructively owned by such entity until the option is exercised. (See paragraph (b)(2) of § 53.4943–3 for rules that options are not stock for purposes of determining excess business holdings.)

(2) *Powers of appointment.* Any interest in business enterprise over which a foundation or a disqualified person has a power of appointment exercisable in favor of the foundation or a disqualified person shall be considered owned by the foundation or disqualified person holding such power of appointment.

(3) *Determination of extent of constructive ownership.* If an interest in a business enterprise owned by a corporation is constructively owned by a shareholder, each shareholder's proportion of ownership is generally computed on the basis of the voting stock each shareholder has in the corporation. In determining holdings permitted under section 4943(c) (4) and (5), each shareholder's proportion of ownership in the business enterprise shall also be computed on the basis of value, taking into account both voting and nonvoting stock held by the shareholder.

(4) *Nonvoting stock.* If a private foundation, its disqualified persons, or both, own (directly or constructively) nonvoting stock of a parent corporation, the holdings of which are treated as constructively owned by its shareholders by reason of section 4943(d)(1) and this section, such nonvoting stock

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shall be treated as nonvoting stock of any corporation in which the parent corporation holds an interest for purposes of the limitation on the holding of nonvoting stock under section 4943(c)(2)(A) and § 53.4943–3(b)(2).

(5) *Interests held by certain disqualified persons.* In the case of an entity that is a disqualified person (other than an entity described in section 4946(a)(1)(H)), the holdings of which are treated as constructively owned by its shareholders, partners, or beneficiaries, for purposes of determining the total holdings of disqualified persons the holdings of the entity shall be considered held by a disqualified person only to the extent such holdings are treated as constructively owned by disqualified persons who are shareholders, partners, or beneficiaries of the entity. In the case of an entity described in section 4946(a)(1)(H) or an entity, the holdings of which are not treated as constructively owned by its shareholders, partners, or beneficiaries, all holdings of such entity shall be treated as held by a disqualified person if and only if the entity itself is a disqualified person.

(b) *Estates and trusts*—(1) *In general.* Any interest actually or constructively owned by an estate or trust is deemed constructively owned, in the case of an estate, by its beneficiaries or, in the case of a trust, by its remainder beneficiaries except as provided in paragraphs (b) (2), (3) and (4) of this section (relating to certain split-interest trusts described in section 4947(a)(2), to trusts of qualified pension, profit-sharing, and stock bonus plans described in section 401(a) and to revocable trusts). Thus, if a trust owns 100 percent of the stock of a corporation A, and if, on an actuarial basis, W's life interest in the trust is 15 percent, Y's life interest is 25 percent, and Z's remainder interest is 60 percent, under this paragraph (b), Z will be considered to be the owner of 100 percent of the stock of corporation A. See § 53.4943–4, § 53.4943–5 and § 53.4943–6 for rules relating to certain actual or constructive holdings of a foundation being treated as held by a disqualified person. For the treatment of certain property acquired by an estate or trust after May 26, 1969, see paragraph (a)(2) of § 53.4943–5.

(2) *Split-interest trusts*—(i) *Amounts transferred in trust after May 26, 1969.* In the case of an interest in a business enterprise which was transferred to a trust described in section 4947(a)(2) after May 26, 1969, for the benefit of a private foundation, no portion of such interest shall be considered as owned by the private foundation:

(A) If the foundation holds only an income interest in the trust, or

(B) If the foundation holds only a remainder interest in the trust (unless the foundation can exercise primary investment discretion with respect to such interest)

until such trust ceases to be so described. See section 4947(a)(2) and (b)(3) and the regulations thereunder for rules relating to such trusts. See also sections 4946(a)(1) (G) and (H) and the regulations thereunder for rules relating to when a trust described in this paragraph (b)(2) is itself a disqualified person.

(ii) *Amounts transferred in trust on or before May 26, 1969.* In the case of an interest in a business enterprise which was transferred to a trust described in section 4947(a)(2) (without regard to section 4947(a)(2)(C)) on or before May 26, 1969, for the benefit of a private foundation, no portion of such interest shall be considered as owned by the foundation until it is actually distributed to the foundation or until the trust ceases to be so described. See section 4943(c)(5) and § 53.4943–5 for rules relating to certain trusts which were irrevocable on May 26, 1969.

(3) *Employee benefit trusts.* An interest in a business enterprise owned by a trust described in section 401(a) (pension and profit-sharing plans) shall not be considered as owned by its beneficiaries, unless disqualified persons (within the meaning of section 4946) control the investment of the trust assets.

(4) *Revocable trusts.* An interest in a business enterprise owned by a revocable trust shall be treated as owned by the grantor of such trust.

(5) *Estates.* For purposes of applying section 4943(d)(1) to estates, the term ''beneficiary'' includes any person (including a private foundation) entitled to receive property of a decedent pursuant to a will or pursuant to laws of

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descent and distribution. However, a person shall no longer be considered a beneficiary of an estate when all the property to which he is entitled has been received by him, when he no longer has a claim against the estate and when there is only a remote possibility that it will be necessary for the estate to seek the return of property or to seek payment from him by contribution or otherwise to satisfy claims against the estate or expenses of administration. When pursuant to the preceding sentence, a person (including a private foundation) ceases to be a beneficiary, stock or another interest in a business enterprise owned by the estate shall not thereafter be considered owned by such person. If any person is the constructive owner of an interest in a business enterprise actually held by an estate, the date of death of the testator or decedent intestate shall be the first day on which such person shall be considered a constructive owner of such interest. See § 53.4943–5 for rules relating to wills executed on or before May 26, 1969.

(c) *Corporation actively engaged in a trade or business*—(1) *In general*. Except as provided in paragraphs (c)(2) and (3) of this section, any interest (whether or not in a separate entity) owned by a corporation which is actively engaged in a trade or business shall not be deemed to be constructively owned by such corporation's shareholders.

(2) *Actively engaged in a trade or business*. For purposes of paragraph (c)(1) of this section:

(i) A corporation shall not be considered to be actively engaged in a trade or business if the corporation is not a business enterprise by reason of section 4943(d)(3) (A) or (B) and § 53.4943–10 (b) or (c);

(ii) In the case of a corporation which owns passive holdings and is actively engaged in a trade or business, such corporation shall not be considered to be actively engaged in a trade or business if the net assets used in such trade or business are insubstantial when compared to passive holdings.

(3) *Exceptions*. If a corporation has been involved in a prohibited transaction, any interest in a business enterprise owned by such corporation shall be treated as constructively owned by its shareholders, whether or not such corporation is actively engaged in a trade or business. For a definition of prohibited transaction, see § 53.4943–7 (d)(2).

(4) *Affiliated group*. In applying this paragraph to the common parent in an affiliated group (as defined in § 53.4943–10 (c)(3)(ii)), the assets and activities of the affiliated group shall be treated as the assets and activities of the common parent.

(d) *Partnerships*. Any interest in a business enterprise which is owned by a partnership shall be deemed to be constructively owned by the partners in such partnerships.

(e) *Examples*. The provisions of this section are illustrated by the following examples.

Example 1. F, a private foundation, directly owns voting stock of X, a holding company described in section 4943(d)(3)(B). That stock represents 40% of the voting power in X and 20% of the value of all outstanding shares of all classes of stock in X. F also owns nonvoting stock in X that represents 10% of the value of all outstanding shares of all classes of stock in X. D, a disqualified person, owns voting stock of X that represents 40% of the voting power in X and 20% of the value. D does not own any nonvoting stock in X. X corporation's only holding is stock of Y corporation. The Y voting stock held by X represents 50% of the voting power in Y and 25% of the value of all outstanding shares of all classes of stock in Y. X also owns nonvoting stock in Y that represents 25% of the value of all outstanding shares of all classes of stock in Y. Under paragraph (a)(3) of this section, F and D each constructively owns 20% of the voting power in Y through their voting interest in X (40% of X's 50% of Y). F also constructively owns 15% of the value of all outstanding shares of all classes of stock in Y through F's interest in X (F's 30% of the value of X multiplied by X's 50% of the value of Y), while D constructively owns 10% of the value of Y (D's 20% of the value of X multiplied by X's 50% of the value of Y).

Example 2. (i) F, a private foundation, owns 50% of the one class of nonvoting stock of X corporation, a corporation described in section 4943(d)(3)(B) and paragraph (c)(2)(i) above. D, a disqualified person with respect to F as described in section 4946(a)(1)(A), owns 40% of the one class of voting stock of X. X corporation is a disqualified person with respect to F because D owns more than 35% of the voting of X. (See section 4946(a)(1)(E)). On January 1, 1980, X purchases for cash 40% of the only class of stock of Y corporation, a retail clothing store, from unrelated third parties.

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(ii) Under paragraph (a)(4) of this section, F is treated as owning nonvoting stock of Y. Although X is a disqualified person, its holdings are not treated as held by disqualified persons except as constructive holdings. Therefore, the ''deemed'' nonvoting stock in Y is a permitted holding because D, a disqualified person with respect to F, constructively owns only 16% of the voting stock of Y (less than 20% permitted under section 4943(c)(2)).

Example 3. (i) The facts are the same as in *Example (2)*, except that X purchases 100% of this stock of Y corporation. Under paragraph (a)(4) of this section, F is treated as owning nonvoting stock of Y. The ''deemed'' nonvoting stock in Y is not a permitted holdings because D, a disqualified person with respect to F, constructively owns 40% of the voting stock of Y.

Example 4. (i) D, a disqualified person with respect to F, owns 40% of the one class of stock in X corporation, an active business. X is a disqualified person with respect to F. X acquires 40% of the voting stock in Y corporation. Under paragraph (a)(5) of this section, the holdings of X in Y are treated as held by a disqualified person. F cannot hold any Y stock, voting or nonvoting.

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6484, Feb. 22, 1984]

§ 53.4943–9 Business holdings; certain periods.

(a) *Taxable period*—(1) *In general.* For purposes of section 4943, the term ''taxable period'' means, with respect to any excess business holdings of a private foundation in a business enterprise, the period beginning with the first day on which there are such excess business holdings and ending on the earliest of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed on the holdings by the section 4943(a);

(ii) The date on which the excess is eliminated; or

(iii) The date on which the tax imposed by section 4943(a) is assessed.

For example, *M*, a private foundation, first has excess business holdings in *X*, a corporation, on February 5, 1972. A notice of deficiency is mailed under section 6212 to *M* on June 1, 1974. With respect to *M*'s excess business holdings in *X*, the taxable period begins on February 5, 1972, and ends on June 1, 1974.

(2) *Special rule.* Where a notice of deficiency referred to in subparagraph (1)(i) of this paragraph is not mailed because there is a waiver of the restrictions on assessment and collection of a deficiency, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively, shall be treated as the end of the taxable period.

(3) *Suspension of taxable period for 90 days.* In any case in which a private foundation has excess business holdings solely because of the acquisition of an interest in a business enterprise to which paragraph (a)(1) (ii) or (iii) of § 53.4943–2 applies, the taxable period described in paragraph (a) of this section shall be suspended for the 90-day period (as extended) starting with the date on which the foundation knows or has reason to know of the acquisition, provided that at the end of such period the foundation has disposed of such excess holdings.

(b) *Cross reference.* For rules relating to taxable events that are corrected within the correction period, defined in section 4863(e), see section 4861(a) and the regulations thereunder.

(c) *Correction.* For purposes of section 4943, correction shall be considered as made when no interest in the enterprise held by the foundation is classified as an excess business holdings under section 4943(c)(1). In any case where the private foundation has excess business holdings which are constructively held for it under section 4943(c)(1), correction shall be considered made when either a corporation, partnership, estate, or trust in which holdings in such enterprise are constructively held for the foundation or a disqualified person; the foundation itself; or a disqualified person disposes of a sufficient interest in the enterprise so that no interest in the enterprise held by the foundation is classified as excess business holdings under section 4943(c)(1).

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 8084, 51 FR 16302, May 2, 1986]

§ 53.4943–10 Business enterprise; definition.

(a) *In general.* (1) Except as provided in paragraph (b) or (c) of this section under section 4943(d)(4) the term

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''business enterprise'' includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513. For purposes of the preceding sentence, where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from the classification of a business enterprise merely because it does not result in a profit.

(2) Notwithstanding paragraph (a)(1) of this section, a bond or other evidence of indebtedness does not constitute a holding in a business enterprise unless such bond or evidence of indebtedness is otherwise determined to be an equitable interest in such enterprise. Similarly, a lease-hold interest in real property does not constitute an interest in a business enterprise, even though rent payable under such lease is dependent, in whole or in part, upon the income or profits derived by another from such property, unless such leasehold interest constitutes an interest in the income or profits of an unrelated trade or business under section 513.

(b) *Certain program-related activities.* For purposes of section 4943(d)(4) the term ''business enterprise'' does not include a functionally related business as defined in section 4942(j)(5). See § 53.4942(a)–2(c)(3)(iii). In addition, business holdings do not include program-related investments (such as investments in small businesses in central cities or in corporations to assist in neighborhood renovation) as defined in section 4944(c) and the regulations thereunder.

(c) *Income derived from passive sources*—(1) *In general.* For purposes of section 4943(d)(4), the term ''business enterprise'' does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources; except that if in the taxable year in question less than 95 percent of the income of a trade or business is from passive sources, the foundation may, in applying this 95 percent test, substitute for the passive source gross income in such taxable year the average gross income from passive sources for the 10 taxable years immediately preceding the taxable year in question (or for such shorter period as the entity has been in existence). Thus, stock in a passive holding company is not to be considered a holding in a business enterprise even if the company is controlled by the foundation. Instead, the foundation is treated as owning its proportionate share of any interests in a business enterprise held by such company under section 4943(d)(1).

(2) *Gross income from passive sources.* Gross income from passive sources, for purposes of this paragraph, includes the items excluded by section 512(b)(1) (relating to dividends, interest, and annuities), 512(b)(2) (relating to royalties), 512(b)(3) (relating to rent) and 512(b)(5) (relating to gains or losses from the disposition of certain property). Any income classified as passive under this paragraph does not lose its character merely because section 512(b)(4) or 514 (relating to unrelated debt-financed income) applies to such income. In addition, income from passive sources includes income from the sale of goods (including charges or costs passed on at cost to purchasers of such goods or income received in settlement of a dispute concerning or in lieu of the exercise of the right to sell such goods) if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods. Thus, for example, where a corporation purchases a product under a contract with the manufacturer, resells it under contract at a uniform markup in price, and does not physically handle the product, the income derived from that markup meets the definition of passive income for purposes of this paragraph. On the other hand, income from individually negotiated sales, such as those made by a broker, would not meet such definition even if the broker did not physically handle the goods.

(3) *Affiliated group.* (i) For a common parent corporation in an affiliated group, substitute ''consolidated gross income'' in subparagraph (1) of this paragraph.

(ii) For purposes of this section, the term *affiliated group* shall have the

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same meaning as in section 1504(a), without regard to section 1504 (b) through (e).

(iii) Section 53.4943–11(d) provides a transitional rule for certain parent corporations.

(d) *Application of section 4943(c)(6)*—(1) *Program related activities.* If a private foundation holds an interest which is not an interest in a business enterprise because of paragraph (b) of this section (relating to program related activities), and such interest later becomes an interest in a business enterprise solely by reason of failing to meet the requirements of such paragraph (b), such interest will then be subject to section (regardless of when it was originally acquired) and will be treated as having been acquired other than by purchase for purposes of section 4943(c)(6).

(2) *Passive holdings, etc.* (i) Except as provided in subdivision (ii), if a private foundation holds an interest that is not an interest in a business enterprise, and the interest later becomes an interest in a business enterprise (other than by reason of a readjustment as defined in § 53.4943–7(d)(1)), the interest will be treated as having been acquired by purchase by a disqualified person at the time the interest becomes an interest in a business enterprise. The treatment of an interest that becomes an interest in a business enterprise by reason of a readjustment shall be determined under § 53.4943–6 and § 53.4943–7.

(ii) If a private foundation establishes that the events which caused an interest not originally a business enterprise to become a business enterprise were not effectively controlled by the private foundation, then such interest shall be treated as acquired other than by purchase from the time of the change for purposes of section 4943(c)(6).

(iii) See § 53.4943–3(b)(3)(ii) for the definition of effective control.

(e) *Sole proprietorship.* For purposes of section 4943 and the regulations thereunder, the term ''sole proprietorship'' means any business enterprise (as defined in paragraphs (a), (b), and (c) of this section:

(1) Which is actually and directly owned by a private foundation,

(2) In which the foundation has a 100 percent equity interest, and

(3) Which is not held by a corporation, trust, or other business entity for such foundation.

A foundation may be considered to own a sole proprietorship even though the foundation is itself a corporation or a trust. However, a sole proprietorship which is owned by a foundation shall cease to be treated as a sole proprietorship when the foundation no longer has a 100-percent interest in the equity of the business enterprise. Thus, if and when a foundation sells a 10-percent interest in a sole proprietorship, such business enterprise shall be treated as a partnership under section 4943 and the regulations thereunder.

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6484, Feb. 22, 1984]

§ 53.4943–11 Effective/applicability date.

(a) *In general.* Section 4943 and §§ 53.4943–1 through 53.4943–11 shall take effect for taxable years beginning after December 31, 1969, except as otherwise provided by such sections.

(b) *Special transitional rule.* In the case of any acquisition of excess holdings prior to February 2, 1973, section 4943(a)(1) shall not apply if correction occurs (within the meaning of paragraph (c) of § 53.4943–9) within a period ending 90 days after July 5, 1977 extended (prior to the expiration of the original period) by any period which the Commissioner determines is reasonable and necessary (within the meaning of paragraph (b) of § 53.4943–9) to bring about such correction.

(c) *Special transitional rule for acquisition by will, etc.* (1) The rule in § 53.4943–6(b)(1) whereby holdings not held by a decedent are not treated as acquired under a will shall not apply to acquisitions of after-acquired property of a decedent's estate occurring on or before May 22, 1984.

(2) The rule in § 53.4943–6(b)(1) treating a purchase by an estate as a purchase by a disqualified person where the executor is a disqualified person shall not apply to purchases occurring on or before May 22, 1984.

(d) *Special transitional rule for affiliated groups.* If on or before May 22, 1984

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a foundation holds an interest in a common parent corporation in an affiliated group, as defined in § 53.4943–10(c)(3)(ii), the foundation may elect to have both § 53.4943–8(c)(4) and § 53.4943–10(c)(3) not apply to such common parent corporation. No election may be made to have only one section not apply. Such election shall be made by the governing body of the private foundation at any time prior to February 22, 1985.

(e) *Special transitional rule for changes to a business enterprise.* Any interest that is not an interest in a business enterprise which becomes an interest in a business enterprise under § 53.4943–10(d)(2) prior to May 22, 1984 will be treated as having been acquired other than by purchase for purposes of section 4943(c)(6).

(f) *Special transitional rule for private foundations that qualified as Type III supporting organizations before August 17, 2006.* The present holdings of a private foundation that qualified as a Type III supporting organization under section 509(a)(3) immediately before August 17, 2006, and that was reclassified as a private foundation under section 509(a) on or after August 17, 2006, solely as a result of the rules enacted by section 1241 of the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780), will be determined using the same rules that apply to Type III supporting organizations under section 4943(f)(7).

(g) *Special transitional rule for Type III supporting organizations created as trusts before November 20, 1970.* A trust that qualifies as a Type III supporting organization under section 509(a)(3) and meets the requirements of § 1.509(a)–4(i)(9) of this chapter will be treated as a ''functionally integrated Type III supporting organization'' for purposes of section 4943(f)(3)(A).

[T.D. 7496, 42 FR 46285, Sept. 15, 1977, as amended by T.D. 7944, 49 FR 6485, Feb. 22, 1984; T.D. 9605, 77 FR 76400, Dec. 28, 2012]

Subpart E—Taxes on Investments Which Jeopardize Charitable Purpose

SOURCE: T.D. 7240, 37 FR 28747, Dec. 27, 1972, unless otherwise noted.

§ 53.4944–1 Initial taxes.

(a) *On the private foundation*—(1) *In general.* If a private foundation (as defined in section 509) invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes, section 4944(a) (1) of the Code imposes an excise tax on the making of such investment. This tax is to be paid by the private foundation and is at the rate of 5 percent of the amount so invested for each taxable year (or part thereof) in the taxable period (as defined in section 4944(e) (1)). The tax imposed by section 4944(a)(1) and this paragraph shall apply to investments of either income or principal.

(2) *Jeopardizing investments.* (i) Except as provided in section 4944(c), § 53.4944–3, § 53.4944–6(a), and subdivision (ii) of this subparagraph, an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a per se violation of section 4944. However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation

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managers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of ''puts,'' ''calls,'' and ''straddles,'' the purchase of warrants, and selling short. The determination whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight. Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of such investment, the foundation subsequently realizes a loss. The provisions of section 4944 and the regulations thereunder shall not exempt or relieve any person from compliance with any Federal or State law imposing any obligation, duty, responsibility, or other standard of conduct with respect to the operation or administration of an organization or trust to which section 4944 applies. Nor shall any State law exempt or relieve any person from any obligation, duty, responsibility, or other standard of conduct provided in section 4944 and the regulations thereunder.

(ii)(*a*) Section 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation. If such foundation furnishes any consideration to such person upon the transfer, the foundation will be treated as having made an investment (within the meaning of section 4944(a)(1)) in the amount of such consideration.

(*b*) Section 4944 shall not apply to an investment which is acquired by a private foundation solely as a result of a corporate reorganization within the meaning of section 368(a).

(iii) For purposes of section 4944, a private foundation which, after December 31, 1969, changes the form or terms of an investment (regardless of whether subdivision (ii) of this subparagraph applies to such investment), will be considered to have entered into a new investment on the date of such change, except as provided in subdivision (ii)(*b*) of this subparagraph. Accordingly, a determination, under subdivision (i) of this subparagraph, whether such change in the investment jeopardizes the carrying out of the foundation's exempt purposes shall be made at such time.

(iv) It is not intended that the taxes imposed under Chapter 42 be exclusive. For example, if a foundation purchases a sole proprietorship in a business enterprise within the meaning of section 4943(d)(4), in addition to tax under section 4943, the foundation may be liable for tax under section 4944 if the investment jeopardizes the carrying out of any of its exempt purposes.

(b) *On the management*—(1) *In general.* In any case in which a tax is imposed by section 4944(a)(1) and paragraph (a) of this section, section 4944 (a)(2) of the Code imposes on the participation of any foundation manager in the making of the investment, knowing that it is jeopardizing the carrying out of any of the foundation's exempt purposes, a tax equal to 5 percent of the amount so invested for each taxable year of the foundation (or part thereof) in the taxable period (as defined in section 4944(e)(1)), subject to the provisions of section 4944(d) and § 53.4944–4, unless such participation is not willful and is due to reasonable cause. The tax imposed under section 4944(a)(2) shall be paid by the foundation manager.

(2) *Definitions and special rules*—(i) *Knowing.* For purposes of section 4944, a foundation manager shall be considered to have participated in the making of an investment ''knowing'' that it is jeopardizing the carrying out of any of the foundation's exempt purposes only if:

(*a*) He has actual knowledge of sufficient facts so that, based solely upon such facts, such investment would be a jeopardizing investment under paragraph (a)(2) of this section,

(*b*) He is aware that such an investment under these circumstances may violate the provisions of federal tax law governing jeopardizing investments, and

(*c*) He negligently fails to make reasonable attempts to ascertain whether the investment is a jeopardizing investment, or he is in fact aware that it is such an investment.

For purposes of this part and Chapter 42, the term *knowing* does not mean ''having reason to know''. However, evidence tending to show that a foundation manager has reason to know of a particular fact or particular rule is relevant in determining whether he had actual knowledge of such fact or rule. Thus, for example, evidence tending to show that a foundation manager has reason to know of sufficient facts so that, based solely upon such facts, an investment would be a jeopardizing investment is relevant in determining whether he has actual knowledge of such facts.

(ii) *Willful.* A foundation manager's participation in a jeopardizing investment is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make such participation willfull. However, a foundation manager's participation in a jeopardizing investment is not willful if he does not know that it is a jeopardizing investment under paragraph (a)(2) of this section.

(iii) *Due to reasonable cause.* A foundation manager's actions are due to reasonable cause if he has exercised his responsibility on behalf of the foundation with ordinary business care and prudence.

(iv) *Participation.* The participation of any foundation manager in the making of an investment shall consist of any manifestation of approval of the investment.

(v) *Advice of counsel.* If a foundation manager, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of such counsel expressed in a reasoned written legal opinion that a particular investment would not jeopardize the carrying out of any of the foundation's exempt purposes (because, as a matter of law, the investment is excepted from such classification, for example, as a program-related investment under section 4944(c)), then although such investment is subsequently held to be a jeopardizing investment under paragraph (a)(2) of this section, the foundation manager's participation in such investment will ordinarily not be considered ''knowing'' or ''willfull'' and will ordinarily be considered ''due to reasonable cause'' within the meaning of section 4944(a)(2). In addition, if a foundation manager, after full disclosure of the factual situation to qualified investment counsel, relies on the advice of such counsel, such advice being derived in a manner consistent with generally accepted practices of persons who are such a qualified investment counsel and being expressed in writing that a particular investment will provide for the long and short term financial needs of the foundation under paragraph (a)(2) of this section, then although such investment is subsequently held not to provide for such long and short term financial needs, the foundation manager's participation in failing to provide for such long and short term financial needs will ordinarily not be considered ''knowing'' or ''willful'' and will ordinarily be considered ''due to reasonable cause'' within the meaning of section 4944(a)(2). For purposes of this subdivision, a written legal opinion will be considered ''reasoned'' even if it reaches a conclusion which is subsequently determined to be incorrect so long as such opinion addresses itself to the facts and applicable law. However, a written legal opinion will not be considered ''reasoned'' if it does nothing more than recite the facts and express a conclusion. However, the absence of advice of legal counsel or qualified investment counsel with respect to the investment shall not, by itself, give rise to any inference that a foundation manager participated in such investment knowingly, willfully, or without reasonable cause.

(vi) *Cross reference.* For provisions relating to the burden of proof in cases involving the issue whether a foundation manager has knowingly participated in the making of a jeopardizing investment, see section 7454(b).

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. A is a foundation manager of B, a private foundation with assets of $100,000. A approves the following three investments by B after taking into account with respect to each of them B's portfolio as a whole: (1)

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An investment of $5,000 in the common stock of corporation X; (2) an investment of $10,000 in the common stock of corporation Y; and (3) an investment of $8,000 in the common stock of corporation Z. Corporation X has been in business a considerable time, its record of earnings is good and there is no reason to anticipate a diminution of its earnings. Corporation Y has a promising product, has had earnings in some years and substantial losses in others, has never paid a dividend, and is widely reported in investment advisory services as seriously undercapitalized. Corporation Z has been in business a short period of time and manufactures a product that is new, is not sold by others, and must compete with a well-established alternative product that serves the same purpose. Z's stock is classified as a high-risk investment by most investment advisory services with the possibility of substantial long-term appreciation but with little prospect of a current return. A has studied the records of the three corporations and knows the foregoing facts. In each case the price per share of common stock purchased by B is favorable to B. Under the standards of paragraph (a)(2)(i) of this section, the investment of $10,000 in the common stock of Y and the investment of $8,000 in the common stock of Z may be classified as jeopardizing investments, while the investment of $5,000 in the common stock of X will not be so classified. B would then be liable for an initial tax of $500 (*i.e.*, 5 percent of $10,000) for each year (or part thereof) in the taxable period for the investment in Y, and an initial tax of $400 (*i.e.*, 5 percent of $8,000) for each year (or part thereof) in the taxable period for the investment in Z. Further, since A had actual knowledge that the investments in the common stock of Y and Z were jeopardizing investments, A would then be liable for the same amount of initial taxes as B.

Example 2. Assume the facts as stated in Example (1), except that: (1) In the case of corporation Y, B's investment will be made for new stock to be issued by Y and there is reason to anticipate that B's investment, together with investments required by B to be made concurrently with its own, will satisfy the capital needs of corporation Y and will thereby overcome the difficulties that have resulted in Y's uneven earnings record; and (2) in the case of corporation Z, the management has a demonstrated capacity for getting new businesses started successfully and Z has received substantial orders for its new product. Under the standards of paragraph (a) (2) (i) of this section, neither the investment in Y nor the investment in Z will be classified as a jeopardizing investment and neither A nor B will be liable for an initial tax on either of such investments.

Example 3. D is a foundation manager of E, a private foundation with assets of $200,000. D was hired by E to manage E's investments after a careful review of D's training, experience and record in the field of investment management and advice indicated to E that D was well qualified to provide professional investment advice in the management of E's investment assets. D, after careful research into how best to diversify E's investments, provide for E's long-term financial needs, and protect against the effects of long-term inflation, decides to allocate a portion of E's investment assets to unimproved real estate in selected areas of the country where population patterns and economic factors strongly indicate continuing growth at a rapid rate. D determines that the short-term financial needs of E can be met through E's other investments. Under the standards of paragraph (a)(2)(i) of this section, the investment of a portion of E's investment assets in unimproved real estate will not be classified as a jeopardizing investment and neither D nor E will be liable for an initial tax on such investment.

[T.D. 7240, 37 FR 28747, Dec. 29, 1972, as amended by T.D. 7299, 38 FR 35304, Dec. 27, 1973]

§ 53.4944–2 Additional taxes.

(a) *On the private foundation.* Section 4944(b)(1) of the Code imposes an excise tax in any case in which an initial tax is imposed by section 4944(a)(1) and § 53.4944–1(a) on the making of a jeopardizing investment by a private foundation and such investment is not removed from jeopardy within the taxable period (as defined in section 4944(e)(1)). The tax imposed under section 4944(b)(1) is to be paid by the private foundation and is at the rate of 25 percent of the amount of the investment. This tax shall be imposed upon the portion of the investment which has not been removed from jeopardy within the taxable period.

(b) *On the management.* Section 4944(b)(2) of the Code imposes an excise tax in any case in which an additional tax is imposed by section 4944 (b)(1) and paragraph (a) of this section and a foundation manager has refused to agree to part or all of the removal of the investment from jeopardy. The tax imposed under section 4944(b)(2) is at the rate of 5 percent of the amount of the investment, subject to the provisions of section 4944(d) and § 53.4944–4. This tax is to be paid by any foundation manager who has refused to agree to the removal of part or all of the investment from jeopardy, and shall be

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imposed upon the portion of the investment which has not been removed from jeopardy within the taxable period.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. X is a foundation manager of Y, a private foundation. On the advice of X, Y invests $5,000 in the common stock of corporation M. Assume that both X and Y are liable for the taxes imposed by section 4944(a) on the making of the investment. Assume further that no part of the investment is removed from jeopardy within the taxable period and that X refused to agree to such removal. Y will be liable for an additional tax of $1,250 (*i.e.*, $5,000 × 25%). X will be liable for an additional tax of $250 (*i.e.*, $5,000 × 5%).

Example 2. Assume the facts as stated in Example (1), except that X is not liable for the tax imposed by section 4944(a)(2) for his participation in the making of the investment, because such participation was not willful and was due to reasonable cause. X will nonetheless be liable for the tax of $250 imposed by section 4944(b)(2) since an additional tax has been imposed upon Y and since X refused to agree to the removal of the investment from jeopardy.

Example 3. Assume the facts as stated in Example (1), except that Y removes $2,000 of the investment from jeopardy within the taxable period, with X refusing to agree to the removal from jeopardy of the remaining $3,000 of such investment. Y will be liable for an additional tax of $750, imposed upon the portion of the investment which has not been removed from jeopardy within the taxable period (*i.e.*, $3,000 × 25%). Further X will be liable for an additional tax of $150, also imposed upon the same portion of the investment (*i.e.*, $3,000 × 5%).

[T.D. 7240, 37 FR 28747, Dec. 27, 1972, as amended by T.D. 8084, 51 FR 16302, May 2, 1986]

§ 53.4944–3 Exception for program-related investments.

(a) *In general.* (1) For purposes of section 4944 and §§ 53.4944–1 through 53.4944–6, a ''program-related investment'' shall not be classified as an investment which jeopardizes the carrying out of the exempt purposes of a private foundation. A *program-related investment* is an investment which possesses the following characteristics:

(i) The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B);

(ii) No significant purpose of the investment is the production of income or the appreciation of property; and

(iii) No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(D).

(2)(i) An investment shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities. For purposes of section 4944 and §§ 53.4944–1 through 53.4944–6, the term *purposes described in section 170(c)(2)(B)* shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c).

(ii) An investment in an activity described in section 4942(j)(4)(B) and the regulations thereunder shall be considered, for purposes of this paragraph, as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B).

(iii) In determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation. However, the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(iv) An investment shall not be considered as made to accomplish one or more of the purposes described in section 170(c)(2)(D) if the recipient of the investment appears before, or communicates to, any legislative body with respect to legislation or proposed legislation of direct interest to such recipient, provided that the expense of engaging in such activities would qualify as a deduction under section 162.

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(3)(i) Once it has been determined that an investment is ''program-related'' it shall not cease to qualify as a ''program-related investment'' provided that changes, if any, in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property. A change made in the form or terms of a program-related investment for the prudent protection of the foundation's investment shall not ordinarily cause the investment to cease to qualify as program-related. Under certain conditions, a program-related investment may cease to be program-related because of a critical change in circumstances, as, for example, where it is serving an illegal purpose or the private purpose of the foundation or its managers. For purposes of the preceding sentence, an investment which ceases to be program-related because of a critical change in circumstances shall in no event subject the foundation making the investment to the tax imposed by section 4944(a)(1) before the 30th day after the date on which such foundation (or any of its managers) has actual knowledge of such critical change in circumstances.

(ii) If a private foundation changes the form or terms of an investment, and if, as a result of the application of subdivision (i) of this subparagraph, such investment no longer qualifies as program-related, the determination whether the investment jeopardizes the carrying out of exempt purposes shall be made pursuant to the provisions of § 53.4944–1(a)(2).

(b) *Examples*. The provisions of this section may be illustrated by the following examples:

Example 1. X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose for making the loan is to encourage the economic development of such minority groups. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

Example 2. Assume the facts as stated in Example (1), except that after the date of execution of the loan Y extends the due date of the loan. The extension is granted in order to permit X to achieve greater financial stability before it is required to repay the loan. Since the change in the terms of the loan is made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property, the loan shall continue to qualify as a program-related investment.

Example 3. X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, Y, a private foundation, purchases shares of X's common stock. Y's primary purpose in purchasing the stock is to encourage the economic development of such minority group, and no significant purpose involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock is a program-related investment, even though Y may realize a profit if X is successful and the common stock appreciates in value.

Example 4. X is a business enterprise which is not owned by low-income persons or minority group members, but the continued operation of X is important to the economic well-being of a deteriorated urban area because X employs a substantial number of low-income persons from such area. Conventional sources of funds are unwilling or unable to provide funds to X at reasonable interest rates. Y, a private foundation, makes a loan to X at an interest rate below the market rate for commercial loans of comparable risk. The loan is made pursuant to a program run by Y to assist low-income persons by providing increased economic opportunities and to prevent community deterioration. No significant purpose of the loan involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between

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the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 5. X is a business enterprise which is financially secure and the stock of which is listed and traded on a national exchange. Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, even though X is large and established, the investment is program-related.

Example 6. X is a business enterprise which is owned by a nonprofit community development corporation. When fully operational, X will market agricultural products, thereby providing a marketing outlet for low-income farmers in a depressed rural area. Y, a private foundation, makes a loan to X bearing interest at a rate less than the rate charged by financial institutions which have agreed to lend funds to X if Y makes the loan. The loan is made pursuant to a program run by Y to encourage economic redevelopment of depressed areas, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 7. X, a private foundation, invests $100,000 in the common stock of corporation M. The dividends received from such investment are later applied by X in furtherance of its exempt purposes. Although there is a relationship between the return on the investment and the accomplishment of X's exempt activities, there is no relationship between the investment per se and such accomplishment. Therefore, the investment cannot be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) and cannot qualify as program-related.

Example 8. S, a private foundation, makes an investment in T, a business corporation, which qualifies as a program-related investment under section 4944(c) at the time that it is made. All of T's voting stock is owned by S. T experiences financial and management problems which, in the judgment of the foundation, require changes in management, in financial structure or in the form of the investment. The following three methods of resolving the problems appear feasible to S, but each of the three methods would result in reduction of the exempt purposes for which the program-related investment was initially made:

(*a*) *Sale of stock or assets.* The foundation sells its stock to an unrelated person. Payment is made in part at the time of sale; the balance is payable over an extended term of years with interest on the amount outstanding. The foundation receives a purchase-money mortgage.

(*b*) *Lease.* The corporation leases its assets for a term of years to an unrelated person, with an option in the lessee to buy the assets. If the option is exercised, the terms of payment are to be similar to those described in (*a*) of this example.

(*c*) *Management contract.* The corporation enters into a management contract which gives broad operating authority to one or more unrelated persons for a term of years. The foundation and the unrelated persons are obligated to contribute toward working capital requirements. The unrelated persons will be compensated by a fixed fee or a share of profits, and they will receive an option to buy the stock held by S or the assets of the corporation. If the option is exercised, the terms of payment are to be similar to those described in (*a*) of this example.

Each of the three methods involves a change in the form or terms of a program-related investment for the prudent protection of the foundation's investment. Thus, under § 53.4944–3(a)(3)(i), none of the three transactions (nor any debt instruments or other obligations held by S as a result of engaging in one of these transactions) would cause the investment to cease to qualify as program-related.

Example 9. X is a socially and economically disadvantaged individual. Y, a private foundation, makes an interest-free loan to X for the primary purpose of enabling X to attend college. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 10. Y, a private foundation, makes a high-risk investment in low-income housing, the indebtedness with respect to which is insured by the Federal Housing Administration. Y's primary purpose in making the investment is to finance the purchase, rehabilitation, and construction of housing for low-income persons. The investment has no significant purpose involving the production of income or the appreciation of property.

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The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the investment is program-related.

Example 11. X is a business enterprise that researches and develops new drugs. X's research demonstrates that a vaccine can be developed within ten years to prevent a disease that predominantly affects poor individuals in developing countries. However, neither X nor other commercial enterprises like X will devote their resources to develop the vaccine because the potential return on investment is significantly less than required by X or other commercial enterprises to undertake a project to develop new drugs. Y, a private foundation, enters into an investment agreement with X in order to induce X to develop the vaccine. Pursuant to the investment agreement, Y purchases shares of the common stock of S, a subsidiary corporation that X establishes to research and develop the vaccine. The agreement requires S to distribute the vaccine to poor individuals in developing countries at a price that is affordable to the affected population, although, the agreement does not preclude S from selling the vaccine to other individuals at a market rate. The agreement also requires S to publish the research results, disclosing substantially all information about the results that would be useful to the interested public. S agrees that the publication of its research results will be made as promptly after the completion of the research as is reasonably possible without jeopardizing S's right to secure patents necessary to protect its ownership or control of the results of the research. The expected rate of return on Y's investment in S is less than the expected market rate of return for an investment of similar risk. Y's primary purpose in making the investment is to fund scientific research in the public interest. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, Y's purchase of the common stock of S is a program-related investment.

Example 12. Q, a developing country, produces a substantial amount of recyclable solid waste materials that are currently disposed of in landfills and by incineration, contributing significantly to environmental deterioration in Q. X is a new business enterprise located in Q. X's only activity will be collecting recyclable solid waste materials in Q and delivering those materials to recycling centers that are inaccessible to a majority of the population. If successful, the recycling collection business would prevent pollution in Q caused by the usual disposition of solid waste materials. X has obtained funding from only a few commercial investors who are concerned about the environmental impact of solid waste disposal. Although X made substantial efforts to procure additional funding, X has not been able to obtain sufficient funding because the expected rate of return is significantly less than the acceptable rate of return on an investment of this type. Because X has been unable to attract additional investors on the same terms as the initial investors, Y, a private foundation, enters into an investment agreement with X to purchase shares of X's common stock on the same terms as X's initial investors. Although there is a high risk associated with the investment in X, there is also the potential for a high rate of return if X is successful in the recycling business in Q. Y's primary purpose in making the investment is to combat environmental deterioration. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, Y's purchase of the X common stock is a program-related investment.

Example 13. Assume the facts as stated in *Example 12*, except that X offers Y shares of X's common stock in order to induce Y to make a below-market rate loan to X. X previously made the same offer to a number of commercial investors. These investors were unwilling to provide loans to X on such terms because the expected return on the combined package of stock and debt was below the expected market return for such a package based on the level of risk involved, and they were also unwilling to provide loans on other terms X considers economically feasible. Y accepts the stock and makes the loan on the same terms that X offered to the commercial investors. Y's primary purpose in making the investment is to combat environmental deterioration. No significant purpose of the investment involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the loan accompanied by the acceptance of common stock is a program-related investment.

Example 14. X is a business enterprise located in V, a rural area in State Z. X employs a large number of poor individuals in V. A natural disaster occurs in V, causing significant damage to the area. The business operations of X are harmed because of damage to X's equipment and buildings. X has insufficient funds to continue its business operations and conventional sources of funds

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are unwilling or unable to provide loans to X on terms it considers economically feasible. In order to enable X to continue its business operations, Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose in making the loan is to provide relief to the poor and distressed. No significant purpose of the loan involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 15. Y, a private foundation, makes loans bearing interest below the market rate for commercial loans of comparable risk to poor individuals who live in W, a developing country, to enable them to start small businesses such as a roadside fruit stand. Conventional sources of funds were unwilling or unable to provide such loans on terms they consider economically feasible. Y's primary purpose in making the loans is to provide relief to the poor and distressed. No significant purpose of the loans involves the production of income or the appreciation of property. The loans significantly further the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loans and Y's exempt activities. Accordingly, the loans to the poor individuals who live in W are program-related investments.

Example 16. X is a limited liability company treated as a partnership for federal income tax purposes. X purchases coffee from poor farmers residing in a developing country, either directly or through farmer-owned cooperatives. To fund the provision of efficient water management, crop cultivation, pest management, and farm management training to the poor farmers by X, Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. The loan agreement requires X to use the proceeds from the loan to provide the training to the poor farmers. X would not provide such training to the poor farmers absent the loan. Y's primary purpose in making the loan is to educate poor farmers about advanced agricultural methods. No significant purpose of the loan involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 17. X is a social welfare organization that is recognized as an organization described in section 501(c)(4). X was formed to develop and encourage interest in painting, sculpture, and other art forms by, among other things, conducting weekly community art exhibits. X needs to purchase a large exhibition space to accommodate the demand for exhibition space within the community. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X at an interest rate below the market rate for commercial loans of comparable risk to fund the purchase of the new space. Y's primary purpose in making the loan is to promote the arts. No significant purpose of the loan involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 18. X is a non-profit corporation that provides child care services in a low-income neighborhood, enabling many residents of the neighborhood to be gainfully employed. X meets the requirements of section 501(k) and is recognized as an organization described in section 501(c)(3). X's current child care facility has reached capacity and has a long waiting list. X has determined that the demand for its services warrants the construction of a new child care facility in the same neighborhood. X is unable to obtain a loan from conventional sources of funds including B, a commercial bank because of X's credit record. Pursuant to a deposit agreement, Y, a private foundation, deposits $h in B, and B lends an identical amount to X to construct the new child care facility. The deposit agreement requires Y to keep $h on deposit with B during the term of X's loan and provides that if X defaults on the loan, B may deduct the amount of the default from the deposit. To facilitate B's access to the funds in the event of default, the agreement requires that the funds be invested in instruments that allow B to access them readily. The deposit agreement also provides that Y will earn interest at a rate of t% on the deposit. The t% rate is substantially less than Y could otherwise earn on this sum of money, if Y invested it elsewhere. The loan agreement between B and X requires X to use the proceeds from the loan to construct the new child care facility. Y's primary purpose in making the deposit is to further its educational purposes by enabling X to provide child care services within the meaning of section 501(k). No significant purpose of the deposit involves the production of income or the appreciation of property. The deposit significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the deposit and Y's exempt activities. Accordingly, the deposit is a program-related investment.

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Example 19. Assume the same facts as stated in *Example 18*, except that instead of making a deposit of $h into B, Y enters into a guarantee agreement with B. The guarantee agreement provides that if X defaults on the loan, Y will repay the balance due on the loan to B. B was unwilling to make the loan to X in the absence of Y's guarantee. X must use the proceeds from the loan to construct the new child care facility. At the same time, X and Y enter into a reimbursement agreement whereby X agrees to reimburse Y for any and all amounts paid to B under the guarantee agreement. The signed guarantee and reimbursement agreements together constitute a ''guarantee and reimbursement arrangement.'' Y's primary purpose in entering into the guarantee and reimbursement arrangement is to further Y's educational purposes. No significant purpose of the guarantee and reimbursement arrangement involves the production of income or the appreciation of property. The guarantee and reimbursement arrangement significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the guarantee and reimbursement arrangement and Y's exempt activities. Accordingly, the guarantee and reimbursement arrangement is a program-related investment.

(c) *Effective/applicability date.* Paragraphs (a)(2)(ii) and (b), *Examples 11* through *19* of this section, apply on or after April 25, 2016.

[T.D. 7240, 37 FR 28747, Dec. 27, 1972, as amended by T.D. 9762, 81 FR 24017, Apr. 25, 2016]

§ 53.4944–4 Special rules.

(a) *Joint and several liability.* In any case where more than one foundation manager is liable for the tax imposed under section 4944 (a)(2) or (b)(2) with respect to any one jeopardizing investment, all such foundation managers shall be jointly and severally liable for the tax imposed under each such paragraph with respect to such investment.

(b) *Limits on liability for management.* With respect to anyone jeopardizing investment, the maximum aggregate amount of tax collectible under section 4944(a)(2) from all foundation managers shall not exceed $5,000, and the maximum aggregate amount of tax collectible under section 4944(b)(2) from all foundation managers shall not exceed $10,000.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. A, B, and C are foundation managers of X, a private foundation. Assume that A, B, and C are liable for both initial and additional taxes under sections 4944(a)(2) and 4944(b)(2), respectively, for the following investments by X: an investment of $5,000 in the common stock of corporation M, and an investment of $10,000 in the common stock of corporation N. A, B, and C will be jointly and severally liable for the following initial taxes under section 4944(a)(2): a tax of $250 (*i.e.*, 5 percent of $5,000) for each year (or part thereof) in the taxable period (as defined in section 4944(e)(1)) for the investment in M, and a tax of $500 (*i.e.*, 5 percent of $10,000) for each year (or part thereof) in the taxable period for the investment in N. Further, A, B, and C will be jointly and severally liable for the following additional taxes under section 4944(b)(2): a tax of $250 (*i.e.*, 5 percent of $5,000) for the investment in M, and a tax of $500 (*i.e.*, 5 percent of $10,000) for the investment in N.

Example 2. Assume the facts as stated in Example (1), except that X has invested $500,000 in the common stock of M, and $1 million in the common stock of N. A, B, and C will be jointly and severally liable for the following initial taxes under section 4944(a)(2): a tax of $5,000 for the investment in M, and a tax of $5,000 for the investment in N. Further, A, B, and C will be jointly and severally liable for the following additional taxes under section 4944(b) (2): a tax of $10,000 for the investment in M, and a tax of $10,000 for the investment in N.

§ 53.4944–5 Definitions.

(a) *Taxable period*—(1) *In general.* For purposes of section 4944, the term ''taxable period'' means, with respect to any investment which jeopardizes the carrying out of a private foundation's exempt purposes, the period beginning with the date on which the amount is invested and ending on the earliest of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed on the making of the investment by section 4944(a)(1);

(ii) The date on which the amount invested is removed from jeopardy; or

(iii) The date on which the tax imposed by section 4944(a)(1) is assessed.

(2) *Special rule.* Where a notice of deficiency referred to in subparagraph (1)(i) of this paragraph is not mailed because there is a waiver of the restrictions on assessment and collection of a deficiency, or because the deficiency is paid, the date of filing of the waiver or the date of such payment, respectively,

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shall be treated as the end of the taxable period.

(b) *Removal from jeopardy*. An investment which jeopardizes the carrying out of a private foundation's exempt purposes shall be considered to be removed from jeopardy when:

(1) The foundation sells or otherwise disposes of the investment, and

(2) The proceeds of such sale or other disposition are not themselves investments which jeopardize the carrying out of such foundation's exempt purposes.

A change by a private foundation in the form or terms of a jeopardizing investment shall result in the removal of the investment from jeopardy if, after such change, the investment no longer jeopardizes the carrying out of such foundation's exempt purposes. For purposes of section 4944, the making by a private foundation of one jeopardizing investment and a subsequent exchange by the foundation of such investment for another jeopardizing investment will be treated as only one jeopardizing investment, except as provided in § 53.4944–6 (b) and (c). For the treatment of a jeopardizing investment which is removed from jeopardy or otherwise transferred by a private foundation by the making of a grant or by bargain-sale, see sections 4941 and 4945 and the regulations thereunder. A jeopardizing investment cannot be removed from jeopardy by a transfer from a private foundation to another private foundation which is related to the transferor foundation within the meaning of section 4946(a) (1)(H) (i) or (ii), unless the investment is a program-related investment in the hands of the transferee foundation.

(c) *Examples*. The provisions of this section may be illustrated by the following examples:

Example 1. X, a private foundation on the calendar year basis, makes a $1,000 jeopardizing investment on January 1, 1970. X thereafter sells the investment for $1,000 on January 3, 1971. The taxable period is from January 1, 1970, to January 3, 1971. X will be liable for an initial tax of $100, that is, a tax of 5 percent of the amount of the investment for each year (or part thereof) in the taxable period.

Example 2. Assume that both C and D are investments which jeopardize exempt purposes. X, a private foundation, purchases C in 1971 and later exchanges C for D. Such exchange does not constitute a removal of C from jeopardy. In addition, no new taxable period will arise with respect to D, since, for purposes of section 4944, only one jeopardizing investment has been made.

Example 3. Assume the facts as stated in Example (2), except that X sells C for cash and later reinvests such cash in D. Two separate investments jeopardizing exempt purposes have resulted. Since the cash received in the interim is not of a jeopardizing nature, the amount invested in C has been removed from jeopardy and, thus, the taxable period with respect to C has been terminated. The subsequent reinvestment of such cash in D gives rise to a new taxable period with respect to D.

(d) *Cross reference*. For rules relating to taxable events that are corrected within the correction period, defined in section 4963(e), see section 4961(a) and the regulations thereunder.

[T.D. 7240, 37 FR 28747, Dec. 27, 1972, as amended by T.D. 8084, 51 FR 16303, May 2, 1986]

§ 53.4944–6 Special rules for investments made prior to January 1, 1970.

(a) Except as provided in paragraph (b) or (c) of this section, an investment made by a private foundation prior to January 1, 1970, shall not be subject to the provisions of section 4944.

(b) If the form or terms of an investment made by a private foundation prior to January 1, 1970, are changed (other than as described in paragraph (c) of this section) on or after such date, the provisions of § 53.4944–1(a)(2)(iii) shall apply with respect to such investment.

(c) In the case of an investment made by a private foundation prior to January 1, 1970, which is exchanged on or after such date for another investment, for purposes of section 4944 the foundation will be considered to have made a new investment on the date of such exchange, unless the post-1969 investment is described in § 53.4944–1(a)(2)(ii)(*b*). Accordingly, a determination, under § 53.4944–1(a) (2)(i), whether the investment jeopardizes the carrying out of the foundation's exempt purposes shall be made at such time.

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Subpart F—Taxes on Taxable Expenditures

SOURCE: T.D. 7215, 37 FR 23161, Oct. 31, 1972, unless otherwise noted.

§ 53.4945–1 Taxes on taxable expenditures.

(a) *Imposition of initial taxes*—(1) *Tax on private foundation.* Section 4945(a)(1) of the Code imposes an excise tax on each taxable expenditure (as defined in section 4945(d)) of a private foundation. This tax is to be paid by the private foundation and is at the rate of 10 percent of the amount of each taxable expenditure.

(2) *Tax on foundation manager*—(i) *In general.* Section 4945(a)(2) of the Code imposes, under certain circumstances, an excise tax on the agreement of any foundation manager to the making of a taxable expenditure by a private foundation. This tax is imposed only in cases in which the following circumstances are present:

(*a*) A tax is imposed by section 4945(a)(1);

(*b*) Such foundation manager knows that the expenditure to which he agrees is a taxable expenditure, and

(*c*) Such agreement is willfull and is not due to reasonable cause.

However, the tax with respect to any particular expenditure applies only to the agreement of those foundation managers who are authorized to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the foundation and to those foundation managers who are members of a group (such as the foundation's board of directors or trustees) which is so authorized. For the definition of the term *foundation manager*, see section 4946(b) and the regulations thereunder.

(ii) *Agreement.* The agreement of any foundation manager to the making of a taxable expenditure shall consist of any manifestation of approval of the expenditure which is sufficient to constitute an exercise of the foundation manager's authority to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the foundation, whether or not such manifestation of approval is the final or decisive approval on behalf of the foundation.

(iii) *Knowing.* For purposes of section 4945, a foundation manager shall be considered to have agreed to an expenditure "knowing" that it is a taxable expenditure only if:

(*a*) He has actual knowledge of sufficient facts so that, based solely upon such facts, such expenditure would be a taxable expenditure,

(*b*) He is aware that such an expenditure under these circumstances may violate the provisions of federal tax law governing taxable expenditures, and

(*c*) He negligently fails to make reasonable attempts to ascertain whether the expenditure is a taxable expenditure, or he is in fact aware that it is such an expenditure.

For purposes of this part and Chapter 42, the term *knowing* does not mean "having reason to know". However, evidence tending to show that a foundation manager has reason to know of a particular fact or particular rule is relevant in determining whether he had actual knowledge of such fact or rule. Thus, for example, evidence tending to show that a foundation manager has reason to know of sufficient facts so that, based solely upon such facts, an expenditure would be a taxable expenditure is relevant in determining whether he has actual knowledge of such facts.

(iv) *Willful.* A foundation manager's agreement to a taxable expenditure is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an agreement willful. However, a foundation manager's agreement to a taxable expenditure is not willful if he does not know that it is a taxable expenditure.

(v) *Due to reasonable cause.* A foundation manager's actions are due to reasonable cause if he has exercised his responsibility on behalf of the foundation with ordinary business care and prudence.

(vi) *Advice of counsel.* If a foundation manager, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of such counsel expressed in a reasoned written legal opinion that an

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expenditure is not a taxable expenditure under section 4945 (or that expenditures conforming to certain guidelines are not taxable expenditures), although such expenditure is subsequently held to be a taxable expenditure (or that certain proposed reporting procedures with respect to an expenditure will satisfy the tests of section 4945(h), although such procedures are subsequently held not to satisfy such section), the foundation manager's agreement to such expenditure (or to grants made with provision for such reporting procedures which are taxable solely because of such inadequate reporting procedures) will ordinarily not be considered ''knowing'' or ''willful'' and will ordinarily be considered ''due to reasonable cause'' within the meaning of section 4945(a)(2). For purposes of the subdivision, a written legal opinion will be considered ''reasoned'' even if it reaches a conclusion which is subsequently determined to be incorrect so long as such opinion addresses itself to the facts and applicable law. However, a written legal opinion will not be considered ''reasoned'' if it does nothing more than recite the facts and express a conclusion. However, the absence of advice of counsel with respect to an expenditure shall not, by itself, give rise to any inference that a foundation manager agreed to the making of the expenditure knowingly, willfully, or without reasonable cause.

(vii) *Rate and incidence of tax.* The tax imposed under section 4945(a)(2) is at the rate of 2½ percent of the amount of each taxable expenditure to which the foundation manager has agreed. This tax shall be paid by the foundation manager.

(viii) *Cross reference.* For provisions relating to the burden of proof in cases involving the issue whether a foundation manager has knowingly agreed to the making of a taxable expenditure, see section 7454(b).

(b) *Imposition of additional taxes*—(1) *Tax on private foundation.* Section 4945(b)(1) of the Code imposes an excise tax in any case in which an initial tax is imposed under section 4945(a)(1) on a taxable expenditure of a private foundation and the expenditure is not corrected within the taxable period (as defined in section 4945(i)(2)). The tax imposed under section 4945(b)(1) is to be paid by the private foundation and is at the rate of 100 percent of the amount of each taxable expenditure.

(2) *Tax on foundation manager.* Section 4945(b)(2) of the Code imposes an excise tax in any case in which a tax is imposed under section 4945(b)(1) and a foundation manager has refused to agree to part or all of the correction of the taxable expenditure. The tax imposed under section 4945(b)(2) is at the rate of 50 percent of the amount of the taxable expenditure. This tax is to be paid by any foundation manager who has refused to agree to part or all of the correction of the taxable expenditure.

(c) *Special rules*—(1) *Joint and several liability.* In any case where more than one foundation manager is liable for tax imposed under section 4945 (a) (2) or (b)(2) with respect to the making of a taxable expenditure, all such foundation managers shall be jointly and severally liable for the tax imposed under such paragraph with respect to such taxable expenditure.

(2) *Limits on liability for management.* The maximum aggregate amount of tax collectible under section 4945(a)(2) from all foundation managers with respect to any one taxable expenditure shall be $5,000, and the maximum aggregate amount of tax collectible under section 4945(b) (2) from all foundation managers with respect to any one taxable expenditure shall be $10,000.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, B, and C comprise the board of directors of Foundation M. They vote unanimously in favor of a grant of $100,000 to D, a business associate of each of the directors. The grant is to be used by D for travel and educational purposes and is not made in accordance with the requirements of section 4945(g). Each director knows that D was selected as the recipient of the grant solely because of his friendship with the directors and is aware that some grants made for travel, study, or other similar purposes may be taxable expenditures. Also, none of the directors makes any attempt to consult counsel, or to otherwise determine, whether this grant is a taxable expenditure. Initial taxes are imposed under paragraphs (1) and (2) of section 4945(a). The tax to be paid by the foundation is $10,000 (10 percent of $100,000). The tax to be paid by the board of directors is $2,500 (2½

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percent of $100,000). A, B, and C are jointly and severally liable for this $2,500 and this sum may be collected by the Service from any one of them.

Example 2. Assume the same facts as in example (1). Further assume that within the taxable period A makes a motion to correct the taxable expenditure at a meeting of the board of directors. The motion is defeated by a two-to-one vote, A voting for the motion and B and C voting against it. In these circumstances an additional tax is imposed on the private foundation in the amount of $100,000 (100 percent of $100,000). The additional tax imposed on B and C is $10,000 (50 percent of $100,000 subject to a maximum of $10,000). B and C are jointly and severally liable for the $10,000, and this sum may be collected by the Service from either of them.

(d) *Correction*—(1) *In general.* Except as provided in paragraph (d) (2) or (3) of this paragraph, correction of a taxable expenditure shall be accomplished by recovering part or all of the expenditure to the extent recovery is possible, and, where full recovery cannot be accomplished, by any additional corrective action which the Commissioner may prescribe. Such additional corrective action is to be determined by the circumstances of each particular case and may include the following:

(i) Requiring that any unpaid funds due the grantee be withheld;

(ii) Requiring that no further grants be made to the particular grantee;

(iii) In addition to other reports that are required, requiring periodic (e.g., quarterly) reports from the foundation with respect to all expenditures of the foundation (such reports shall be equivalent in detail to the reports required by section 4945(h)(3) and § 53.4945–5(d));

(iv) Requiring improved methods of exercising expenditure responsibility;

(v) Requiring improved methods of selecting recipients of individual grants; and

(vi) Requiring such other measures as the Commissioner may prescribe in a particular case.

The foundation making the expenditure shall not be under any obligation to attempt to recover the expenditure by legal action if such action would in all probability not result in the satisfaction of execution on a judgment.

(2) *Correction for inadequate reporting.* If the expenditure is taxable only because of a failure to obtain a full and complete report as required by section 4945(h)(2) or because of a failure to make a full and detailed report as required by section 4945(h)(3), correction may be accomplished by obtaining or making the report in question. In addition, if the expenditure is taxable only because of a failure to obtain a full and complete report as required by section 4945(h)(2) and an investigation indicates that no grant funds have been diverted to any use not in furtherance of a purpose specified in the grant, correction may be accomplished by exerting all reasonable efforts to obtain the report in question and reporting the failure to the Internal Revenue Service, even though the report is not finally obtained.

(3) *Correction for failure to obtain advance approval.* Where an expenditure is taxable under section 4945(d)(3) only because of a failure to obtain advance approval of procedures with respect to grants as required by section 4945(g), correction may be accomplished by obtaining approval of the grant making procedures and establishing to the satisfaction of the Commissioner that:

(i) No grant funds have been diverted to any use not in furtherance of a purpose specified in the grant;

(ii) The grant making procedures instituted would have been approved if advance approval of such procedures had been properly requested; and

(iii) Where advance approval of grant making procedures is subsequently required, such approval will be properly requested.

(e) *Certain periods*—(1) *Taxable period.* For purposes of section 4945, the term ''taxable period'' means, with respect to any taxable expenditure, the period beginning with the date on which the taxable expenditure occurs and ending on the earlier of:

(i) The date of mailing of a notice of deficiency under section 6212 with respect to the tax imposed on taxable expenditures by section 4945(a)(1); or

(ii) The date on which the tax imposed by section 4945(a)(1) is assessed.

(2) *Cross reference.* For rules relating to taxable events that are corrected within the correction period, defined in

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section 4963(e), see section 4961(a) and the regulations thereunder.

[T.D. 7215, 37 FR 23161, Oct. 31, 1972, as amended by T.D. 7299, 38 FR 35305, Dec. 27, 1973; T.D. 7527, 42 FR 64625, Dec. 27, 1977; T.D. 8084, 51 FR 16303, May 2, 1986]

§53.4945–2 Propaganda influencing legislation.

(a) *Propaganda influencing legislation, etc.*—(1) *In general.* Under section 4945(d)(1) the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation to carry on propaganda, or otherwise to attempt, to influence legislation. An expenditure is an attempt to influence legislation if it is for a direct or grass roots lobbying communication, as defined in §56.4911–2 (without reference to §§56.4911–2(b)(3) and 56.4911–2(c)) and §56.4911–3. See, however, paragraph (d) of this section for exceptions to the general rule of this paragraph (a)(1).

(2) *Expenditures for membership communications.* Section 56.4911–5, which provides special rules for electing public charities' communications with their members, does not apply to private foundations. Thus, whether a private foundation's communications with its members (assuming it has any) are lobbying communications is determined solely under §56.4911–2 and without reference to §56.4911–5. However, where a private foundation makes a grant to an electing public charity, §56.4911–5 applies to the electing public charity's communications with its own members. Therefore, in the limited context of determining whether a private foundation's grant to an electing public charity is a taxable expenditure under section 4945, the §56.4911–5 membership rules apply. For example, if the grant is specifically earmarked for a communication from the electing public charity to its members and the communication is, because of §56.4911–5, a nonlobbying communication, the grant is not a taxable expenditure under section 4945.

(3) *Jointly funded projects.* A private foundation will not be treated as having paid or incurred any amount to attempt to influence legislation merely because it makes a grant to another organization upon the condition that the recipient obtain a matching support appropriation from a governmental body. In addition, a private foundation will not be treated as having made taxable expenditures of amounts paid or incurred in carrying on discussions with officials of governmental bodies provided that:

(i) The subject of such discussions is a program which is jointly funded by the foundation and the Government or is a new program which may be jointly funded by the foundation and the Government,

(ii) The discussions are undertaken for the purpose of exchanging data and information on the subject matter of the programs, and

(iii) Such discussions are not undertaken by foundation managers in order to make any direct attempt to persuade governmental officials or employees to take particular positions on specific legislative issues other than such program.

(4) *Certain expenditures by recipients of program-related investments.* Any amount paid or incurred by a recipient of a program-related investment (as defined in §53.4944–3) in connection with an appearance before, or communication with, any legislative body with respect to legislation or proposed legislation of direct interest to such recipient shall not be attributed to the investing foundation, if:

(i) The foundation does not earmark its funds to be used for any activities described in section 4945(d) (1) and

(ii) A deduction under section 162 is allowable to the recipient for such amount.

(5) *Grants to public organizations*—(i) *In general.* A grant by a private foundation to an organization described in section 509(a) (1), (2) or (3) does not constitute a taxable expenditure by the foundation under section 4945(d), other than under section 4945(d)(1), if the grant by the private foundation is not earmarked to be used for any activity described in section 4945(d) (2) or (5), is not earmarked to be used in a manner which would violate section 4945(d) (3) or (4), and there does not exist an agreement, oral or written, whereby the grantor foundation may cause the grantee to engage in any such prohibited activity or to select the recipient to which the grant is to be devoted.

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For purposes of this paragraph (a)(5)(i), a grant by a private foundation is earmarked if the grant is given pursuant to an agreement, oral or written, that the grant will be used for specific purposes. For the expenditure responsibility requirements with respect to organizations other than those described in section 509(a) (1), (2), or (3), see § 53.4945–5. For rules for determining whether grants to public charities are taxable expenditures under section 4945(d)(1), see paragraphs (a)(2), (a)(6) and (a)(7) of this section.

(ii) *Certain ''public'' organizations.* For purposes of this section, an organization shall be considered a section 509(a)(1) organization if it is treated as such under subparagraph (4) of § 53.4945–5(a).

(6) *Grants to public organizations that attempt to influence legislation*—(i) *General support grant.* A general support grant by a private foundation to the organization described in section 509(a) (1), (2), or (3) (a ''public charity'' for purposes of paragraphs (a) (6) and (7) of this section) does not constitute a taxable expenditure under section 4945(d)(1) to the extent that the grant is not earmarked, within the meaning of § 53.4945–2(a)(5)(i), to be used in an attempt to influence legislation. The preceding sentence applies without regard to whether the public charity has made the election under section 501(h).

(ii) *Specific project grant.* A grant, by a private foundation to fund a specific project of a public charity is not a taxable expenditure by the foundation under section 4945(d)(1) to the extent that—

(A) The grant is not earmarked, within the meaning of § 53.4945–2(a)(5)(i), to be used in an attempt to influence legislation, and

(B) The amount of the grant, together with other grants by the same private foundation for the same project for the same year, does not exceed the amount budgeted, for the year of the grant, by the grantee organization for activities of the project that are not attempts to influence legislation. If the grant is for more than one year, the preceding sentence applies to each year of the grant with the amount of the grant measured by the amount actually disbursed by the private foundation in each year or divided equally between years, at the option of the private foundation. The same method of measuring the annual amount must be used in all years of a grant. This paragraph (a)(6)(ii) applies without regard to whether the public charity has made the election under section 501(h).

(iii) *Reliance upon grantee's budget.* For purposes of determining the amount budgeted by a prospective grantee for specific project activities that are not attempts to influence legislation under paragraph (a)(6)(ii) of this section, a private foundation may rely on budget documents or other sufficient evidence supplied by the grantee organization (such as a signed statement by an authorized officer, director or trustee of such grantee organization) showing the proposed budget of the specific project, unless the private foundation doubts or, in light of all the facts and circumstances, reasonably should doubt the accuracy or reliability of the documents.

(7) *Grants to organizations that cease to be described in 501(c)(3)*—(i) *Not taxable expenditure; conditions.* A grant to a public charity (as defined in paragraph (a)(6)(i) of this section) that thereafter ceases to be an organization described in section 501(c)(3) by reason of its attempts to influence legislation is not a taxable expenditure if—

(A) The grant meets the requirements of paragraph (a)(6) of this section,

(B) The recipient organization had received a ruling or determination letter, or an advance ruling or determination letter, that it is described in sections 501(c)(3) and 509(a),

(C) Notice of a change in the recipient organization's status has not been made to the public (such as by publication in the Internal Revenue Bulletin), and the private foundation has not acquired knowledge that the Internal Revenue Service has given notice to the recipient organization that it will be deleted from such status; and

(D) The recipient organization is not controlled directly or indirectly by the private foundation. A recipient organization is controlled by a private foundation for this purpose if the private foundation and disqualified persons (defined in section 4946(a)(1) (A)

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through (H) with reference to the private foundation, by aggregating their votes or positions of authority, can cause or prevent action on legislative issues by the recipient.

(ii) *Examples*. The provisions of paragraphs (a)(6) and (a)(7) of this section are illustrated by the following examples:

Example 1. W, a private foundation, makes a general support grant to Z, a public charity described in section 509(a)(1). Z informs W that, as an insubstantial portion of its activities, Z attempts to influence the State legislature with regard to changes in the mental health laws. The use of the grant is not earmarked by W to be used in a manner that would violate section 4945(d)(1). Even if the grant is subsequently devoted by Z to its legislative activities, the grant by W is not a taxable expenditure under section 4945(d).

Example 2. X, a private foundation, makes a specific project grant to Y University for the purpose of conducting research on the potential environmental effects of certain pesticides. X does not earmark the grant for any purpose that would violate section 4945(d)(1) and there is no oral or written agreement or understanding whereby X may cause Y to engage in any activity described in section 4945(d) (1), (2), or (5), or to select any recipient to which the grant may be devoted. Further, X determines, based on budget information supplied by Y, that Y's budget for the project does not contain any amount for attempts to influence legislation. X has no reason to doubt the accuracy or reliability of the budget information. Y uses most of the funds for the research project; however, Y expends a portion of the grant funds to send a representative to testify at Congressional hearings on a specific bill proposing certain pesticide control measures. The portion of the grant funds expended with respect to the Congressional hearings is not treated as a taxable expenditure by X under section 4945(d)(1).

Example 3. M, a private foundation, makes a specific project grant of $150,000 to P, a public charity described in section 509(a)(1). In requesting the grant from M, P stated that the total budgeted cost of the project is $200,000, and that of this amount $20,000 is allocated to attempts to influence legislation related to the project. M relies on the budget figures provided by P in determining the amount P will spend on influencing legislation and M has no reason to doubt the accuracy or reliability of P's budget figures. In making the grant, M did not earmark any of the funds from the grant to be used for attempts to influence legislation. M's grant of $150,000 to P will not constitute a taxable expenditure under section 4945(d)(1) because M did not earmark any of the funds for attempts to influence legislation and because the amount of its grant ($150,000) does not exceed the amount allocated to specific project activities that are not attempts to influence legislation ($200,000 − $20,000 = $180,000).

Example 4. Assume the same facts as in example (3), except that M's grant letter to P provides that M has the right to renegotiate the terms of the grant if there is a substantial deviation from those terms. This additional fact does not make M's grant a taxable expenditure under section 4945(d)(1).

Example 5. Assume the same facts as in example (3), except that M made a specific project grant of $200,000 to P. Part of M's grant of $200,000 will constitute a taxable expenditure under section 4945(d)(1). The amount of the grant ($200,000) exceeds by $20,000 the amount P allocated to specific project activities that are not attempts to influence legislation ($180,000). M has made a taxable expenditure of $20,000.

Example 6. Assume the same facts as example (3), except that M made a specific project grant of $180,000, and received from P an enforceable commitment that grant funds would not be used in connection with attempts to influence legislation. M's grant is not a taxable expenditure under section 4945(d)(1).

Example 7. Assume the same facts as in example (3) except that M directed P to hire A, an individual, to expend $20,000 from the grant to engage in direct lobbying (within the meaning of §56.4911–2(b)) and grass roots lobbying (within the meaning of §56.4911–2(c)). P does not expend any other grant funds for lobbying activities. The $20,000 that is earmarked for direct lobbying and grass roots lobbying is a taxable expenditure under section 4945(d)(1).

Example 8. R, a public charity described in section 509(a)(1), requested N, a private foundation, to make a general purpose grant to it to aid R in carrying out its exempt purpose. In making this request, R notified N that it had elected the expenditure test under section 501(h) and that it expected to attempt to influence legislation in areas related to its exempt purpose. Since its formation, R generally has had exempt purpose expenditures (as defined in §56.4911–4) in excess of $7,000,000 in each of its taxable years, and has budgeted in excess of $7,000,000 of exempt purpose expenditures for the year of the grant. N made a grant of $200,000 to R. N did not earmark the funds for R's attempt to influence legislation. The general purpose grant by N does not constitute a taxable expenditure under section 4945(d)(1).

Example 9. Assume the same facts as in example (8), except that N learns that R has had excess lobbying expenditures (within the meaning of §56.4911–1(b)) in some prior years. N also learns that in no year has R's lobbying or grass roots expenditures (within the meaning of §56.4911–2 (a) and (c)) exceeded

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the corresponding ceiling amount (within the meaning of § 1.501(h)–3(c) (3) and (6)). N then makes the grant to R. After receiving the grant, R spends a large portion of its funds on influencing legislation and, as a consequence, is denied exemption from tax, as an organization described in section 501(c)(3), under section 501(h) and § 1.501(h)–3. No disqualified person with respect to N controlled, in whole or in part, R's attempts to influence legislation. The general purpose grant will not constitute a taxable expenditure under section 4945(d)(1).

Example 10. X, a private foundation, makes a specific project grant to Y, a public charity described in section 509(a). In requesting the grant, Y stated that it planned to use the funds to purchase a computer for purpose of computerizing its research files and that the grant will not be used to influence legislation. Two years after X makes the grant, X discovers that Y has also used the computer for purposes of maintaining and updating the mailing list for Y's lobbying newsletter. Because X did not earmark any of the grant funds to be used for attempts to influence legislation and because X had no reason to doubt the accuracy or reliability of Y's documents representing that the grant would not be used to influence legislation, X's grant is not treated as a taxable expenditure.

Example 11. G, a private foundation, makes a specific project grant of $300,000 to L, a public charity described in section 509(a)(1) for a three-year specific project studying child care problems. L provides budget material indicating that the specific project will expend $200,000 in each of three years. L's budget materials indicate that attempts to influence legislation will amount to $10,000 in the first year, $20,000 in the second year and $100,000 in the third year. G intends to pay its $300,000 grant over three years as follows: $200,000 in the first year, $50,000 in the second year and $50,000 in the third year. The amount of the grant actually disbursed by G in the first year of the grant exceeds the nonlobbying expenditures of L in that year. However, because the amount of the grant in each of the three years, when divided equally among the three years ($100,000 for each year), is not more than the nonlobbying expenditures of L on the specific project for any of the three years, none of the grant is treated as a taxable expenditure under section 4945(d)(1).

Example 12. P, a private foundation, makes a $120,000 specific project grant to C, a public charity described in section 509(a) for a three-year project. P intends to pay its grant to C in three equal annual installments of $40,000. C provides budget material indicating that the specific project will expend $100,000 in each of three years. C's budget materials, which P reasonably does not doubt, indicate that the project's attempts to influence legislation will amount to $50,000 in each of the three years. After P pays the first annual installment to C, but before P pays the second installment to C, reliable information comes to P's attention that C has spent $90,000 of the project's $100,000 first-year budget on attempts to influence legislation. This information causes P to doubt the accuracy and reliability of C's budget materials. Because of the information, P does not pay the second-year installment to C. P's payment of the first installment of $40,000 is not a taxable expenditure under section 4945(d)(1) because the grant in the first year is not more than the nonlobbying expenditures C projected in its budget materials that P reasonably did not doubt.

Example 13. Assume the same facts as in Example (12), except that P pays the second-year installment of $40,000 to C. In the project's second year, C once again spends $90,000 of the project's $100,000 annual budget in attempts to influence legislation. Because P doubts or reasonably should doubt the accuracy or reliability of C's budget materials when P makes the second-year grant payment, P may not rely upon C's budget documents at that time. Accordingly, although none of the $40,000 paid in the first installment is a taxable expenditure, only $10,000 ($100,000 minus $90,000) of the second-year grant payment is not a taxable expenditure. The remaining $30,000 of the second installment is a taxable expenditure within the meaning of section 4945(d)(1).

Example 14. B, a private foundation, makes a specific project grant to C, a public charity described in section 509(a), of $40,000 for the purpose of conducting a study on the effectiveness of seat belts in preventing traffic deaths. B did not earmark any of the grant for attempts to influence legislation. In requesting the grant from B, C submitted a budget of $100,000 for the project. The budget contained expenses for postage and mailing, computer time, advertising, consulting services, salaries, printing, advertising, and similar categories of expenses. C also submitted to B a statement, signed by an officer of C, that 30% of the budgeted funds would be devoted to attempts to influence legislation within the meaning of section 4945. B has no reason to doubt the accuracy of the budget figures or the statement. B may rely on the budget figures and signed statement provided by C in determining the amount C will spend on influencing legislation. B's grant to C will not constitute a taxable expenditure under section 4945(d)(1), because the amount of the grant does not exceed the amount allocated to specific project activities that are not attempts to influence legislation.

(b)–(c) [Reserved]

(d) *Exceptions*—(1) *Nonpartisan analysis, study, or research*—(i) *In general.* A communication is not a lobbying communication, for purposes of § 53.4945–

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2(a)(1), if the communication constitutes engaging in nonpartisan analysis, study or research and making available to the general public or a segment or members thereof or to governmental bodies, officials, or employees the results of such work. Accordingly, an expenditure for such a communication does not constitute a taxable expenditure under section 4945(d)(1) and § 53.4945–2(a)(1).

(ii) *Nonpartisan analysis, study, or research.* For purposes of section 4945(e), ''nonpartisan analysis, study, or research'' means an independent and objective exposition of a particular subject matter, including any activity that is ''educational'' within the meaning of § 1.501(c)(3)–1(d)(3). Thus, ''nonpartisan analysis, study, or research'' may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. On the other hand, the mere presentation of unsupported opinion does not qualify as ''nonpartisan analysis, study, or research''.

(iii) *Presentation as part of a series.* Normally, whether a publication or broadcast qualifies as ''nonpartisan analysis, study, or research'' will be determined on a presentation-by-presentation basis. However, if a publication or broadcast is one of a series prepared or supported by a private foundation and the series as a whole meets the standards of subdivision (ii) of this subparagraph, then any individual publication or broadcast within the series will not result in a taxable expenditure even though such individual broadcast or publication does not, by itself, meet the standards of subdivision (ii) of this subparagraph. Whether a broadcast or publication is considered part of a series will ordinarily depend on all the facts and circumstances of each particular situation. However, with respect to broadcast activities, all broadcasts within any period of 6 consecutive months will ordinarily be eligible to be considered as part of a series. If a private foundation times or channels a part of a series which is described in this subdivision in a manner designed to influence the general public or the action of a legislative body with respect to a specific legislative proposal in violation of section 4945(d)(1), the expenses of preparing and distributing such part of the analysis, study, or research will be a taxable expenditure under this section.

(iv) *Making available results of analysis, study, or research.* A private foundation may choose any suitable means, including oral or written presentations, to distribute the results of its nonpartisan analysis, study, or research, with or without charge. Such means include distribution of reprints of speeches, articles, and reports (including the report required under section 6056); presentation of information through conferences, meetings, and discussions; and dissemination to the news media, including radio, television, and newspapers, and to other public forums. For purposes of this paragraph (d)(1)(iv), such communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue.

(v) *Subsequent lobbying use of certain analysis, study, or research*—(A) *In general.* Even though certain analysis, study or research is initially within the exception for nonpartisan analysis, study, or research, subsequent use of that analysis, study or research for grass roots lobbying may cause that analysis, study or research to be treated as a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study, or research. This paragraph (d)(1)(v) of this section does not cause any analysis, study, or research to be considered a direct lobbying communication. For rules regarding when analysis, study, or research is treated as a grass roots lobbying communication that is not within the scope of the exception for nonpartisan analysis, study, or research, see § 56.4911–2(b)(2)(v).

(B) *Special rule for grants to public charities.* This paragraph (d)(1)(v)(B) of this section applies where a public charity uses a private foundation grant to finance, in whole or in part, a nonlobbying communication that is subsequently used in lobbying, causing the public charity's expenditures for the

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communication to be treated as lobbying expenditures under the subsequent use. In such a case, the private foundation's grant will ordinarily not be characterized as a lobbying expenditure by virtue of the subsequent use rule. The only situations where the private foundation's grant will be treated as a lobbying expenditure under the subsequent use rule are where the private foundation's primary purpose in making the grant to the public charity was for lobbying or where, at the time of making the grant, the private foundation knows (or in light of all the facts and circumstances reasonably should know) that the public charity's primary purpose in preparing the communication to be funded by the grant is for use in lobbying.

(vi) *Directly encouraging action by recipients of a communication.* A communication that reflects a view on specific legislation is not within the nonpartisan analysis, study, or research exception of this § 53.4945–2(d)(1) if the communication directly encourages the recipient to take action with respect to such legislation. For purposes of this section, a communication directly encourages the recipient to take action with respect to legislation if the communication is described in one or more of § 56.4911–2(b)(2)(iii)(A) through (C). As described in § 56.4911–2(b)(2)(iv), a communication would encourage the recipient to take action with respect to legislation, but not *directly* encourage such action, if the communication does no more than specifically identify one or more legislators who will vote on the legislation as: opposing the communication's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation.

(vii) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. M, a private foundation, establishes a research project to collect information for the purpose of showing the dangers of the use of pesticides in raising crops. The information collected includes data with respect to proposed legislation, pending before several State legislatures, which would ban the use of pesticides. The project takes favorable positions on such legislation without producing a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion on the pros and cons of the use of pesticides. This project is not within the exception for nonpartisan analysis, study, or research because it is designed to present information merely on one side of the legislative controversy.

Example 2. N, a private foundation, establishes a research project to collect information concerning the dangers of the use of pesticides in raising crops for the ostensible purpose of examining and reporting information as to the pros and cons of the use of pesticides in raising crops. The information is collected and distributed in the form of a published report which analyzes the effects and costs of the use and nonuse of various pesticides under various conditions on humans, animals, and crops. The report also presents the advantages, disadvantages, and economic cost of allowing the continued use of pesticides unabated, of controlling the use of pesticides, and of developing alternatives to pesticides. Even if the report sets forth conclusions that the disadvantages as a result of using pesticides are greater than the advantages of using pesticides and that prompt legislative regulation of the use of pesticides is needed, the project is within the exception for nonpartisan analysis, study or research since it is designed to present information on both sides of the legislative controversy and presents a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion.

Example 3. O, a private foundation, establishes a research project to collect information on the presence or absence of disease in humans from eating food grown with pesticides and the presence or absence of disease in humans from eating food not grown with pesticides. As part of the research project, O hires a consultant who prepares a ''fact sheet'' which calls for the curtailment of the use of pesticides and which addresses itself to the merits of several specific legislative proposals to curtail the use of pesticides in raising crops which are currently pending before State legislatures. The ''fact sheet'' presents reports of experimental evidence tending to support its conclusions but omits any reference to reports of experimental evidence tending to dispute its conclusions. O distributes 10,000 copies to citizens' groups. Expenditures by O in connection with this work of the consultant are not within the exception for nonpartisan analysis, study, or research.

Example 4. P publishes a bi-monthly newsletter to collect and report all published materials, ongoing research, and new developments with regard to the use of pesticides in raising crops. The newsletter also includes notices of proposed pesticide legislation with

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impartial summaries of the provisions and debates on such legislation. The newsletter does not encourage recipients to take action with respect to such legislation, but is designed to present information on both sides of the legislative controversy and does present information fully and fairly. It is within the exception for nonpartisan analysis, study, or research.

Example 5. X is satisfied that A, a member of the faculty of Y University, is exceptionally well qualified to undertake a project involving a comprehensive study of the effects of pesticides on crop yields. Consequently, X makes a grant to A to underwrite the cost of the study and of the preparation of a book on the effect of pesticides on crop yields. X does not take any position on the issues or control the content of A's output. A produces a book which concludes that the use of pesticides often has a favorable effect on crop yields, and on that basis argues against pending bills which would ban the use of pesticides. A's book contains a sufficiently full and fair exposition of the pertinent facts, including known or potential disadvantages of the use of pesticides, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. The book does not directly encourage readers to take action with respect to the pending bills. Consequently, the book is within the exception for nonpartisan analysis, study, or research.

Example 6. Assume the same facts as Example (2), except that, instead of issuing a report, X presents within a period of 6 consecutive months a two-program television series relating to the pesticide issue. The first program contains information, arguments, and conclusions favoring legislation to restrict the use of pesticides. The second program contains information, arguments, and conclusions opposing legislation to restrict the use of pesticides. The programs are broadcast within 6 months of each other during commensurate periods of prime time. X's programs are within the exception for nonpartisan analysis, study, or research. Although neither program individually could be regarded as nonpartisan, the series of two programs constitutes a balanced presentation.

Example 7. Assume the same facts as Example (6), except that X arranged for televising the program favoring legislation to restrict the use of pesticides at 8 p.m. on a Thursday evening and for televising the program opposing such legislation at 7 a.m. on a Sunday morning. X's presentation is not within the exception for nonpartisan analysis, study, or research, since X disseminated its information in a manner prejudicial to one side of the legislative controversy.

Example 8. Organization Z researches, writes, prints and distributes a study on the use and effects of pesticide X. A bill is pending in the U.S. Senate to ban the use of pesticide X. Z's study leads to the conclusion that pesticide X is extremely harmful and that the bill pending in the U.S. Senate is an appropriate and much needed remedy to solve the problems caused by pesticide X. The study contains a sufficiently full and fair exposition of the pertinent facts, including known or potential advantages of the use of pesticide X, to enable the public or an individual to form an independent opinion or conclusion as to whether pesticides should be banned as provided in the pending bills. In its analysis of the pending bill, the study names certain undecided Senators on the Senate committee considering the bill. Although the study meets the three part test for determining whether a communication is a grass roots lobbying communication, the study is within the exception for nonpartisan analysis, study or research, because it does not directly encourage recipients of the communication to urge a legislator to oppose the bill.

Example 9. Assume the same facts as in Example (8), except that, after stating support for the pending bill, the study concludes: ''You should write to the undecided committee members to support this crucial bill.'' The study is not within the exception for nonpartisan analysis, study or research because it directly encourages the recipients to urge a legislator to support a specific piece of legislation.

Example 10. Organization X plans to conduct a lobbying campaign with respect to illegal drug use in the United States. It incurs $5,000 in expenses to conduct research and prepare an extensive report primarily for use in the lobbying campaign. Although the detailed report discusses specific pending legislation and reaches the conclusion that the legislation would reduce illegal drug use, the report contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent conclusion regarding the effect of the legislation. The report does not encourage readers to contact legislators regarding the legislation. Accordingly, the report does not, in and of itself, constitute a lobbying communication.

Copies of the report are available to the public at X's office, but X does not actively distribute the report or otherwise seek to make the contents of the report available to the general public. Whether or not X's distribution is sufficient to meet the requirement in § 53.4945–2(d)(1)(iv) that a nonpartisan communication be made available, X's distribution is not substantial (for purposes of §§ 53.4945–2(D)(1)(v) and 56.4911–2(b)(2)(v)) in light of all of the facts and circumstances, including the normal distribution pattern of similar nonpartisan reports. X then mails copies of the report, along with

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a letter, to 10,000 individuals on X's mailing list. In the letter, X requests that individuals contact legislators urging passage of the legislation discussed in the report. Because X's research and report were primarily undertaken by X for lobbying purposes and X did not make a substantial distribution of the report (without an accompanying lobbying message) prior to or contemporaneously with the use of the report in lobbying, the report is a grass roots lobbying communication that is not within the exception for nonpartisan analysis, study or research. Thus, the expenditures for preparing and mailing both the report and the letter are taxable expenditures under section 4945.

Example 11. Assume the same facts as in Example (10), except that before using the report in the lobbying campaign, X sends the research and report (without an accompanying lobbying message) to universities and newspapers. At the same time, X also advertises the availability of the report in its newsletter. This distribution is similar in scope to the normal distribution pattern of similar nonpartisan reports. In light of all of the facts and circumstances, X's distribution of the report is substantial. Because of X's substantial distribution of the report, X's primary purpose will be considered to be other than for use in lobbying and the report will not be considered a grass roots lobbying communication. Accordingly, only the expenditures for copying and mailing the report to the 10,000 individuals on X's mailing list, as well as for preparing and mailing the letter, are expenditures for grass roots lobbying communications, and are thus taxable expenditures under section 4945.

Example 12. Organization M pays for a bumper sticker that reads: ''STOP ABORTION: Vote *NO* on Prop. X!'' M also pays for a 30-second television advertisement and a billboard that similarly advocate opposition to Prop. X. In light of the limited scope of the communications, none of the communications is within the exception for nonpartisan analysis, study or research. First, none of the communications rises to the level of analysis, study or research. Second, none of the communications is nonpartisan because none contains a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. Thus, each communication is a lobbying communication.

(2) *Technical advice or assistance*—(i) *In general.* Amounts paid or incurred in connection with providing technical advice or assistance to a governmental body, a governmental committee, or a subdivision of either of the foregoing, in response to a written request by such body, committee, or subdivision do not constitute taxable expenditures for purposes of this section. Under this exception, the request for assistance or advice must be made in the name of the requesting governmental body, committee or subdivision rather than an individual member thereof. Similarly, the response to such request must be available to every member of the requesting body, committee or subdivision. For example, in the case of a written response to a request for technical advice or assistance from a congressional committee, the response will be considered available to every member of the requesting committee if the response is submitted to the person making such request in the name of the committee and it is made clear that the response is for the use of all the members of the committee.

(ii) *Nature of technical advice or assistance.* ''Technical advice or assistance'' may be given as a result of knowledge or skill in a given area. Because such assistance or advice may be given only at the express request of a governmental body, committee or subdivision, the oral or written presentation of such assistance or advice need not qualify as nonpartisan analysis, study or research. The offering of opinions or recommendations will ordinarily qualify under this exception only if such opinions or recommendations are specifically requested by the governmental body, committee or subdivision or are directly related to the materials so requested.

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

Example 1. A congressional committee is studying the feasibility of legislation to provide funds for scholarships to U.S. students attending schools abroad. X, a private foundation which has engaged in a private scholarship program of this type, is asked, in writing, by the committee to describe the manner in which it selects candidates for its program. X's response disclosing its methods of selection constitutes technical advice or assistance.

Example 2. Assume the same facts as Example (1), except that X's response not only includes a description of its own grant-making procedures, but also its views regarding the wisdom of adopting such a program. Since such views are directly related to the subject matter of the request for technical advice or assistance, expenditures paid or incurred

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with respect to the presentation of such views would not constitute taxable expenditures. However, expenditures paid or incurred with respect to a response which is not directly related to the subject matter of the request for technical advice or assistance would constitute taxable expenditures unless the presentation can qualify as the making available of nonpartisan analysis, study or research.

Example 3. Assume the same facts as Example (1), except that X is requested, in addition, to give any views it considers relevant. A response to this request giving opinions which are relevant to the committee's consideration of the scholarship program but which are not necessarily directly related to X's scholarship program, such as discussions of alternative scholarships programs and their relative merits, would qualify as ''technical advice or assistance'', and expenditures paid or incurred with respect to such response would not constitute taxable expenditures.

Example 4. A, an official of the State Department, makes a written request in his official capacity for information from foundation Y relating to the economic development of country M and for the opinions of Y as to the proper position of the United States in pending negotiations with M concerning a proposed treaty involving a program of economic and technical aid to M. Y's furnishing of such information and opinions constitutes technical advice or assistance.

Example 5. In response to a telephone inquiry from Senator X's staff, organization B sends Senator X a report concluding that the Senate should not advise and consent to the nomination of Z to serve as a Supreme Court Justice. Because the request was not in writing, and also because the request was not from the Senate itself or from a committee or subcommittee, B's report is not within the scope of the exception for responses to requests for technical advice. Accordingly, B's report is a lobbying communication unless the report is within the scope of the exception for nonpartisan analysis, study or research.

Example 6. Assume the same facts as in Example (5), except that B's report is sent in response to a written request that Senator X sends to B. The request from Senator X is a request from the Senator as an individual member of the Senate rather than from the Senate itself or from a committee or subcommittee. Accordingly, B's report is not within the scope of the exception for responses to requests for technical advice and is a lobbying conmmunication unless the report is within the scope of the exception for nonpartisan analysis, study or research.

Example 7. Assume the same facts as in Example (6), except that B's report is sent in response to a written request from the Senate committee that is considering the nomination for an evaluation of the nominee's legal writings and a recommendation as to whether the candidate is or is not qualified to serve on the Supreme Court. The report is within the scope of the exception for responses to requests for technical advice and is not a lobbying communication.

(3) *Decisions affecting the powers, duties, etc., of a private foundation*—(i) *In general.* Paragraph (c) of this section does not apply to any amount paid or incurred in connection with an appearance before, or communication with, any legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deductibility of contributions to such foundation. Under this exception, a foundation may communicate with the entire legislative body, committees or subcommittees of such legislative body, individual congressmen or legislators, members of their staffs, or representatives of the executive branch, who are involved in the legislative process, if such communication is limited to the prescribed subjects. Similarly, the foundation may make expenditures in order to initiate legislation if such legislation concerns only matters which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deductibility of contributions to such foundation.

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A bill is being considered by Congress which would, if enacted, restrict the power of a private foundation to engage in transactions with certain related persons. Under the proposed bill a private foundation would lose its exemption from taxation if it engages in such transactions. W, a private foundation, writes to the congressional committee considering the bill, arguing that the enactment of such a bill would not be advisable, and subsequently appears before such committee to make its arguments. In addition, W requests that the congressional committee consider modification of the 2 percent de minimis rule of section 4943(c) (2) (C). Expenditures paid or incurred with respect to such submissions do not constitute taxable expenditures since they are made with respect to a possible decision of Congress which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation.

Example 2. A bill being considered in a State legislature is designed to implement the requirements of section 508(e) of the Internal Revenue Code of 1954. Under such section, a private foundation is required to make certain amendments to its governing instrument. X, a private foundation, makes a submission to the legislature which proposes alternative measures which might be taken in lieu of the proposed bill. X also arranges to have its president contact certain State legislators with regard to this bill. Expenditures paid or incurred in making such submission and in contacting the State legislators do not constitute taxable expenditures since they are made with respect to a possible decision of such State legislature which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation.

Example 3. A bill is being considered by a State legislature under which the State would assume certain responsibilities for nursing care of the aged. Y, a private foundation which hitherto has engaged in such activities, appears before the State legislature and contends that such activities can be better performed by privately supported organizations. Expenditures paid or incurred with respect to such appearance are not made with respect to possible decisions of the State legislature which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation, but rather merely affect the scope of the private foundation's future activities.

Example 4. A State legislature is considering the annual appropriations bill. Z, a private foundation which had hitherto performed contract research for the State, appears before the appropriations committee in order to attempt to persuade the committee of the advisability of continuing the program. Expenditures paid or incurred with respect to such appearance are not made with respect to possible decisions of the State legislature which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation, but rather merely affect the scope of the private foundation's future activities.

(4) *Examination and discussions of broad social, economic, and similar problems.* Examinations and discussions of broad social, economic, and similar problems are neither direct lobbying communications under § 56.4911–2(b)(1) nor grass roots lobbying communications under § 56.4911–2(b)(2) even if the problems are of the type with which government would be expected to deal ultimately. Thus, under §§ 56.4911–2(b) (1) and (2), lobbying communications do not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as such discussion does not directly encourage recipients to take action with respect to legislation. For example, this paragraph (d)(4) excludes from grass roots lobbying under § 56.4911(b)(2) an organization's discussions of problems such as environmental pollution or population growth that are being considered by Congress and various State legislatures, but only where the discussions are not directly addressed to specific legislation being considered, and only where the discussions do not directly encourage recipients of the communication to contact a legislator, an employee of a legislative body, or a government official or employee who may participate in the formulation of legislation.

[T.D. 7215, 37 FR 23161, Oct. 31, 1972; 37 FR 23918, Nov. 11, 1972, as amended by T.D. 8308, 55 FR 35594, Aug. 31, 1990]

§ 53.4945–3 Influencing elections and carrying on voter registration drives.

(a) *Expenditures to influence elections or carry on voter registration drives*—(1) *In general.* Under section 4945(d) (2), the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive, unless such amount is paid or incurred by an organization described in section 4945(f). However, for treatment of nonearmarked grants to public organizations, see § 53.4945–2(a) (5) and for treatment of certain earmarked grants to organizations described in section 4945(f), see paragraph (b) (2) of this section.

(2) *Influencing the outcome of a specific public election.* For purposes of this section, an organization shall be considered to be influencing the outcome of

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any specific public election if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. The term *candidate for public office* means an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, State or local. Activities which constitute participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to:

(i) Publishing or distributing written or printed statements or making oral statements on behalf of or in opposition to such a candidate;

(ii) Paying salaries or expenses of campaign workers; and

(iii) Conducting or paying the expenses of conducting a voter-registration drive limited to the geographic area covered by the campaign.

(b) *Nonpartisan activities carried on by certain organizations*—(1) *In general.* If an organization meets the requirements described in section 4945(f), an amount paid or incurred by such organization shall not be considered a taxable expenditure even though the use of such amount is otherwise described in section 4945(d) (2). Such requirements are:

(i) The organization is described in section 501(c) (3) and exempt from taxation under section 501(a);

(ii) The activities of the organization are nonpartisan, are not confined to one specific election period, and are carried on in five or more States;

(iii) The organization expends at least 85 percent of its income directly for the active conduct (within the meaning of section 4942(j) (3) and the regulations thereunder) of the activities constituting the purpose or function for which it is organized and operated;

(iv) The organization receives at least 85 percent of its support (other than gross investment income as defined in section 509(e)) from exempt organizations, the general public, governmental units described in section 170(c) (1), or any combination of the foregoing; the organization does not receive more than 25 percent of its support (other than gross investment income) from any one exempt organization (for this purpose treating private foundations which are described in section 4946(a) (1) (H) with respect to each other as one exempt organization); and not more than half of the support of the organization is received from gross investment income; and

(v) Contributions to the organization for voter registration drives are not subject to conditions that they may be used only in specified States, possessions of the United States, or political subdivisions or other areas of any of the foregoing, or the District of Columbia, or that they may be used in only one specific election period.

(2) *Grants to section 4945(f) organizations.* If a private foundation makes a grant to an organization described in section 4945(f) (whether or not such grantee is a private foundation as defined in section 509(a)), such grant will not be treated as a taxable expenditure under section 4945(d) (2) or (4). Even if a grant to such an organization is earmarked for voter registration purposes generally, such a grant will not be treated as a taxable expenditure under section 4945(d) (2) or (4) as long as such earmarking does not violate section 4945(f) (5).

(3) *Period for determining support*—(i) *In general.* The determination whether an organization meets the support test in section 4945(f) (4) for any taxable year is to be made by aggregating all amounts of support received by the organization during the taxable year and the immediately preceding four taxable years. However, the support received in any taxable year which begins before January 1, 1970, shall be excluded.

(ii) *New organizations and organizations with no preceding taxable years beginning after December 31, 1969.* Except as provided in subparagraph (4) of this paragraph, in the case of a new organization or an organization with no taxable years that begin after December 31, 1969, and immediately precede the taxable year in question, the requirements of the support test in section 4945(f)(4) will be considered as met for the taxable year if such requirements are met by the end of the taxable year.

(iii) *Organization with three or fewer preceding taxable years.* In the case of an

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organization which has been in existence for at least 1 but fewer than 4 preceding taxable years beginning after December 31, 1969, the determination whether such organization meets the requirements of the support test in section 4945(f)(4) for the taxable year is to be made by taking into account all the support received by such organization during the taxable year and during each preceding taxable year beginning after December 31, 1969.

(4) *Advance rulings*. An organization will be given an advance ruling that it is an organization described in section 4945(f) for its first taxable year of operation beginning after October 30, 1972, or for its first taxable year of operation beginning after December 31, 1969, if it submits evidence establishing that it can reasonably be expected to meet the tests under section 4945(f) for such taxable year. An organization which, pursuant to this subparagraph, has been treated as an organization described in section 4945(f) for a taxable year (without withdrawal of such treatment by notification from the Internal Revenue Service during such year), but which actually fails to meet the requirements of section 4945(f) for such taxable year, will not be treated as an organization described in section 4945(f) as of the first day of its next taxable year (for purposes of making any determination under the internal revenue laws with respect to such organization) and until such time as the organization does meet the requirements of section 4945(f). For purposes of section 4945, the status of grants or contributions with respect to grantors or contributors to such organization will not be affected until notice of change of status of such organization is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or was aware of, the fact that the organization did not satisfy section 4945(f) at the end of the taxable year with respect to which the organization had obtained an advance ruling or a determination letter that it was a section 4945(f) organization, or acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from classification as a section 4945(f) organization.

[T.D. 7215, 37 FR 23161, Oct. 31, 1972; 37 FR 23918, Nov. 11, 1972]

§ 53.4945–4 Grants to individuals.

(a) *Grants to individuals*—(1) *In general*. Under section 4945(d) (3) the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes by such individual unless the grant satisfies the requirements of section 4945(g). Grants to individuals which are not taxable expenditures because made in accordance with the requirements of section 4945(g) may result in the imposition of excise taxes under other provisions of chapter 42.

(2) *''Grants'' defined*. For purposes of section 4945, the term ''grants'' shall include, but is not limited to, such expenditures as scholarships, fellowships, internships, prizes, and awards. Grants shall also include loans for purposes described in section 170(c) (2) (B) and ''program related investments'' (such as investments in small businesses in central cities or in businesses which assist in neighborhood renovation). Similarly, ''grants'' include such expenditures as payments to exempt organizations to be used in furtherance of such recipient organizations' exempt purposes whether or not such payments are solicited by such recipient organizations. Conversely, ''grants'' do not ordinarily include salaries or other compensation to employees. For example, ''grants'' do not ordinarily include educational payments to employees which are includible in the employees' incomes pursuant to section 61. In addition, ''grants'' do not ordinarily include payments (including salaries, consultants' fees and reimbursement for travel expenses such as transportation, board, and lodging) to persons (regardless of whether such persons are individuals) for personal services in assisting a foundation in planning, evaluating or developing projects or areas of program activity by consulting, advising, or participating in conferences organized by the foundation.

(3) *Requirements for individual grants*—(i) *Grants for other than section 4945(d)(3) purposes*. A grant to an individual for

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purposes other than those described in section 4945(d) (3) is not a taxable expenditure within the meaning of section 4945(d) (3). For example, if a foundation makes grants to indigent individuals to enable them to purchase furniture, such grants are not taxable expenditures within the meaning of section 4945(d) (3) even if the requirements of section 4945(g) are not met.

(ii) *Grants for section 4945(d) (3) purposes.* Under section 4945(g), a grant to an individual for travel, study, or other similar purposes is not a ''taxable expenditure'' only if:

(*a*) The grant is awarded on an objective and nondiscriminatory basis (within the meaning of paragraph (b) of this section);

(*b*) The grant is made pursuant to a procedure approved in advance by the Commissioner; and

(*c*) It is demonstrated to the satisfaction of the Commissioner that:

(*1*) The grant constitutes a scholarship or fellowship grant which is excluded from gross income under section 117(a) and is to be utilized for study at an educational institution described in section 151(e) (4);

(*2*) The grant constitutes a prize or award which is excluded from gross income under section 74(b), and the recipient of such prize or award is selected from the general public (within the meaning of section 4941(d) (2) (G) (i) and the regulations thereunder); or

(*3*) The purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.

If a grant is made to an individual for a purpose described in section 4945(g) (3) and such grant otherwise meets the requirements of section 4945(g), such grant shall not be treated as a taxable expenditure even if it is a scholarship or a fellowship grant which is not excludable from income under section 117 or if it is a prize or award which is includible in income under section 74.

(iii) *Renewals.* A renewal of a grant which satisfied the requirements of subdivision (ii) of this subparagraph shall not be treated as a grant to an individual which is subject to the requirements of this section, if:

(*a*) The grantor has no information indicating that the original grant is being used for any purpose other than that for which it was made,

(*b*) Any reports due at the time of the renewal decision pursuant to the terms of the original grant have been furnished, and

(*c*) Any additional criteria and procedures for renewal are objective and nondiscriminatory.

For purposes of this section, an extension of the period over which a grant is to be paid shall not itself be regarded as a grant or a renewal of a grant.

(4) *Certain designated grants*—(i) *In general.* A grant by a private foundation to another organization, which the grantee organization uses to make payments to an individual for purposes described in section 4945(d)(3), shall not be regarded as a grant by the private foundation to the individual grantee if the foundation does not earmark the use of the grant for any named individual and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the individual grantee by the grantee organization. For purposes of this subparagraph, a grant described herein shall not be regarded as a grant by the foundation to an individual grantee even though such foundation has reason to believe that certain individuals would derive benefits from such grant so long as the grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation.

(ii) *Certain grants to ''public charities''.* A grant by a private foundation to an organization described in section 509(a) (1), (2), or (3), which the grantee organization uses to make payments to an individual for purposes described in section 4945(d)(3), shall not be regarded as a grant by the private foundation to the individual grantee (regardless of the application of subdivision (i) of this subparagraph) if the grant is made for a project which is to be undertaken under the supervision of the section 509(a) (1), (2), or (3) organization and such grantee organization controls the selection of the individual grantee.

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This subdivision shall apply regardless of whether the name of the individual grantee was first proposed by the private foundation, but only if there is an objective manifestation of the section 509(a), (1), (2), or (3) organization's control over the selection process, although the selection need not be made completely independently of the private foundation. For purposes of this subdivision, an organization shall be considered a section 509(a)(1) organization if it is treated as such under subparagraph (4) of § 53.4945–5(a).

(iii) *Grants to governmental agencies.* If a private foundation makes a grant to an organization described in section 170(c)(1) (regardless of whether it is described in section 501(c)(3)) and such grant is earmarked for use by an individual for purposes described in section 4945(d)(3), such grant is not subject to the requirements of section 4945(d)(3) and (g) and this section (regardless of the application of subdivision (i) of this subparagraph) if the section 170(c)(1) organization satisfies the Commissioner in advance that its grant-making program:

(*a*) Is in furtherance of a purpose described in section 170(c)(2)(B),

(*b*) Requires that the individual grantee submit reports to it which would satisfy paragraph (c)(3) of this section, and

(*c*) Requires that the organization investigate jeopardized grants in a manner substantially similar to that described in paragraph (c)(4) of this section.

(iv) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. M, a university described in section 170(b)(1)(A)(ii), requests that P, a private foundation, grant it $100,000 to enable M to obtain the services of a particular scientist for a research project in a special field of biochemistry in which he has exceptional qualifications and competence. P, after determining that the project deserves support, makes the grant to M to enable it to obtain the services of this scientist. M is authorized to keep the funds even if it is unsuccessful in attempting to employ the scientist. Under these circumstances P will not be treated as having made a grant to the individual scientist for purposes of section 4945(d)(3) and (g), since the requirements of subdivision (i) of this subparagraph have been satisfied. Even if M were not authorized to keep the funds if it is unsuccessful in attempting to employ the scientist, P would not be treated as having made a grant to the individual scientist for purposes of section 4945(d)(3) and (g), since it is clear from the facts and circumstances that the selection of the particular scientist was made by M and thus the requirements of subdivision (ii) of this subparagraph would have been satisfied.

Example 2. Assume the same facts as Example (1), except that there are a number of scientists who are qualified to administer the research project, P suggests the name of the particular scientist to be employed by M, and M is not authorized to keep the funds if it is unsuccessful in attempting to employ the particular scientist. For purposes of section 4945(d)(3) and (g), P will be treated as having made a grant to the individual scientist whose name it suggested, since it is clear from the facts and circumstances that selection of the particular scientist was made by P.

Example 3. X, a private foundation, is aware of the exceptional research facilities at Y University, an organization described in section 170(b)(1)(A)(ii). Officials of X approach officials of Y with an offer to give Y a grant of $100,000 if Y will engage an adequately qualified physicist to conduct a specific research project. Y's officials accept this proposal, and it is agreed that Y will administer the funds. After examining the qualifications of several research physicists, the officials of Y agree that A, whose name was first suggested by officials of X and who first suggested the specific research project to X, is uniquely qualified to conduct the project. X's grant letter provides that X has the right to renegotiate the terms of the grant if there is a substantial deviation from such terms, such as breakdown of Y's research facilities or termination of the conduct of the project by an adequately qualified physicist. Under these circumstances, X will not be treated as having made a grant to A for purposes of section 4945(d)(3) and (g), since the requirements of subdivision (ii) of this subparagraph have been satisfied.

Example 4. Professor A, a scholar employed by University Y, an organization described in section 170(b)(1)(A)(ii), approaches Foundation X to determine the availability of grant funds for a particular research project supervised or conducted by Professor A relevant to the program interests of Foundation X. After learning that Foundation X would be willing to consider the project if University Y were to submit the project to X, Professor A submits his proposal to the appropriate administrator of University Y. After making a determination that it should assume responsibility for the project, that Professor A is qualified to conduct the project, and that his participation would be consistent with his other faculty duties, University Y formally adopts the grant proposal

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and submits it to Foundation X. The grant is made to University Y which, under the terms of the grant, is responsible for the expenditure of the grant funds and the grant project. In such a case, and even if Foundation X retains the right to renegotiate the terms of the grant if the project ceases to be conducted by Professor A, the grant shall not be regarded as a grant by Foundation X to Professor A since University Y has retained control over the selection process within the meaning of subdivision (ii) of this subparagraph.

(5) *Earmarked grants to individuals.* A grant by a private foundation to an individual, which meets the requirements of section 4945(d)(3) and (g), is a taxable expenditure by such foundation under section 4945(d) only if:

(i) The grant is earmarked to be used for any activity described in section 4945(d) (1), (2), or (5), or is earmarked to be used in a manner which would violate section 4945(d) (3) or (4),

(ii) There is an agreement, oral or written, whereby such grantor foundation may cause the grantee to engage in any such prohibited activity and such grant is in fact used in a manner which violates section 4945(d), or

(iii) The grant is made for a purpose other than a purpose described in section 170(c)(2)(B).

For purposes of this subparagraph, a grant by a private foundation is earmarked if such grant is given pursuant to an agreement, oral or written, that the grant will be used for specific purposes.

(b) *Selection of grantees on ''an objective and nondiscriminatory basis''*—(1) *In general.* For purposes of this section, in order for a foundation to establish that its grants to individuals are made on an objective and nondiscriminatory basis, the grants must be awarded in accordance with a program which, if it were a substantial part of the foundation's activities, would be consistent with:

(i) The existence of the foundation's exempt status under section 501(c)(3);

(ii) The allowance of deductions to individuals under section 170 for contributions to the granting foundation; and

(iii) The requirements of subparagraphs (2), (3), and (4) of this paragraph.

(2) *Candidates for grants.* Ordinarily, selection of grantees on an objective and nondiscriminatory basis requires that the group from which grantees are selected be chosen on the basis of criteria reasonably related to the purposes of the grant. Furthermore, the group must be sufficiently broad so that the giving of grants to members of such group would be considered to fulfill a purpose described in section 170(c)(2)(B). Thus, ordinarily the group must be sufficiently large to constitute a charitable class. However, selection from a group is not necessary where taking into account the purposes of the grant, one or several persons are selected because they are exceptionally qualified to carry out these purposes or it is otherwise evident that the selection is particularly calculated to effectuate the charitable purpose of the grant rather than to benefit particular persons or a particular class of persons. Therefore, consistent with the requirements of this subparagraph, the foundation may impose reasonable restrictions on the group of potential grantees. For example, selection of a qualified research scientist to work on a particular project does not violate the requirements of section 4945(d)(3) merely because the foundation selects him from a group of three scientists who are experts in that field.

(3) *Selection from within group of potential grantees.* The criteria used in selecting grant recipients from the potential grantees should be related to the purpose of the grant. Thus, for example, proper criteria for selecting scholarship recipients might include (but are not limited to) the following: Prior academic performance; performance on tests designed to measure ability and aptitude for college work; recommendations from instructors; financial need; and the conclusions which the selection committee might draw from a personal interview as to the individual's motivation, character, ability, and potential.

(4) *Persons making selections.* The person or group of persons who select recipients of grants should not be in a position to derive a private benefit, directly or indirectly, if certain potential grantees are selected over others.

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(5) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. X company employs 100,000 people of whom 1,000 are classified by the company as executives. The company has organized the X company foundation which, as its sole activity, provides 100 4-year college scholarships per year for children of the company's employees. Children of all employees (other than disqualified persons with respect to the foundation) who have worked for the X company for at least 2 years are eligible to apply for these scholarships. In previous years, the number of children eligible to apply for such scholarships has averaged 2,000 per year. Selection of scholarship recipients from among the applicants is made by three prominent educators, who have no connection (other than as members of the selection committee) with the company, the foundation or any of the employees of the company. The selections are made on the basis of the applicants' prior academic performance, performance on certain tests designed to measure ability and aptitude for college work, and financial need. No disproportionate number of scholarships has been granted to relatives of executives of X company. Under these circumstances, the operation of the scholarship program by the X company foundation: (1) Is consistent with the existence of the foundation's exempt status under section 501(c) (3) and with the allowance of deductions under section 170 for contributions to the foundation; (2) utilizes objective and nondiscriminatory criteria in selecting scholarship recipients from among the applicants; and (3) utilizes a selection committee which appears likely to make objective and nondiscriminatory selections of grant recipients.

Example 2. Assume the same facts as Example (1), except that the foundation establishes a program to provide 20 college scholarships per year for members of a certain ethnic minority. All members of this minority group (other than disqualified persons with respect to the foundation) living in State Z are eligible to apply for these scholarships. It is estimated that at least 400 persons will be eligible to apply for these scholarships each year. Under these circumstances, the operation of this scholarship program by the foundation: (1) Is consistent with the existence of the foundation's exempt status under section 501(c)(3) and with the allowance of deductions under section 170 for contributions to the foundation; (2) utilizes objective and nondiscriminatory criteria in selecting scholarship recipients from among the applicants; and (3) utilizes a selection committee which appears likely to make objective and nondiscriminatory selections of grant recipients.

(c) *Requirements of a proper procedure*—(1) *In general.* Section 4945(g) requires that grants to individuals must be made pursuant to a procedure approved in advance. To secure such approval, a private foundation must demonstrate to the satisfaction of the Commissioner that:

(i) Its grant procedure includes an objective and nondiscriminatory selection process (as described in paragraph (b) of this section);

(ii) Such procedure is reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance; and

(iii) The foundation plans to obtain reports to determine whether the grantees have performed the activities that the grants are intended to finance.

No single procedure or set of procedures is required. Procedures may vary depending upon such factors as the size of the foundation, the amount and purpose of the grants and whether one or more recipients are involved.

(2) *Supervision of scholarship and fellowship grants.* Except as provided in subparagraph (5) of this paragraph, with respect to any scholarship or fellowship grants, a private foundation must make arrangements to receive a report of the grantee's courses taken (if any) and grades received (if any) in each academic period. Such a report must be verified by the educational institution attended by the grantee and must be obtained at least once a year. In cases of grantees whose study at an educational institution does not involve the taking of courses but only the preparation of research papers or projects, such as the writing of a doctoral thesis, the foundation must receive a brief report on the progress of the paper or project at least once a year. Such a report must be approved by the faculty member supervising the grantee or by another appropriate university official. Upon completion of a grantee's study at an educational institution, a final report must also be obtained.

(3) *Grants described in section 4945(g)(3).* With respect to a grant made under section 4945(g)(3), the private foundation shall require reports on the use of the funds and the progress made by the grantee toward achieving the

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purposes for which the grant was made. Such reports must be made at least once a year. Upon completion of the undertaking for which the grant was made, a final report must be made describing the grantee's accomplishments with respect to the grant and accounting for the funds received under such grant.

(4) *Investigation of jeopardized grants.* (i) Where the reports submitted under this paragraph or other information (including the failure to submit such reports) indicates that all or any part of a grant is not being used in furtherance of the purposes of such grant, the foundation is under a duty to investigate. While conducting its investigation, the foundation must withhold further payments to the extent possible until any delinquent reports required by this paragraph have been submitted and where required by subdivision (ii) or (iii) of this subparagraph.

(ii) In cases in which the grantor foundation determines that any part of a grant has been used for improper purposes and the grantee has not previously diverted grant funds to any use not in furtherance of a purpose specified in the grant, the foundation will not be treated as having made a taxable expenditure solely because of the diversion so long as the foundation:

(*a*) Is taking all reasonable and appropriate steps either to recover the grant funds or to insure the restoration of the diverted funds and the dedication (consistent with the requirements of (*b*) (*1*) and (*2*) of this subdivision) of other grant funds held by the grantee to the purposes being financed by the grant, and

(*b*) Withholds any further payments to the grantee after the grantor becomes aware that a diversion may have taken place (hereinafter referred to as ''further payments'') until it has:

(*1*) Received the grantee's assurances that future diversions will not occur, and

(*2*) Required the grantee to take extraordinary precaution to prevent future diversions from occurring.

If a foundation is treated as having made a taxable expenditure under this subparagraph in a case to which this subdivision applies, then unless the foundation meets the requirements of (*a*) of this subdivision the amount of the taxable expenditure shall be the amount of the diversion plus the amount of any further payments to the same grantee. However, if the foundation complies with the requirements of (*a*) of this subdivision but not the requirements of (b) of this subdivision, the amount of the taxable expenditure shall be the amount of such further payments.

(iii) In cases where a grantee has previously diverted funds received from a grantor foundation, and the grantor foundation determines that any part of a grant has again been used for improper purposes, the foundation will not be treated as having made a taxable expenditure solely by reason of such diversion so long as the foundation:

(*a*) Is taking all reasonable and appropriate steps to recover the grant funds or to insure the restoration of the funds and the dedication (consistent with the requirements of (*b*) (*2*) and (*3*) of this subdivision) of other grant funds held by the grantee to the purposes being financed by the grant, and

(*b*) Withholds further payments until:

(*1*) Such funds are in fact so recovered or restored,

(*2*) It has received the grantee's assurances that future diversions will not occur, and

(*3*) It requires the grantee to take extraordinary precautions to prevent future diversions from occurring.

If a foundation is treated as having made a taxable expenditure under this subparagraph in a case to which this subdivision applies, then unless the foundation meets the requirements of (*a*) of this subdivision, the amount of the taxable expenditure shall be the amount of the diversion plus the amount of any further payments to the same grantee. However, if the foundation complies with the requirements of (*a*) of this subdivision, but fails to withhold further payments until the requirements of (*b*) of this subdivision are met, the amount of the taxable expenditure shall be the amount of such further payments.

(iv) The phrase ''all reasonable and appropriate steps'' in subdivisions (ii) and (iii) of this subparagraph includes

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legal action where appropriate but need not include legal action if such action would in all probability not result in the satisfaction of execution on a judgment.

(5) *Supervision of certain scholarship and fellowship grants.* Subparagraphs (2) and (4) of this paragraph shall be considered satisfied with respect to scholarship or fellowship grants under the following circumstances:

(i) The scholarship or fellowship grants are described in section 4945(g)(1);

(ii) The grantor foundation pays the scholarship or fellowship grants to an educational institution described in section 151(e) (4); and

(iii) Such educational institution agrees to use the grant funds to defray the recipient's expenses or to pay the funds (or a portion thereof) to the recipient only if the recipient is enrolled at such educational institution and his standing at such educational institution is consistent with the purposes and conditions of the grant.

(6) *Retention of records.* A private foundation shall retain records pertaining to all grants to individuals for purposes described in section 4945(d)(3). Such records shall include:

(i) All information the foundation secures to evaluate the qualification of potential grantees;

(ii) Identification of grantees (including any relationship of any grantee to the foundation sufficient to make such grantee a disqualified person of the private foundation within the meaning of section 4946(a) (1));

(iii) Specification of the amount and purpose of each grant; and

(iv) The follow-up information which the foundation obtains in complying with subparagraphs (2), (3), and (4) of this paragraph.

(7) *Example.* The provisions of paragraphs (b) and (c) of this section may be illustrated by the following example:

Example. The X foundation grants 10 scholarships each year to graduates of high schools in its area to permit the recipients to attend college. It makes the availability of its scholarships known by oral or written communications each year to the principals of three major high schools in the area. The foundation obtains information from each high school on the academic qualifications, background, and financial need of applicants. It requires that each applicant be recommended by two of his teachers or by the principal of his high school. All application forms are reviewed by the foundation officer responsible for making the awards and scholarships are granted on the basis of the academic qualifications and financial need of the grantees. The foundation obtains annual reports on the academic performance of the scholarship recipient from the college or university which he attends. It maintains a file on each scholarship awarded, including the original application, recommendations, a record of the action taken on the application, and the reports on the recipient from the institution which he attends. The described procedures of the X foundation for the making of grants to individuals qualify for Internal Revenue Service approval under section 4945(g). Furthermore, if the X foundation's scholarship program meets the requirements of subparagraph (5) of this paragraph, X foundation will not have to obtain reports on the academic performance of the scholarship recipients.

(d) *Submission of grant procedure*—(1) *Contents of request for approval of grant procedures.* A request for advance approval of a foundation's grant procedures must fully describe the foundation's procedures for awarding grants and for ascertaining that such grants are used for the proper purposes. The approval procedure does not contemplate specific approval of particular grant programs but instead one-time approval of a system of standards, procedures, and follow-up designed to result in grants which meet the requirements of section 4945(g). Thus, such approval shall apply to a subsequent grant program as long as the procedures under which it is conducted do not differ materially from those described in the request to the Commissioner. The request must contain the following items:

(i) A statement describing the selection process. Such statement shall be sufficiently detailed for the Commissioner to determine whether the grants are made on an objective and nondiscriminatory basis under paragraph (b) of this section.

(ii) A description of the terms and conditions under which the foundation ordinarily makes such grants, which is sufficient to enable the Commissioner to determine whether the grants awarded under such procedures would

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meet the requirements of paragraph (1), (2), or (3) of section 4945(g).

(iii) A detailed description of the private foundation's procedure for exercising supervision over grants, as described in paragraph (c) (2) and (3) of this section.

(iv) A description of the foundation's procedures for review of grantee reports, for investigation where diversion of grant funds from their proper purposes is indicated, and for recovery of diverted grant funds, as described in paragraph (c) (4) of this section.

(2) *Place of submission.* Request for approval of grant procedures shall be submitted to the District Director.

(3) *Internal Revenue Service action on request for approval of grant procedures.* The 45th day after a request for approval of grant procedures has been properly submitted to the Internal Revenue Service, the organization has not been notified that such procedures are not acceptable, such procedures shall be considered as approved from the date of submission until receipt of actual notice from the Internal Revenue Service that such procedures do not meet the requirements of this section. If a grant to an individual for a purpose described in section 4945(d) (3) is made after notification to the organization by the Internal Revenue Service that the procedures under which the grant is made are not acceptable, such grant is a taxable expenditure under this section.

(e) *Effective dates*—(1) *In general.* This section shall apply to all grants to individuals for travel, study, or other similar purposes which are made by private foundations more than 90 days after October 30, 1972.

(2) *Transitional rules*—(i) *Grants committed prior to January 1, 1970.* Section 4945(d) (3) and (g) and this section shall not apply to a grant for section 170(c) (2) (B) purposes made on or after January 1, 1970, if the grant was made pursuant to a commitment entered into prior to such date, but only if such commitment was made in accordance with the foundation's usual practices and is reasonable in amount in light of the purposes of the grant. For purposes of this subdivision, a commitment will be considered entered into prior to January 1, 1970, if prior to such date, the amount and nature of the payments to be made and the name of the payee were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee in writing.

(ii) *Grants awarded on or after January 1, 1970.* In the case of a grant awarded on or after January 1, 1970, but prior to the expiration of 90 days after October 30, 1972, and paid within 48 months after the award of such grant, the requirements of section 4945(g) that an individual grant be awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Commissioner will be deemed satisfied if the grantor utilizes any procedure in good faith in awarding a grant to an individual which, in fact, is reasonably calculated to provide objectivity and nondiscrimination in the awarding of such grant and to result in a grant which complies with the conditions of section 4945(g) (1), (2), or (3).

§ 53.4945–5 Grants to organizations.

(a) *Grants to nonpublic organizations*—(1) *In general.* Under section 4945(d)(4) the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation as a grant to an organization (other than an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4940(d)(2)), unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with section 4945(h). However, the granting foundation does not have to exercise expenditure responsibility with respect to amounts granted to organizations described in section 4945(f).

(2) *''Grants'' described.* For a description of the term ''grants'', see § 53.4945–4(a)(2).

(3) *Section 509(a) (1), (2), and (3) organizations.* See section 508(b) and the regulations thereunder for rules relating to when a grantor may rely on a potential grantee's characterization of its status as set forth in the notice described in section 508(b).

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(4) *Certain ''public'' organizations.* For purposes of this section, an organization will be treated as a section 509(a)(1) organization if:

(i) It qualifies as such under paragraph (a) of § 1.509(a)–2 of this chapter;

(ii) It is an organization described in section 170(c)(1) or 511(a)(2)(B), even if it is not described in section 501(c)(3); or

(iii) It is a foreign government, or any agency or instrumentality thereof, or an international organization designated as such by Executive order under 22 U.S.C. 288, even if it is not described in section 501(c)(3).

However, any grant to an organization referred to in this subparagraph must be made exclusively for charitable purposes as described in section 170(c)(2)(B).

(5) *Certain foreign organizations*—(i) *In general.* If a private foundation makes a grant to a foreign organization, which does not have a ruling or determination letter that it is an organization described in section 509(a)(1), (a)(2), or (a)(3) or in section 4940(d)(2), the grant will nonetheless be treated as a grant made to an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4940(d)(2) if the grantor private foundation has made a good faith determination that the grantee organization is an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4940(d)(2). A determination ordinarily will be considered a good faith determination if the determination is based on current written advice received from a qualified tax practitioner concluding that the grantee is an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4940(d)(2), and if the foundation reasonably relied in good faith on the written advice in accordance with the requirements of § 1.6664–4(c)(1) of this chapter. The written advice must set forth sufficient facts concerning the operations and support of the grantee organization for the Internal Revenue Service to determine that the grantee organization would be likely to qualify as an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4940(d)(2) as of the date of the written advice. For purposes of these rules, except as provided in the next sentence, written advice will be considered current if, as of the date of the grant payment, the relevant law on which the advice is based has not changed since the date of the written advice and the factual information on which the advice is based is from the grantee's current or prior taxable year (or annual accounting period if the grantee does not have a taxable year for United States federal tax purposes). Written advice that a grantee met the public support test under section 170(b)(1)(A)(vi) or section 509(a)(2) for a test period of five years will be treated as current for purposes of grant payments to the grantee during the two taxable years (or, as applicable, annual accounting periods) of the grantee immediately following the end of the five-year test period. See paragraphs (b)(5) and (6) of this section for additional rules relating to foreign organizations.

(ii) *Definitions.* For purposes of this paragraph (a)(5)—

(*a*) The term ''foreign organization'' means any organization that is not described in section 170(c)(2)(A).

(*b*) The term ''qualified tax practitioner'' means an attorney, a certified public accountant, or an enrolled agent, within the meaning of 31 CFR 10.2 and 10.3, who is subject to the requirements in 31 CFR part 10.

(6) *Certain earmarked grants*—(i) *In general.* A grant by a private foundation to a grantee organization which the grantee organization uses to make payments to another organization (the secondary grantee) shall not be regarded as a grant by the private foundation to the secondary grantee if the foundation does not earmark the use of the grant for any named secondary grantee and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the secondary grantee by the organization to which it has given the grant. For purposes of this subdivision, a grant described herein shall not

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be regarded as a grant by the foundation to the secondary grantee even though such foundation has reason to believe that certain organizations would derive benefits from such grant so long as the original grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation.

(ii) *To governmental agencies.* If a private foundation makes a grant to an organization described in section 170(c)(1) and such grant is earmarked for use by another organization, the granting foundation need not exercise expenditure responsibility with respect to such grant if the section 170(c)(1) organization satisfies the Commissioner in advance that:

(*a*) Its grantmaking program is in furtherance of a purpose described in section 170(c)(2)(B), and

(*b*) The section 170(c)(1) organization exercises ''expenditure responsibility'' in a manner that would satisfy this section if it applied to such section 170(c)(1) organization. However, with respect to such grant, the granting foundation must make the reports required by section 4945(h)(3) and paragraph (d) of this section, unless such grant is earmarked for use by an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)), or in section 4940(d)(2).

(b) *Expenditure responsibility*—(1) *In general.* A private foundation is not an insurer of the activity of the organization to which it makes a grant. Thus, satisfaction of the requirements of sections 4945(d)(4) and (h) and of subparagraph (3) or (4) of this paragraph, will ordinarily mean that the grantor foundation will not have violated section 4945(d) (1) or (2). A private foundation will be considered to be exercising ''expenditure responsibility'' under section 4945(h) as long as it exerts all reasonable efforts and establishes adequate procedures:

(i) To see that the grant is spent solely for the purpose for which made,

(ii) To obtain full and complete reports from the grantee on how the funds are spent, and

(iii) To make full and detailed reports with respect to such expenditures to the Commissioner.

In cases in which pursuant to paragraph (a)(6) of this section a grant is considered made to a secondary grantee rather than the primary grantee, the grantor foundation's obligation to obtain reports from the grantee pursuant to section 4945(h)(2) and this section will be satisfied if appropriate reports are obtained from the secondary grantee. For rules relating to expenditure responsibility with respect to transfers of assets described in section 507(b)(2), see section 507(b)(2) and the regulations thereunder.

(2) *Pre-grant inquiry*—(i) Before making a grant to an organization with respect to which expenditure responsibility must be exercised under this section, a private foundation should conduct a limited inquiry concerning the potential grantee. Such inquiry should be complete enough to give a reasonable man assurance that the grantee will use the grant for the proper purposes. The inquiry should concern itself with matters such as: (*a*) The identity, prior history and experience (if any) of the grantee organization and its managers; and (*b*) any knowledge which the private foundation has (based on prior experience or otherwise) of, or other information which is readily available concerning, the management, activities, and practices of the grantee organization. The scope of the inquiry might be expected to vary from case to case depending upon the size and purpose of the grant, the period over which it is to be paid, and the prior experience which the grantor has had with respect to the capacity of the grantee to use the grant for the proper purposes. For example, if the grantee has made proper use of all prior grants to it by the grantor and filed the required reports substantiating such use, no further pregrant inquiry will ordinarily be necessary. Similarly, in the case of an organization, such as a trust described in section 4947(a)(2), which is required by the terms of its governing instrument to make payments to a specified organization exempt from taxation under section 501(a), a less extensive pregrant inquiry is required than in the case of a private foundation

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possessing discretion with respect to the distribution of funds.

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

Example 1. Officials of M, a newly established organization which is described in section 501(c)(4), request a grant from X foundation to be used for a proposed program to combat drug abuse by establishing neighborhood clinics in certain ghetto areas of a city. Before making a grant to M, X makes an inquiry concerning the identity, prior history and experience of the officials of M. X obtains information pertaining to the officials of M from references supplied by these officials. Since one of the references indicated that A, an official of M, has an arrest record, police records are also checked and A's probation officer is interviewed.

The inquiry also shows M has no previous history of administering grants and that the officials of M have had no experience in administering programs of this nature. However, in the opinion of X's managers, M's officials (including A who appears to be fully rehabilitated after having been convicted of a narcotics violation several years ago) are well qualified to conduct this program since they are members of the communities in which the clinics are to be established and are more likely to be trusted by drug users in these communities than are outsiders. Under these circumstances X has complied with the requirements of this subparagraph and a grant to M for its proposed program will not be treated as a taxable expenditure solely because of the operation of this subparagraph.

Example 2. Foundation Y wishes to make a grant to foundation R for use in R's scholarship program. Y has made similar grants to R annually for the last several years and knows that R's managers have observed the terms of the previous grants and have made all requested reports with respect to such grants. No changes in R's management have occurred during the past several years. Under these circumstances, Y has enough information to have such assurance as a reasonable man would require that the grant to R will be used for proper purposes. Consequently, Y is under no obligation to make any further pregrant inquiry pursuant to this subparagraph.

Example 3. S foundation requests a grant from Z foundation for use in S's program of providing medical research fellowships. S has been engaged in this program for several years and has received large numbers of grants from other foundations. Z's managers know that the reputations of S and of S's officials are good. Z's managers also have been advised by managers of W foundation that W had recently made a grant to S and that W's managers were satisfied that such grant has been used for the purposes for which it was made. Under these circumstances Z has enough information to have such assurance as a reasonable man would require that the grant to S will be used for proper purposes. Consequently, Z is under no obligation to make any further pregrant inquiry pursuant to this subparagraph.

(3) *Terms of grants.* Except as provided in subparagraph (4) of this paragraph, in order to meet the expenditure responsibility requirements of section 4945(h), a private foundation must require that each grant to an organization, with respect to which expenditure responsibility must be exercised under this section, be made subject to a written commitment signed by an appropriate officer, director, or trustee of the grantee organization. Such commitment must include an agreement by the grantee:

(i) To repay any portion of the amount granted which is not used for the purposes of the grant,

(ii) To submit full and complete annual reports on the manner in which the funds are spent and the progress made in accomplishing the purposes of the grant, except as provided in paragraph (c)(2) of this section,

(iii) To maintain records of receipts and expenditures and to make its books and records available to the grantor at reasonable times, and

(iv) Not to use any of the funds:

(*a*) To carry on propaganda, or otherwise to attempt, to influence legislation (within the meaning of section 4945(d)(1)),

(*b*) To influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive (within the meaning of section 4945(d)(2)),

(*c*) To make any grant which does not comply with the requirements of section 4945(d) (3) or (4), or

(*d*) To undertake any activity for any purpose other than one specified in section 170(c)(2)(B).

The agreement must also clearly specify the purposes of the grant. Such purposes may include contributing for capital endowment, for the purchase of capital equipment, or for general support provided that neither the grants nor the income therefrom may be used

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for purposes other than those described in section 170(c)(2)(B).

(4) *Terms of program-related investments.* In order to meet the expenditure responsibility requirements of section 4945(h), with regard to the making of a program-related investment (as defined in section 4944 and the regulations thereunder), a private foundation must require that each such investment with respect to which expenditure responsibility must be exercised under section 4945(d)(4) and (h) and this section be made subject to a written commitment signed by an appropriate officer, director, or trustee of the recipient organization. Such commitment must specify the purpose of the investment and must include an agreement by the organization:

(i) To use all the funds received from the private foundation (as determined under paragraph (c)(3) of this section) only for the purposes of the investment and to repay any portion not used for such purposes, provided that, with respect to equity investments, such repayment shall be made only to the extent permitted by applicable law concerning distributions to holders of equity interests,

(ii) At least once a year during the existence of the program-related investment, to submit full and complete financial reports of the type ordinarily required by commercial investors under similar circumstances and a statement that it has complied with the terms of the investment,

(iii) To maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances and to make such books and records available to the private foundation at reasonable times, and

(iv) Not to use any of the funds:

(*a*) To carry on propaganda, or otherwise to attempt, to influence legislation (within the meaning of section 4945(d)(1)),

(*b*) To influence the outcome of any specific public election, or to carry on directly or indirectly, and voter registration drive (within the meaning of section 4945(d)(2)), or

(*c*) With respect to any recipient which is a private foundation (as defined in section 509(a)), to make any grant which does not comply with the requirements of section 4945 (d) (3) or (4).

(5) *Certain grants to foreign organizations.* With respect to a grant to a foreign organization (other than an organization described in section 509(a)(1), (a)(2), or (a)(3) (other than an organization described in section 4942(g)(4)(A)(i) or (ii)) or in section 4940(d)(2) or treated as so described pursuant to paragraph (a)(4) or (5) of this section), paragraph (b)(3)(iv) or (b)(4)(iv) of this section shall be deemed satisfied if the agreement referred to in paragraph (b)(3) or (4) of this section imposes restrictions on the use of the grant substantially equivalent to the limitations imposed on a domestic private foundation under section 4945(d). Such restrictions may be phrased in appropriate terms under foreign law or custom and ordinarily will be considered sufficient if an affidavit or opinion of counsel (of the grantor or grantee) or written advice of a qualified tax practitioner is obtained stating that, under foreign law or custom, the agreement imposes restrictions on the use of the grant substantially equivalent to the restrictions imposed on a domestic private foundation under paragraph (b)(3) or (4) of this section.

(6) *Special rules for grants by foreign private foundations.* With respect to activities in jurisdictions other than those described in section 170(c)(2)(A), the failure of a foreign private foundation which is described in section 4948(b) to comply with subparagraph (3) or (4) of this paragraph with respect to a grant to an organization shall not constitute an act or failure to act which is a prohibited transaction (within the meaning of section 4948(c)(2)).

(7) *Expenditure responsibility with respect to certain transfers of assets described in section 507*—(i) *Transfers of assets described in section 507(b)(2).* For rules relating to the extent to which the expenditure responsibility rules contained in section 4945 (d)(4) and (h) and this section apply to transfers of assets described in section 507(b)(2), see §§ 1.507–3(a)(7), 1.507–3 (a)(8)(ii)(*f*), and 1.507–3(a)(9) of this chapter.

(ii) *Certain other transfers of assets.* For rules relating to the extent to

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which the expenditure responsibility rules contained in section 4945 (d)(4) and (h) and this section apply to certain other transfers of assets described in § 1.507–3(b) of this chapter, see § 1.507–3(b) of this chapter.

(8) *Restrictions on grants (other than program-related investments) to organizations not described in section 501(c)(3).* For other restrictions on certain grants (other than program-related investments) to organizations which are not described in section 501(c)(3), see § 53.4945–6(c).

(c) *Reports from grantees*—(1) *In general.* In the case of grants described in section 4945(d)(4), except as provided in subparagraph (2) of this paragraph, the granting private foundation shall require reports on the use of the funds, compliance with the terms of the grant, and the progress made by the grantee toward achieving the purposes for which the grant was made. The grantee shall make such reports as of the end of its annual accounting period within which the grant or any portion thereof is received and all such subsequent periods until the grant funds are expended in full or the period of the grantee for which such reports shall be furnished to the grantor within a reasonable period of time after the close of the annual accounting period of the grantee for which such reports are made. Within a reasonable period of time after the close of its annual accounting period during which the use of the grant funds is completed, the grantee must make a final report with respect to all expenditures made from such funds (including salaries, travel, and supplies), and indicating the progress made toward the goals of the grant. The grantor need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability.

(2) *Capital endowment grants to exempt private foundations.* If a private foundation makes a grant described in section 4945(d)(4) to a private foundation which is exempt from taxation under section 501(a) for endowment, for the purchase of capital equipment, or for other capital purposes, the grantor foundation shall require reports from the grantee on the use of the principal and the income (if any) from the grant funds. The grantee shall make such reports annually for its taxable year in which the grant was made and the immediately succeeding 2 taxable years. Only if it is reasonably apparent to the grantor that, before the end of such second succeeding taxable year, neither the principal, the income from the grant funds, nor the equipment purchased with the grant funds has been used for any purpose which would result in liability for tax under section 4945(d), the grantor may then allow such reports to be discontinued.

(3) *Grantees' accounting and recordkeeping procedures.* (i) A private foundation grantee exempt from taxation under section 501(a) (or the recipient of a program-related investment) need not segregate grant funds physically nor separately account for such funds on its books unless the grantor requires such treatment of the grant funds. If such a grantee neither physically segregates grant funds nor establishes separate accounts on its books, grants received within a given taxable year beginning after December 31, 1969, shall be deemed, for purposes of section 4945, to be expended before grants received in a succeeding taxable year. In such case expenditures of grants received within any such taxable year shall be prorated among all such grants.

In accounting for grant expenditures, private foundations may make the necessary computations on a cumulative annual basis (or, where appropriate, as of the date for which the computations are made). The rules set forth in the preceding three sentences shall apply to the extent they are consistent with the available records of the grantee and with the grantee's treatment of qualifying distributions under section 4942(h) and the regulations thereunder. The records of expenditures, as well as copies of the reports submitted to the grantor, must be kept for at least 4 years after completion of the use of the grant funds.

(ii) For rules relating to accounting and recordkeeping requirements for grantees other than those described in subdivision (i) of this subparagraph, see §§ 53.4945–5(b)(8) and 53.4945–6(c).

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(4) *Reliance on information supplied by grantee.* A private foundation exercising expenditure responsibility with respect to its grants may rely on adequate records or other sufficient evidence supplied by the grantee organization (such as a statement by an appropriate officer, director or trustee of such grantee organization) showing, to the extent applicable, the information which the grantor must report to the Internal Revenue Service in accordance with paragraph (d)(2) of this section.

(d) *Reporting to Internal Revenue Service by grantor*—(1) *In general.* To satisfy the reportmaking requirements of section 4945(h)(3), a granting foundation must provide the required information on its annual information return, required to be filed by section 6033, for each taxable year with respect to each grant made during the taxable year which is subject to the expenditure responsibility requirements of section 4945(h). Such information must also be provided on such return with respect to each grant subject to such requirements upon which any amount or any report is outstanding at any time during the taxable year. However, with respect to any grant made for endowment or other capital purposes, the grantor must provide the required information only for any taxable year for which the grantor must require a report from the grantee under paragraph (c)(2) of this section. The requirements of this subparagraph with respect to any grant may be satisfied by submission with the foundation's information return of a report received from the grantee, if the information required by subparagraph (2) of this paragraph is contained in such report.

(2) *Contents of report.* The report required by this paragraph shall include the following information:

(i) The name and address of the grantee.

(ii) The date and amount of the grant.

(iii) The purpose of the grant.

(iv) The amounts expended by the grantee (based upon the most recent report received from the grantee).

(v) Whether the grantee has diverted any portion of the funds (or the income therefrom in the case of an endowment grant) from the purpose of the grant (to the knowledge of the grantor).

(vi) The dates of any reports received from the grantee.

(vii) The date and results of any verification of the grantee's reports undertaken pursuant to and to the extent required under paragraph (c)(1) of this section by the grantor or by others at the direction of the grantor.

(3) *Recordkeeping requirements.* In addition to the information included on the information return, a granting foundation shall make available to the Internal Revenue Service at the foundation's principal office each of the following items:

(i) A copy of the agreement covering each ''expenditure responsibility'' grant made during the taxable year.

(ii) A copy of each report received during the taxable year from each grantee on any ''expenditure responsibility'' grant, and

(iii) A copy of each report made by the grantor's personnel or independent auditors of any audits or other investigations made during the taxable year with respect to any ''expenditure responsibility'' grant.

(4) *Reports received after the close of grantor's accounting year.* Data contained in reports required by this paragraph, which reports are received by a private foundation after the close of its accounting year but before the due date of its information return for that year, need not be reported on such return, but may be reported on the grantor's information return for the year in which such reports are received from the grantee.

(e) *Violations of expenditure responsibility requirements*—(1) *Diversions by grantee.* (i) Any diversion of grant funds (including the income therefrom in the case of an endowment grant) by the grantee to any use not in furtherance of a purpose specified in the grant may result in the diverted portion of such grant being treated as a taxable expenditure of the grantor under section 4945(d)(4). However, for purposes of this section, the fact that a grantee does not use any portion of the grant funds as indicated in the original budget projection shall not be treated as a diversion if the use to which the funds are

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committed is consistent with the purpose of the grant as stated in the grant agreement and does not result in a violation of the terms of such agreement required to be included by paragraph (b)(3) or (b)(4) of this section.

(ii) In any event, a grantor will not be treated as having made a taxable expenditure under section 4945(d)(4) solely by reason of a diversion by the grantee, if the grantor has complied with subdivision (iii) (*a*) and (*b*) or (iv) (*a*) and (*b*) of this subparagraph, whichever is applicable.

(iii) In cases in which the grantor foundation determines that any part of a grant has been used for improper purposes and the grantee has not previously diverted grant funds, the foundation will not be treated as having made a taxable expenditure solely by reason of the diversion so long as the foundation:

(*a*) Is taking all reasonable and appropriate steps either to recover the grant funds or to insure the restoration of the diverted funds and the dedication (consistent with the requirements of (*b*) (*1*) and (*2*) of this subdivision) of the other grant funds held by the grantee to the purposes being financed by the grant, and

(*b*) Withholds any further payments to the grantee after the grantor becomes aware that a diversion may have taken place (hereinafter referred to as ''further payments'') until it has:

(*1*) Received the grantee's assurances that future diversions will not occur, and

(*2*) Required the grantee to take extraordinary precautions to prevent future diversions from occurring.

If a foundation is treated as having made a taxable expenditure under this subparagraph in a case to which this subdivision applies, then unless the foundation meets the requirements of (*a*) of this subdivision the amount of the taxable expenditure shall be the amount of the diversion (for example, the income diverted in the case of an endowment grant, or the rental value of capital equipment for the period of time for which diverted) plus the amount of any further payments to the same grantee. However, if the foundation complies with the requirements of (*a*) of this subdivision but not the requirements of (*b*) of this subdivision, the amount of the taxable expenditure shall be the amount of such further payments.

(iv) In cases where a grantee has previously diverted funds received from a grantor foundation, and the grantor foundation determines that any part of a grant has again been used for improper purposes, the foundation will not be treated as having made a taxable expenditure solely by reason of such diversion so long as the foundation:

(*a*) Is taking all reasonable and appropriate steps to recover the grant funds or to insure the restoration of the diverted funds and the dedication (consistent with the requirements of (*b*) (*2*) and (*3*) of this subdivision) of other grant funds held by the grantee to the purposes being financed by the grant, except that if, in fact, some or all of the diverted funds are not so restored or recovered, then the foundation must take all reasonable and appropriate steps to recover all of the grant funds, and

(*b*) Withholds further payments until:

(*1*) Such funds are in fact so recovered or restored,

(*2*) It has received the grantee's assurances that future diversions will not occur, and

(*3*) It requires the grantee to take extraordinary precautions to prevent future diversions from occurring.

If a foundation is treated as having made a taxable expenditure under this subparagraph in a case to which this subdivision applies, then unless the foundation meets the requirements of (*a*) of this subdivision, the amount of the taxable expenditure shall be the amount of the diversion plus the amount of any further payments to the same grantee. However, if the foundation complies with the requirements of (*a*) of this subdivision, but fails to withhold further payments until the requirements of (*b*) of this subdivision are met, the amount of the taxable expenditure shall be the amount of such further payments.

(v) The phrase ''all reasonable and appropriate steps'' (as used in subdivisions (iii) and (iv) of this subparagraph) includes legal action where appropriate but need not include legal action if

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such action would in all probability not result in the satisfaction of execution on a judgment.

(2) *Grantee's failure to make reports.* A failure by the grantee to make the reports required by paragraph (c) of this section (or the making of inadequate reports) shall result in the grant's being treated as a taxable expenditure by the grantor unless the grantor:

(i) Has made the grant in accordance with paragraph (b) of this section,

(ii) Has complied with the reporting requirements contained in paragraph (d) of this section,

(iii) Makes a reasonable effort to obtain the required report, and

(iv) Withholds all future payments on this grant and on any other grant to the same grantee until such report is furnished.

(3) *Violations by the grantor.* In addition to the situations described in subparagraphs (1) and (2) of this paragraph, a grant which is subject to the expenditure responsibility requirements of section 4945(h) will be considered a taxable expenditure of the granting foundation if the grantor:

(i) Fails to make a pregrant inquiry as described in paragraph (b)(2) of this section,

(ii) Fails to make the grant in accordance with a procedure consistent with the requirements of paragraph (b)(3) or (4) of this section, or

(iii) Fails to report to the Internal Revenue Service as provided in paragraph (d) of this section.

(f) *Effective dates*—(1) *In general.* This section shall apply to all grants which are subject to the expenditure responsibility requirements of section 4945(d)(4) and (h) and which are made by private foundations more than 90 days after October 30, 1972.

(2) *Transitional rules*—(i) *Certain grants awarded prior to May 27, 1969.* Section 4945(d)(4) and (h) and this section shall not apply to a grant to a private foundation which is not controlled, directly or indirectly, by the grantor foundation or one or more disqualified persons (as defined in section 4946) with respect to the grantor foundation, provided that such grant:

(*a*) Is made pursuant to a written commitment which was binding on May 26, 1969, and at all times thereafter,

(*b*) Is made for one or more of the purposes described in section 170(c)(2)(B), and

(*c*) Is to be paid out to such grantee foundation on or before December 31, 1974.

(ii) *Grants or expenditures committed prior to January 1, 1970.* Except as provided in paragraph (e)(2)(i) of § 53.4945–4, section 4945 shall not apply to a grant or an expenditure for section 170(c)(2)(B) purposes made on or after January 1, 1970, if the grant or expenditure was made pursuant to a commitment entered into prior to such date, but only if (in the case of a grant or an expenditure other than an unlimited general-purpose grant to an organization) such commitment is reasonable in amount in light of the purposes of the grant. For purposes of this subdivision, a commitment will be considered entered into prior to January 1, 1970, if prior to such date, the amount and nature of the payments to be made and the name of the payee were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee in writing.

(iii) *Grants awarded on or after January 1, 1970.* Paragraphs (b), (c), and (d) of this section shall not apply to grants awarded on or after January 1, 1970, but prior to the expiration of 90 days after October 30, 1972, if the grantor has made reasonable efforts, and has established adequate procedures such as a prudent man would adopt in managing his own property, to see that the grant is spent solely for the purpose for which made, to obtain full and complete reports from the grantee on how the funds are spent, and to make full and detailed reports with respect to such grant to the Commissioner. With respect to any return filed with the Internal Revenue Service before the expiration of 90 days after October 30, 1972, the grantor may treat reports which satisfy the requirements of the statement to be attached to Form 4720 for the year 1970 under ''Specific Instructions—Question B'' (items (1) through (5)) as satisfying the grantor reporting requirements with respect to ''expenditure responsibility'' grants. In the

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case of a private foundation required to file an annual return for a taxable year ending after January 1, 1970, and before December 31, 1970, the reporting requirements imposed by section 4945(h)(3) for such period shall be regarded as satisfied if such reports are made on the annual return for its first taxable year beginning after December 31, 1969.

(3) *Effective/applicability date of paragraphs (a)(1), (a)(5), (a)(6)(ii), and (b)(5) and transition relief*. Paragraphs (a)(1), (a)(5), (a)(6)(ii), and (b)(5) of this section are effective on and apply with respect to grants paid after September 25, 2015. However, foundations may continue to rely on paragraph (a)(5) as contained in 26 CFR part 53, revised April 1, 2015, with respect to grants paid on or before December 24, 2015 pursuant to a good faith determination made in accordance with such provisions. Also, foundations may continue to rely on paragraph (a)(5) as contained in 26 CFR part 53, revised April 1, 2015, with respect to grants paid pursuant to a written commitment made on or before September 25, 2015 and pursuant to a good faith determination made on or before such date in accordance with such provisions if the committed amount is paid out within five years of such date.

[T.D. 7215, 37 FR 23161, Oct. 31, 1972; 37 FR 23918, Nov. 10, 1972, as amended by T.D. 7233, 37 FR 28162, Dec. 21, 1972; T.D. 7290, 38 FR 31834, Nov. 19, 1973; T.D. 9740, 80 FR 57716, Sept. 25, 2015]

§ 53.4945–6 Expenditures for noncharitable purposes.

(a) *In general*. Under section 4945(d)(5) the term ''taxable expenditure'' includes any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B). Thus, ordinarily only an expenditure for an activity which, if it were a substantial part of the organization's total activities, would cause loss of tax exemption is a taxable expenditure under section 4945(d)(5). For purposes of this section and §§ 53.4945–1 through 53.4945–5, the term ''purposes described in section 170(c)(2)(B)'' shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by an organization described in section 170(c).

(b) *Particular expenditures*. (1) The following types of expenditures ordinarily will not be treated as taxable expenditures under section 4945(d)(5):

(i) Expenditures to acquire investments entered into for the purpose of obtaining income or funds to be used in furtherance of purposes described in section 170(c)(2)(B),

(ii) Reasonable expenses with respect to investments described in subdivision (i) of this subparagraph,

(iii) Payment of taxes,

(iv) Any expenses which qualify as deductions in the computation of unrelated business income tax under section 511,

(v) Any payment which constitutes a qualifying distribution under section 4942(g) or an allowable deduction under section 4940,

(vi) Reasonable expenditures to evaluate, acquire, modify, and dispose of program-related investments, or

(vii) Business expenditures by the recipient of a program-related investment.

(2) Conversely, any expenditures for unreasonable administrative expenses, including compensation, consultant fees, and other fees for services rendered, will ordinarily be taxable expenditures under section 4945(d)(5) unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence. The determination whether an expenditure is unreasonable shall depend upon the facts and circumstances of the particular case.

(c) *Grants to ''noncharitable'' organizations*—(1) *In general*. Since a private foundation cannot make an expenditure for a purpose other than a purpose described in section 170(c)(2)(B), a private foundation may not make a grant to an organization other than an organization described in section 501(c)(3) unless

(i) The making of the grant itself constitutes a direct charitable act or the making of a program-related investment, or

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(ii) Through compliance with the requirements of subparagraph (2) of this paragraph, the grantor is reasonably assured that the grant will be used exclusively for purposes described in section 170(c)(2)(B).

For purposes of this paragraph, an organization treated as a section 509(a)(1) organization under § 53.4945–5(a)(4) shall be treated as an organization described in section 501(c)(3).

(2) *Grants other than transfers of assets described in § 1.507–3(c)(1).* (i) If a private foundation makes a grant which is not a transfer of assets pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization to any organization (other than an organization described in section 501(c)(3) except an organization described in section 509(a)(4)), the grantor is reasonably assured (within the meaning of subparagraph (1)(ii) of this paragraph) that the grant will be used exclusively for purposes described in section 170(c)(2)(B) only if the grantee organization agrees to maintain and, during the period in which any portion of such grant funds remain unexpended, does continuously maintain the grant funds (or other assets transferred) in a separate fund dedicated to one or more purposes described in section 170(c)(2)(B). The grantor of a grant described in this paragraph must also comply with the expenditure responsibility provisions contained in sections 4945(d) and (h) and § 53.4945–5.

(ii) For purposes of this paragraph, a foreign organization which does not have a ruling or determination letter that it is an organization described in section 501(c)(3) (other than section 509(a)(4)) will be treated as an organization described in section 501(c)(3) (other than section 509(a)(4)) if in the reasonable judgment of a foundation manager of the transferor private foundation, the grantee organization is an organization described in section 501(c)(3) (other than section 509(a)(4)). The term ''reasonable judgment'' shall be given its generally accepted legal sense within the outlines developed by judicial decisions in the law of trusts.

(3) *Transfers of assets described in § 1.507–3(c)(1).* If a private foundation makes a transfer of assets (other than a transfer described in subparagraph (1)(i) of this paragraph) pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization to any person, the transferred assets will not be considered used exclusively for purposes described in section 170(c)(2)(B) unless the assets are transferred to a fund or organization described in section 501(c)(3) (other than an organization described in section 509(a)(4)) or treated as so described under section 4947(a)(1).

[T.D. 7215, 37 FR 23161, Oct. 31, 1972, as amended by T.D. 7233, 37 FR 28162, Dec. 21, 1972]

Subpart G—Definitions and Special Rules

§ 53.4946–1 Definitions and special rules.

(a) *Disqualified person.* (1) For purposes of Chapter 42 and the regulations thereunder, the following are disqualified persons with respect to a private foundation:

(i) All substantial contributors to the foundation, as defined in section 507 (d)(2) and the regulations thereunder.

(ii) All foundation managers of the foundation as defined in section 4946 (b)(1) and paragraph (f)(1)(i) of this section,

(iii) An owner of more than 20 percent of:

(*a*) The total combined voting power of a corporation,

(*b*) The profits interest of a partnership,

(*c*) The beneficial interest of a trust or unincorporated enterprise.

which is (during such ownership) a substantial contributor to the foundation, as defined in section 507(d)(2) and the regulations thereunder,

(iv) A member of the family, as defined in section 4946(d) and paragraph (h) of this section, of any of the individuals described in subdivision (i), (ii), or (iii) of this subparagraph,

(v) A corporation of which more than 35 percent of the total combined voting power is owned by persons described in subdivision (i), (ii), (iii), or (iv) of this subparagraph,

(vi) A partnership of which more than 35 percent of the profits interest

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is owned by persons described in subdivision (i), (ii), (iii), or (iv) of this subparagraph, and

(vii) A trust, estate, or unincorporated enterprise of which more than 35 percent of the beneficial interest is owned by persons described in subdivision (i), (ii), (iii), or (iv) of this subparagraph.

(2) For purposes of subparagraphs (1)(iii) (*b*) and (vi) of this paragraph, the profits interest of a partner shall be equal to his distributive share of income of the partnership, as determined under section 707(b)(3) and the regulations thereunder as modified by section 4946(a)(4).

(3) For purposes of subparagraph (1) (iii)(*c*) and (vii) of this paragraph, the beneficial interest in an unincorporated enterprise (other than a trust or estate) includes any right to receive a portion of distributions from profits of such enterprise, and, if the portion of distributions is not fixed by an agreement among the participants, any right to receive a portion of the assets (if any) upon liquidation of the enterprise, except as a creditor or employee. For purposes of this subparagraph, a right to receive distributions of profits includes a right to receive any amount from such profits other than as a creditor or employee, whether as a sum certain or as a portion of profits realized by the enterprise. Where there is no agreement fixing the rights of the participants in such enterprise, the fraction of the respective interests of each participant in such enterprise shall be determined by dividing the amount of all investments or contributions to the capital of the enterprise made or obligated to be made by such participant by the amount of all investments or contributions to capital made or obligated to be made by all of them.

(4) For purposes of subparagraph (1) (iii) (*c*) and (vii) of this paragraph, a person's beneficial interest in a trust shall be determined in proportion to the actuarial interest of such person in the trust.

(5) For purposes of subparagraph (1) (iii) (*a*) and (v) of this paragraph, the term ''combined voting power'' includes voting power represented by holdings of voting stock, actual or constructive (under section 4946(a)(3)), but does not include voting rights held only as a director or trustee.

(6) For purposes of subparagraph (1) (iii) (*a*) and (v) of this paragraph, the term ''voting power'' includes outstanding voting power and does not include voting power obtainable but not obtained, such as, for example, voting power obtainable by converting securities or nonvoting stock into voting stock or by exercising warrants or options to obtain voting stock, and voting power which will vest in preferred stockholders only if and when the corporation has failed to pay preferred dividends for a specified period of time or has otherwise failed to meet specified requirements. Similarly, for purposes of subparagraph (1)(iii) (*b*) and (*c*), (vi), and (vii) of this paragraph, the terms ''profits interest'' and ''beneficial interest'' include any such interest that is outstanding, but do not include any such interest that is obtainable but has not been obtained.

(7) For purposes of sections 170(b) (1)(E)(iii), 507(d)(1), 508(d), 509(a) (1) and (3), and Chapter 42, the term ''disqualified person'' shall not include an organization which is described in section 509(a) (1), (2), or (3), or any other organization which is wholly owned by such section 509(a) (1), (2), or (3) organization.

(8) For purposes of section 4941 only, the term ''disqualified person'' shall not include any organization which is described in section 501(c)(3) (other than an organization described in section 509(a)(4)).

(b) *Section 4943*. (1) For purposes of section 4943 only, the term ''disqualified person'' includes a private foundation:

(i) Which is effectively controlled (within the meaning of § 1.482–1(a)(3) of this chapter), directly or indirectly, by the same person or persons (other than a bank, trust company, or similar organization acting only as a foundation manager) who control the private foundation in question, or

(ii) Substantially all the contributions to which were made, directly or indirectly, by persons described in subdivision (i), (ii), (iii), or (iv) of paragraph (a)(1) of this section who made, directly or indirectly, substantially all

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of the contributions to the private foundation in question.

(2) For purposes of subparagraph (1)(ii) of this paragraph, one or more persons will be considered to have made substantially all of the contributions to a private foundation, if such persons have contributed or bequeathed at least 85 percent (and each such person has contributed or bequeathed at least 2 percent) of the total contributions and bequests (within the meaning of section 507(d)(2) and the regulations thereunder) which have been received by such private foundation during its entire existence.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, a private foundation, has a board of directors made up of X, Y, Z, M, N, and O. Foundation B's board of directors is made up of Y, M, N, and O. The board of directors in each case has plenary power to determine the manner in which the foundation is operated. For purposes of section 4943, foundation A is a disqualified person with respect to foundation B, and foundation B, is a disqualified person with respect to foundation A.

Example 2. Private foundation A has received contributions of $100,000 throughout its existence: $35,000 from X, $51,000 from Y (who is X's father), and $14,000 from Z (an unrelated person). Private foundation B has received $100,000 in contributions during its existence: $50,000 from X and $50,000 from W, X's wife.

For purposes of section 4943, private foundation A is a disqualified person with respect to private foundation B, and private foundation B is a disqualified person with respect to private foundation A.

(c) *Section 4941.* For purposes of section 4941, a government official, as defined in section 4946(c) and paragraph (g) of this section, is a disqualified person.

(d) *Attribution of stockholdings.* (1) For purposes of paragraph (a)(1)(iii) (*a*) and (v) of this section, indirect stockholdings shall be taken into account under section 267(c) and the regulations thereunder. However, for purposes of this paragraph:

(i) Section 267(c)(4) shall be treated as though it provided that the members of the family of an individual are the members within the meaning of section 4946(d) and paragraph (h) of this section; and

(ii) Any stockholdings which have been counted once (whether by reason of actual or constructive ownership) in applying section 4946(a)(1)(E) shall not be counted a second time.

For purposes of paragraph (a)(1)(v) or this section, section 267(c) shall be applied without regard to section 267(c)(3), and stock constructively owned by an individual by reason of the application of section 267(c)(2) shall not be treated as owned by him if he is described in section 4946(a)(1)(D) but not also in section 4946(a)(1) (A), (B), or (C).

(2) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. D is a substantial contributor to private foundation Y. D owns 20 percent of the outstanding stock of corporation P. E, D's wife, owns none of the outstanding stock of P. F, E's father, owns 10 percent of the outstanding stock of P. E is treated under section 507(d)(2) as a substantial contributor to Y. E is also treated under section 267(c)(2) as owning both D's 20 percent and F's 10 percent of P, but E is treated as owning nothing for purposes of section 4946(a)(1)(E) because D's 20 percent and F's 10 percent have already been taken into account once (because of their actual ownership of the stock of P) for such purposes. Hence, corporation P is not a disqualified person under section 4946(a)(1)(E) with respect to private foundation Y because persons described in section 4946(a)(1) (A), (B), (C), and (D) own only 30 percent of the stock of P.

Example 2. I, a substantial contributor to private foundation X, is the son of J. I owns 100 percent of the stock of corporation R, which in turn owns 18 percent of the stock of corporation S. J owns 18 percent of the stock of S. I constructively owns 36 percent of the stock of S (J's 18 percent plus R's 18 percent). Both J's actual holdings and R's actual holdings are counted in determining I's constructive holdings because this does not result in counting either of the holdings more than once for purposes of section 4946 (a)(1)(E). Therefore, S is a disqualified person with respect to private foundation X, since I, a substantial contributor, constructively owns more than 35 percent of S's stock.

(e) *Attribution of profits or beneficial interests.* (1) For purposes of paragraph (a) (1) (iii) (*b*), (iii) (*c*) (vi), and (vii) of this section, ownership of profits or beneficial interests shall be taken into

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account as though such ownership related to stockholdings, if such stockholdings would be taken into account under section 267(c) and the regulations thereunder, except that section 267(c)(3) shall not apply to attribute the ownership of one partner to another solely by reason of such partner relationship. However, for purposes of this paragraph:

(i) Section 267(c)(4) shall be treated as though it provided that the members of the family of an individual are the members within the meaning of section 4946(d) and paragraph (h) of this section; and

(ii) Any profits interest or beneficial interest which has been counted once (whether by reason of actual or constructive ownership) in applying section 4946(a)(1) (F) or (G) shall not be counted a second time.

For purposes of paragraph (a)(1) (vi) and (vii) of this section, profits or beneficial interests constructively owned by an individual by reason of the application of section 267(c)(2) shall not be treated as owned by him if he is described in section 4946(a)(1)(D) but not in section 4946(a)(1)(A), (B) or (C).

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. Partnership S is a substantial contributor to private foundation X. Trust T, of which G is sole beneficiary, owns 12 percent of the profits interest of S. G's husband, H, owns 10 percent of the profits interest of S. H is a disqualified person with respect to X (under section 4946(a)(1)(C)) because he is considered to own 22 percent of the profits interest of S (10 percent actual ownership, plus G's 12 percent constructively under section 267(c)(2)). G is a disqualified person with respect to X (under section 4946(a)(1)(C) because she is considered to own 22 percent of the profits interest of S (12 percent constructively by reason of her beneficial interest in trust T, plus 10 percent constructively under section 267(c)(2) by reason of being a member of the family of H).

(f) *Foundation manager.* (1) For purposes of Chapter 42 and the regulations thereunder, the term ''foundation manager'' means:

(i) An officer, director, or trustee of a foundation (or a person having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), and

(ii) With respect to any act or failure to act, any employee of the foundation having final authority or responsibility (either officially or effectively) with respect to such act or failure to act.

(2) For purposes of subparagraph (1)(i) of this paragraph, a person shall be considered an officer of a foundation if:

(i) He is specifically so designated under the certificate of incorporation, bylaws, or other constitutive documents of the foundation; or

(ii) He regularly exercises general authority to make administrative or policy decisions on behalf of the foundation.

With respect to any act or failure to act, any person described in subdivision (ii) of this subparagraph who has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer. Moreover, such independent contractors as attorneys, accountants, and investment managers and advisers, acting in their capacities as such, are not officers within the meaning of subparagraph (1)(i) of this paragraph.

(3) For purposes of subparagraph (1)(ii) of this paragraph, an individual rendering services to a private foundation shall be considered an employee of the foundation only if he is an employee within the meaning of section 3121(d)(2).

(4) Since the definition of the term ''disqualified person'' contained in section 4946(a)(1)(B) incorporates only so much of the definition of the term ''foundation manager'' as is found in section 4946(b)(1) and subparagraph (1)(i) of this paragraph, any references, in section 4946 and this section, to ''disqualified persons'' do not constitute references to persons who are ''foundation managers'' solely by reason of the definition of that term contained in section 4946(b)(2) and subparagraph (1)(ii) of this paragraph.

(g) *Government official*—(1) *In general.* Except as provided in subparagraph (3) of this paragraph, for purposes of section 4941 and paragraph (c) of this section, the term ''government official'' means, with respect to an act of selfdealing described in section 4941, an individual who, at the time of such act,

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is described in subdivision (i), (ii), (iii), (iv), or (v) of this subparagraph (other than a ''special Government employee'' as defined in 18 U.S.C. 202(a)):

(i)(*a*) An individual who holds an elective public office in the executive or legislative branch of the Government of the United States.

(*b*) An individual who holds an office in the executive or judicial branch of the Government of the United States, appointment to which was made by the President.

(ii) An individual who holds a position in the executive, legislative or judicial branch of the Government of the United States:

(*a*) Which is listed in schedule C of rule VI of the Civil Service Rules, or

(*b*) The compensation for which is equal to or greater than the lowest rate prescribed for GS–16 of the General Schedule under 5 U.S.C. 5332.

(iii) An individual who holds a position under the House of Representatives or the Senate of the United States, as an employee of either of such bodies, who receives gross compensation therefrom at an annual rate of $15,000 or more.

(iv) The holder of an elective or appointive public office in the executive, legislative, or judicial branch of the government of a State, possession of the United States, or political subdivision or other area of any of the foregoing, or of the District of Columbia, for which the gross compensation is at an annual rate of $15,000 or more, who is described in subparagraph (2) of this paragraph.

(v) The holder of a position as personal or executive assistant or secretary to any individual described in subdivision (i), (ii), (iii), or (iv) of this subparagraph.

(2) *Public office*—(i) *Definition*. In defining the term ''public office'' for purposes of section 4946(c)(5) and subparagraph (1)(iv) of this paragraph, such term must be distinguished from mere public employment. Although holding a public office is one form of public employment, not every position in the employ of a State or other governmental subdivision (as described in section 4946 (c)(5)) constitutes a ''public office''. Although a determination whether a public employee holds a public office depends on the facts and circumstances of the case, the essential element is whether a significant part of the activities of a public employee is the independent performance of policy-making functions. In applying this subparagraph, several factors may be considered as indications that a position in the executive, legislative, or judicial branch of the government of a State, possession of the United States, or political subdivision or other area of any of the foregoing, or of the District of Columbia, constitutes a ''public office''. Among such factors to be considered in addition to that set forth above, are that the office is created by the Congress, a State constitution, or the State legislature, or by a municipality or other governmental body pursuant to authority conferred by the Congress, State constitution, or State legislature, and the powers conferred on the office and the duties to be discharged by such office are defined either directly or indirectly by the Congress, State constitution, or State legislature, or through legislative authority.

(ii) *Illustrations*. The following are illustrations of positions of public employment which do not involve policy-making functions within the meaning of subdivision (i) of this subparagraph and which are thus not a ''public office'' for purposes of section 4946(c)(5) and subparagraph (1)(iv) of this paragraph:

(*a*) The chancellor, president, provost, dean, and other officers of a State university who are appointed, elected, or otherwise hired by a State Board of Regents or equivalent public body and who are subject to the direction and supervision of such body;

(*b*) Professors, instructors, and other members of the faculty of a State educational institution who are appointed, elected, or otherwise hired by the officers of the institution or by the State Board of Regents or equivalent public body;

(*c*) The superintendent of public schools and other public school officials who are appointed, elected, or otherwise hired by a Board of Education or equivalent public body and who are subject to the direction and supervision of such body;

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(*d*) Public school teachers who are appointed, elected, or otherwise hired by the superintendent of public schools or by a Board of Education or equivalent public body;

(*e*) Physicians, nurses, and other professional persons associated with public hospitals and State boards of health who are appointed, elected, or otherwise hired by the governing board or officers of such hospitals or agencies; and

(*f*) Members of police and fire departments, except for those department heads who, under the facts and circumstances of the case, independently perform policymaking functions as a significant part of their activities.

(3) *Certain government officials on leave of absence.* For purposes of this paragraph, an individual who is otherwise described in section 4946(c) and this paragraph who was on leave of absence without pay on December 31, 1969, from his position or office pursuant to a commitment entered into on or before such date to engage in certain activities for which he is paid by one or more private foundations, is not to be treated as holding such position or office for any continuous period after December 31, 1969, and prior to January 1, 1971, during which such individual remains on leave of absence to engage in the same activities for which he is paid by such foundations. For purposes of this subparagraph, a commitment is considered entered into on or before December 31, 1969, if on or before such date, the amount and nature of the payments to be made and the name of the individual receiving such payments were entered on the records of the payor, or were otherwise adequately evidenced, or the notice of the payment to be received was communicated to the payee orally or in writing.

(h) *Members of the family.* For purposes of this section, the members of the family of an individual include only:

(1) His spouse,

(2) His ancestors,

(3) His lineal descendants, and

(4) Spouses of his lineal descendants.

For example, a brother or sister of an individual is not a member of his family for purposes of this section. However, for example, the wife of a grandchild of an individual is a member of his family for such purposes. For purposes of this paragraph, a legally adopted child of an individual shall be treated as a child of such individual by blood.

[T.D. 7241, 37 FR 28744, Dec. 29, 1972]

Subpart H—Application to Certain Nonexempt Trusts

§ 53.4947–1 Application of tax.

(a) *In general.* Section 4947 subjects trusts which are not exempt from taxation under section 501(a), all or part of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which have amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 to the same requirements and restrictions as are imposed on private foundations. The basic purpose of section 4947 is to prevent these trusts from being used to avoid the requirements and restrictions applicable to private foundations. For purposes of this section, a trust shall be presumed (in the absence of proof to the contrary) to have amounts under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 if a deduction would have been allowable under one of these sections. Also for purposes of this section and § 53.4947–2, the term ''purposes described in section 170(c)(2)(B)'' shall be treated as including purposes described in section 170(c)(1).

(b) *Charitable trusts*—(1) *General rule.* (i) For purposes of this section and § 53.4947–2, a *charitable trust,* within the meaning of section 4947(a)(1), is a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law). A trust is one for which a deduction was allowed under section 642(c), within the meaning of section 4947(a)(1), once a deduction is allowed under section 642(c) to the trust for any amount paid or permanently set aside. (See sections 642(c)

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and §1.642–4 for the limitation on such deduction in certain cases.) A charitable trust (as defined in this paragraph) shall be treated as an organization described in section 501(c)(3) and, if it is determined under section 509 that the trust is a private foundation, then Part II of Subchapter F of chapter 1 of the Code (other than section 508 (a), (b) and (c) and Chapter 42 shall apply to the trust. However, the charitable trust is not treated as an organization described in section 501(c)(3) for purposes of exemption from taxation under section 501(a). Thus, the trust is subject to the excise tax on its investment income under section 4940(b) rather than the tax imposed by section 4940(a). For purposes of satisfying the organizational test described in §1.501 (c)(3)–1(b) when a charitable trust seeks an exemption from taxation under section 501(a), a charitable trust (as defined in this paragraph) shall be considered organized on the day it first becomes subject to section 4947(a)(1). However, for purposes of the special and transistional rules in section 4940(c)(4)(B), 4942(f)(4), 4943(c)(4)(A)(i) and (B) and section 101(1)(2)(A), (B), (C), and (D), and (1)(3) of the Tax Reform Act of 1969, a charitable trust (as defined in this paragraph) shall be considered organized on the first day it has amounts in trust for which a deduction was allowed (within the meaning of paragraph (a) of this section) under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522. Thus, under this rule, a trust may be treated as a private foundation in existence on a date governing one of the applicable special and transistional rules even though the trust did not otherwise become subject to the provisions of Chapter 42 until a later date.

(ii) The provisions of paragraph (b)(1) of this section may be illustrated by the following examples:

Example 1. On January 30, 1970, X creates an inter vivos trust under which M receives 50 percent and N receives 50 percent of the trust's income for 10 years, and upon the termination of which, at the end of the 10-year period, the corpus is to be distributed to O. M, N and O are all organizations described in section 501(c)(3) and X is allowed a deduction under section 170 for the value of all interests placed in trust. The trustees of the trust do not give notice to the Internal Revenue Service under the provisions of section 508(a), and the trust will therefore not be exempt from taxation under section 501(a). The trust is a charitable trust within the meaning of section 4947(a)(1) from the date of its creation.

Example 2. On March 1, 1971, Y creates a charitable remainder annuity trust described in section 664(d)(1) under which Z, Y's son, receives $10,000 per year for life, remainder to be held in trust for P, an organization described in section 501(c)(3). Y is allowed a deduction under section 170 for the present value of the remainder interest to P. During Z's lifetime, the trust is a split-interest trust described in section 4947(a)(2) and paragraph (c) of this section. Upon the death of Z, all unexpected interests (consisting of P's remainder interest) will be devoted to section 170(c)(2)(B) purposes. Except as provided in §53.4947–1(b)(2)(iv) (relating to a reasonable period of settlement) the trust will be treated as a charitable trust within the meaning of section 4947(a)(1) from the date of the death of Z unless the trustees of the trust apply for recognition of section 501(c)(3) status under the provisions of section 508(a).

(2) *Scope of application of section 4947(a)(1)*—(i) *In general.* Subject to paragraph (b)(2) (ii) through (vii) of this section, section 4947(a)(1) applies to nonexempt trusts in which all unexpired interests are charitable. For purposes of this section, the term *charitable* when used to describe an interest or beneficiary refers to the purposes described in section 170(c)(2)(B). An estate from which the executor or administrator is required to distribute all of the net assets in trust to such beneficiaries will not be considered a charitable trust under section 4947(a)(1) during the period of estate administration or settlement, except as provided in paragraph (b)(2)(ii) of this section. A charitable trust created by will shall be considered a charitable trust under section 4947(a)(1) as of the date of death of the decedent-grantor, except as provided in paragraph (b)(2)(v) of this section (relating to trusts which wind up. For the circumstances under which segregated amounts are treated as charitable trusts, see §53.4947–1(c)(3)(iii).

(ii) *Estates.* (A) When an estate from which the executor or administrator is required to distribute all of the net assets in trust for charitable beneficiaries, or free of trust to such beneficiaries, is considered terminated for Federal income tax purposes under

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§ 1.641(b)–3(a), then the estate will be treated as a charitable trust under section 4947(a)(1) between the date on which the estate is considered terminated under § 1.641(b)–3(a) and the date final distribution of all of the net assets is made to or for the benefit of the charitable beneficiaries. This (ii) does not affect the determination of the tax liability under Subtitle A of the beneficiaries of the estates.

(B) The provisions of this (ii) may be illustrated by the following example:

Example. X bequeaths his entire estate, including 100 percent of the stock of a wholly-owned corporation, to M, an organization described in section 501(c)(3), under a will which gives his executor authority to hold the stock and manage the corporation for a period of up to 10 years for the benefit of M prior to its ultimate disposition. A deduction for the charitable bequest was allowed to X's estate under section 2055. The executor is vested with a full range of powers, including the power of sale. Upon the death of X, his executor distributes X's assets to M except for the stock of the corporation, which he holds for 5 years prior to its disposition. The continued holding of the stock of the corporation by the executor after the expiration of a reasonable time for performance of all the ordinary duties of administration causes the estate to be considered terminated for Federal income tax purposes pursuant to § 1.641(b)–3(a) and thereby subjects it to the provisions of section 4947(a)(1) from the date of such termination to the date of final disposition of the stock of the corporation.

(iii) *Certain split-interest trusts which wind up.* A split-interest trust (as defined in paragraph (c) of this section) in which all of the unexpired interests are charitable remainder interests and in which the charitable beneficiaries have become entitled to distributions of corpus in trust or free of trust shall continue to be treated as as split-interest trust under section 4947(a)(2) until the date on which final distribution of all the net assets is made. However, if after the expiration of any intervening interests the trust is considered terminated for Federal income tax purposes under § 1.641(b)–3(b), then the trust will be treated as a charitable trust under section 4947(a)(1), rather than a split interest trust under section 4947(a)(2), between the date on which the trust is considered terminated under § 1.641(b)–3(b) and the date on which such final distribution of all of the net assets is made to or for the benefit of the charitable remainder beneficiaries. This (iii) does not affect the determination of the tax liability under subtitle A of the beneficiaries of the trusts.

(iv) *Split-interest trusts which become charitable trusts.* (A) A split-interest trust (as defined in paragraph (c) of this section) in which all of the unexpired interests are charitable remainder interests and in which some or all of the charitable beneficiaries are not entitled to distributions of corpus within the meaning of paragraph (b)(2)(iii) of this section shall continue to be treated as a split-interest trust under section 4947(a)(2) rather than a charitable trust under section 4947(a)(1) for a reasonable period of settlement after the expiration of the noncharitable interest. Thus, a split-interest trust which under its terms is to continue to hold assets for charitable beneficiaries after the expiration of the noncharitable interest rather than distributing them as in paragraph (b)(2)(iii) of this section is given a reasonable period of settlement before being treated as a charitable trust. For purposes of this paragraph, the term *reasonable period of settlement* means that period reasonably required (or if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of the rights of the subsequent beneficiaries.

(B) This (iv) may be illustrated by the following example:

Example. On January 15, 1971, A creates a charitable remainder annuity trust described in section 661(d)(1) under which the trustees are required to distribute $10,000 a year to B, A's wife, for life, remainder to be held in trust for the use of M, an organization described in section 501(c)(3). A is allowed a deduction under section 170 for the amount of the charitable interest, and the trust is, therefore, treated as a split-interest trust under section 4947(a)(2) from the date of its creation. B dies on February 10, 1975. On April 15, 1975, the trustees complete performance of the ordinary duties of administration necessary for the settlement of the trust brought about by the death of B. These duties include, for example, an accounting for and payment to the estate of B of amounts

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accrued by B while alive during 1975. However, the trustees do not distribute the corpus to M by April 15, 1975. The trust shall continue to be treated as a split-interest trust under section 4947(a)(2) until April 15, 1975. After April 15, 1975, the trust shall be treated as a charitable trust under section 4947(a)(1).

(v) *Certain revocable and testamentary trusts which wind up.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust for or free of trust to charitable beneficiaries is not considered a charitable trust under section 4947(a)(1) for a reasonable period of settlement (within the meaning of paragraph (b)(2)(iv) of this section) after becoming irrevocable. After that period the trust is considered a charitable trust under section 4947(a)(1).

(vi) *Revocable trusts which become charitable trusts.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor in which all of the unexpired interests are charitable and under the terms of the governing instrument of which the trustee is required to hold some or all of the net assets in trust after becoming irrevocable solely for charitable beneficiaries is not considered a trust under section 4947(a)(1) for a reasonable period of settlement (within the meaning of paragraph (b)(2)(iv) of this section) after becoming irrevocable except that section 4941 may apply if the requirements of § 53.4941(d)–1 (b)(3) are not met. After that period, the trust is considered a charitable trust under section 4947(a)(1).

(vii) *Trust devoted to 170(c) purposes.* (A) A trust all of the unexpired interests in which are devoted to section 170 (c) (3) or (5) purposes together with section 170(c)(2)(B) purposes shall be considered a charitable trust except that payments under the terms of the governing instrument to an organization described in section 170(c) (3) or (5) shall not be considered a violation of section 4945(d)(5) or any other provisions of Chapter 42 and shall be considered qualifying distributions under section 4942.

(B) *Example.* The application of paragraph (b)(2)(vii) of this section may be illustrated by the following example:

Example. On January 30, 1970, H creates an inter vivos trust under the terms of the governing instruments of which M, an organization described in section 170(c)(3), and N, an organization described in section 501(c)(3), are each to receive 50 percent of the income for a period of 10 years. At the end of the 10 year period, the corpus is to be distributed to O, an organization also described in section 501(c)(3). H is allowed a deduction under section 170 for the value of all interests placed in trust. The payments to M do not constitute a violation of section 4945(d)(5) or any other provision of Chapter 42 and constitute qualifying distributions under section 4942. However, except as provided in the previous sentence, the trust shall be considered a charitable trust.

(3) *Charitable trusts described in section 509(a)(3).* For purposes of section 509(a)(3)(A), a charitable trust shall be treated as if organized on the day on which it first becomes subject to section 4947(a)(1). However, for purposes of applying §§ 1.509(a)–4(d) (2)(iv)(*a*), and 1.509(a)–4(i)(1) (ii) and (iii)(*c*) the previous relationship between the charitable trust and the section 509(a) (1) or (2) organizations it benefits or supports may be considered. If the charitable trust otherwise meets the requirements of section 509(a)(3), it may obtain recognition of its status as a section 509(a)(3) organization by requesting a ruling from the Internal Revenue Service. For the special rules pertaining to the application of the organizational test to organizations terminating their private foundation status under the 12-month or 60-month termination period provided under section 507(b)(1)(B) by becoming ''public'' under section 509(a)(3), see the regulations under section 507(b)(1).

(c) *Split-interest trusts*—(1) *General rule*—(i) *Definition.* For purposes of this section and § 53.4947–2, a *split-interest trust,* within the meaning of section 4947(a)(2), is a trust which is not exempt from taxation under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed (within the meaning of paragraph (a) of this section) under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522. A trust is one which has amounts in trust for which a deduction was allowed under section

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00223 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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642(c) within the meaning of section 4947(a)(2) once a deduction is allowed under section 642(c) to the trust for any amount permanently set aside. This (i) also includes any trust which is not treated as a charitable trust by operation of paragraph (b)(2) (iii) or (iv) of this section (relating to split-interest trusts in the process of winding up or during a reasonable period of settlement). Section 4947(a)(1) shall apply to a trust described in this (i) (without regard to section 4947(a)(2)(A), (B), or (C)) from the first date upon which the provisions of paragraph (b)(2) (iii) or (iv) of this section are satisfied. For the circumstances under which a trust all of the unexpired interests in which are devoted to section 170(c) (3) or (5) purposes together with section 170(c)(2)(B) purposes is considered a charitable trust, see § 53.4947–1(b)(2)(vii).

(ii) *Applicability of statutory rules.* A split-interest trust is subject to the provisions of section 507 (except as provided in paragraph (e) of this section), 508(e) (to the extent applicable to a split-interest trust), 4941, 4943 (except as provided in section 4947(b)(3)), 4944 (except as provided in section 4947(b)(3)), and 4945 in the same manner as if such trust were a private foundation.

(iii) *Special rules.* A newly created trust shall, for purposes of section 4947(a)(2), be treated as having amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 from the date of its creation, even if a deduction was allowed for such amounts only at a later date. For purposes of this (iii), the date of creation of a charitable remainder trust shall be determined by applying the rules in § 1.664–1(a)(4).

(2) *Exception for amounts payable to income beneficiaries.* (i) Under section 4947(a)(2)(A), paragraph (c)(1)(ii) of this section does not apply to any amounts payable under the terms of a split-interest trust to income beneficiaries unless a deduction was allowed under section 170(f)(2)(B), 2055(e)(2) (B), or 2522(c)(2)(B) with respect to the income interest of any such beneficiary. See § 1.170A–6(c), § 20.2055(e)(2), and § 25.2522(c)–3(c)(2) for rules regarding the allowance of these deductions. However, section 4947(a)(2)(A) does not apply when the value of all interests in property transferred in trust are deductible under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. H creates a charitable remainder unitrust (described in section 664(d)(2)) which is required annually to pay W, H's wife, 5 percent of the net fair market value of the trust assets, valued annually, for her life; and to pay the remainder to Y, a section 501(c)(3) organization. A deduction under section 170(f)(2)(A) was allowed with respect to the remainder interest of Y. Under section 4947(a)(2)(A), each annual amount which becomes payable to W during her life is not subject to paragraph (c)(1)(ii) of this section on or after the date upon which it becomes so payable and the payment of each amount to W is not an act of self-dealing under section 4941(d)(1) and does not violate any other provision of chapter 42. However, except as provided in the preceding sentence, the trust is subject to paragraph (c)(1)(ii) of this section in the same manner as any other split-interest trust.

Example 2. H bequeaths the residue of his estate in trust for the benefit of S, his son, and Y, an organization described in section 501(c)(3). A guaranteed annuity interest of $10,000 is to be paid to S for 20 years. A guaranteed annuity interest of $5,000 which meets the requirements contained in § 20.2055–2(e)(2)(v)(*a*) is also to be paid to Y for 20 years. Upon termination of the 20-year term, the corpus is to be distributed to Z, another organization described in section 501(c)(3). The trust is a charitable remainder annuity trust as described in section 664(d)(1) and the regulations thereunder, and a deduction under section 2055(e)(2)(A) was allowed with respect to the remainder interest of Z. A deduction was also allowed under section 2055(e)(2)(B) with respect to the guaranteed annuity interest of Y. The assets in the trust are not segregated under section 4947(a)(2)(B) and paragraph (c)(3) of this section. Under section 4947(a)(2)(A), each payment of $10,000 to S is not subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section. The payment of each amount to S is not an act of self-dealing under section 4941(d)(1) and does not violate any other provision of chapter 42. However, except as provided in the preceding sentence, the trust is subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section in the same manner as any other split-interest trust.

Example 3. H creates a trust under which the trustees are required to pay over an annuity interest of $20,000 to W. H's wife, for her life. A guaranteed annuity interest of

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$10,000 which meets the requirements contained in § 25.2522(c)–3(c)(2)(v) is also to be paid X, an organization described in section 501(c)(3), for the life of W. Upon the death of W, the corpus of the trust, which consists of office buildings M and N, is to be distributed to S. H's son. H received a deduction under section 2522(c)(2)(B) for the value of X's income interest in the trust. The assets in the trust are not segregated under section 4947(a)(2)(B) and paragraph (c)(3) of this section. Under section 4947(a)(2)(A), each payment of $20,000 to W is not subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section. The payment of each amount to W is not an act of self-dealing under section 4941(d)(1) and does not violate any other provision of chapter 42. However, except as provided in the preceding sentence, the trust is subject to paragraph (c)(1)(ii) of this section in the same manner as any other split-interest trust. See example (1) of paragraph (c)(3)(v) of this section for the application of section 4947(a)(2)(B) to a similar trust where the trustees segregate the assets of the trust.

(3) *Exception for certain segregated amount*—(i) *In general.* Under section 4947(a)(2)(B) paragraph (c)(1)(ii) of this section does not apply to assets held in trust (together with the income and capital gains derived from the assets), which are segregated from other assets held in trust for which a deduction was allowed for an income or remainder interest under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

(ii) *Segregation of amounts.* Amounts will generally be considered segregated (within the meaning of section 4947(a)(2)(B) if:

(A) Assets with respect to which no deduction was allowed (for an income or remainder interest) under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, are separately accounted for under section 4947(a)(3) and paragraph (c)(4) of this section from assets for which such a deduction was allowed for any income or remainder interest and,

(B) By reason of the separate accounting the trust can be treated as two separate trusts, one of which is devoted exclusively to noncharitable income and remainder interests and the other of which is a charitable trust described in section 4947(a)(1) or a split-interest trust described in section 4947(a)(2).

Under these circumstances, only the ''trust'' which is devoted exclusively to noncharitable income and remainder interests will be considered a segregated amount which under section 4947(a)(2)(B), is not subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section.

(iii) *Exclusively charitable amounts.* If, under section 4947(a)(2)(B),

(A) An amount held in trust which is devoted exclusively to noncharitable income and remainder interests is segregated from

(B) An amount held in trust which is devoted exclusively to charitable income and remainder interests,

Then for purposes of this section the amount described in paragraph (c)(3)(iii)(B) of this section will be treated as a charitable trust which is subject to the provisions of section 4947(a)(1).

(iv) *Charitable and noncharitable amounts.* If, under section 4947(a) (2)(B),

(A) An amount held in trust which is devoted exclusively to noncharitable income and remainder interests is segregated from

(B) An amount held in trust which is devoted to both charitable income or remainder interests and noncharitable income or remainder interests,

Then for purposes of this section the amount described in paragraph (c)(3)(iv)(B) of this section will be treated as a split-interest trust which is subject to the provisions of section 4947(a)(2).

(v) *Examples.* The application of paragraph (c)(3) of this section may be illustrated by the following examples:

Example 1. H creates a trust under which the trustees are required to pay over annually 5 percent of the net fair market value of M building, valued annually, to W, H's wife, for life, remainder to S, H's son. The other asset in the trust is N building, with respect to which the trustees are required to pay over annually 5 percent of the net fair market value of the building, valued annually, to X, a section 501(c)(3) organization, for a period of 15 years, remainder to S. Each asset is separately accounted for under section 4947(a)(3) and paragraph (c)(4) of this section. He received a deduction under section 2522 for the value of X's income interest in N building. Under these circumstances, M building is considered segregated (within the meaning of section 4947(a)(2)(B)) from N building and is not subject to section 4947

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(a)(2). The remainder interest of S in N building is not considered segregated from the income interest of X in N building, since both are interests in the same asset. N building is considered held in a split-interest trust which is subject to section 4947 (a)(2) and paragraph (c)(1)(ii) of this section.

Example 2. H transfers $50,000 in trust to pay $2,500 per year to Z, a section 501(c)(3) organization, for a term of 20 years, remainder to S. H's son. H is allowed a deduction under section 2522 for the present value of Z's income interest. The income interest of Z in the trust asset cannot be segregated (within the meaning of section 4947(a)(2)(B)) from the remainder interest of S since both are interests in the same asset. Therefore, the entire trust is subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section.

(4) *Accounting for segregated amounts*—(i) *General rule.* Under section 4947(a)(2)(B), a trust with respect to which amounts are segregated within the meaning of paragraph (c)(3) of this section must separately account for the various income, deduction, and other items properly attributable to each segregated amount in the books of account and separately account to each of the beneficiaries of the trust.

(ii) *Method.* Separate accounting shall be made:

(A) According to the method regularly employed by the trust, if the method is reasonable, and

(B) In all other cases in a manner which, in the opinion of the Commissioner, is reasonable.

A method of separate accounting will be considered ''regularly employed'' by a trust when the method has been consistently followed in prior taxable years or when a trust which has never before maintained segregated amounts initiates a reasonable method of separate accounting for its segregated amounts and consistently follows such method thereafter. The trust shall keep permanent records and other data relating to the segregated amounts as are necessary to enable the district director to determine the correctness of the application of the rules prescribed in paragraph (c) (3) and (4) of this section.

(5) *Amounts transferred in trust before May 27, 1969*—(i) *General rule.* Under section 4947(a)(2)(C), paragraph (c)(1)(ii) of this section does not apply to any amounts transferred in trust before May 27, 1969. For purposes of this (5), an amount shall be considered to be transferred in trust only when the transfer is one which meets the requirements for the allowance of a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law). Income and capital gains which are derived at any time from amounts transferred in trust before May 27, 1969, shall also be excluded from the application of paragraph (c)(1)(ii) of this section. If an asset which was transferred in trust before May 27, 1969, is sold or exchanged after May 26, 1969, any asset received by the trust upon the sale or exchange shall be treated as an asset which was transferred in trust before May 27, 1969.

(ii) *Requirement for separate accounting for amounts transferred in trust before May 27, 1969.* If:

(A) Amounts are transferred in trust after May 26, 1969, and the trust to which the amounts are transferred also contains

(B) Amounts transferred in trust before May 27, 1969,

the general rule of paragraph (c)(5)(i) of this section applicable to the amounts described in paragraph (c)(5)(ii)(B) of this section will apply only if the amounts described in paragraph (c)(5)(ii)(A) of this section (together with all income and capital gains derived therefrom) are separately accounted for (within the meaning of paragraph (c)(4) of this section) from the amounts described in paragraph (c)(5)(ii)(B) of this section, together with all income and capital gains derived therefrom. For the application of section 508(e) to a trust with respect to which amounts were transferred both before and after May 27, 1969, see section 508(e) and the regulations thereunder.

(iii) *Exception for certain testamentary trusts.* (A) Amounts transferred in trust before May 27, 1969 include amounts transferred in trust after May 26, 1969 when the transfer is made under the terms of a testamentary trust created by the will of a decedent who died before May 27, 1969, (regardless of whether the executors or the testamentary trustees are required to execute testamentary trusts by court order under

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00226 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

applicable local law). Amounts transferred in trust before May 27, 1969, also include amounts transferred to a testamentary trust created by the will of a decedent who died after May 26, 1969 if the will was executed before May 27, 1969 and no dispositive provision of the will was amended (within the meaning of § 20.2055–2(e)(4) and (5)) by the decedent by codicil or otherwise, after May 26, 1969, and the decedent was on May 27, 1969, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii)) to amend the will by codicil or otherwise.

(B) The provisions of this (iii) may be illustrated by the following example:

Example. X executed a will in 1960 which provided for the creation of a testamentary trust which meets the description of a split-interest trust under section 4947(a)(2). X died on April 15, 1969. Under the provisions of his will, the probate court permitted certain property in X's estate to be transferred to the testamentary trust at fixed intervals over a period of two years during the administration of the estate. Section 4947(a)(2) does not apply to any amount described in this example, including the amounts transferred after May 26, 1969, because, for purposes of section 4947(a)(2)(C), each such transfer will be treated as an amount transferred in trust before May 27, 1969, within the meaning of section 4947(a)(2)(C).

(6) *Scope of application of section 4947(a)(2)*—(i) *In general.* Subject to paragraph (c)(6) (ii), (iii), and (iv) of this section, section 4947(a)(2) applies to trusts in which some but not all unexpired interests are charitable. An estate from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries will not be considered to be a split-interest trust under section 4947(a)(2) during the period of estate administration or settlement, except as provided in paragraph (c)(6)(ii) of this section. A split-interest trust created by will shall be considered a split-interest trust under section 4947(a)(2) as of the date of death of the decedent-grantor, except as provided in paragraph (c)(6)(iv) of this section.

(ii) *Estates.* (A) When an estate from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries is considered terminated for Federal income tax purposes under § 1.641(b)–3(a), then the estate will be treated as a split-interest trust under section 4947(a)(2) (or a charitable trust under section 4957(a)(1), if applicable) between the date on which the estate is considered terminated under § 1.641(b)–3(a) and the date on which final distribution of the net assets to the last remaining charitable beneficiary is made. This (ii) does not affect the determination of the tax liability under subtitle A of either charitable or noncharitable beneficiaries of the estates.

(B) The provisions of this (ii) may be illustrated by the following example:

Example. X dies on January 15, 1973 and bequeaths $10,000 to M, an organization described in section 501(c)(3), and the residue of his estate to W, his wife. A deduction for the charitable bequest was allowed to X's estate under section 2055. Substantially all of X's estate consists of 100 percent of the stock of a wholly owned corporation, certain liquid assets such as marketable stocks and securities and bank accounts, and X's home, automobile, and other personal property. X's will gives his executor a full range of powers, including the power to sell the stock of the wholly owned corporation. After the death of X, his executor continues to manage the wholly owned corporation while attempting to sell the stock of the corporation. During this period, the executor makes no distributions to M. On May 24, 1978, the Internal Revenue Service determines under § 1.641(b)–3(a) that the administration of the estate has been unduly prolonged and the estate is considered terminated as of that date for Federal income tax purposes. X's estate will be treated as a split-interest trust described in section 4947(a)(2) between May 24, 1978 and the date on which the $10,000 bequest to M is satisfied. X's estate will therefore be subject to the applicable private foundation provisions during that period and, for example, a sale of the house by the estate to any disqualified person (as defined in section 4946) will be an act of self-dealing under section 4941.

(iii) *Revocable trusts which become split-interest trusts.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor under the terms of the governing instrument of which the trustee is required to hold some or all of its net assets in trust after becoming irrevocable for both charitable and noncharitable beneficiaries is not considered a split-interest trust under section 4947(a)(2) for a

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00227 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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reasonable period of settlement after becoming irrevocable except that section 4941 may apply if the requirements of § 53.4941(d)–1(b)(3) are not met.

After that period, the trust is considered a split-interest trust under section 4947(a)(2). For purposes of this (iii), the term *reasonable period of settlement* means that period reasonably required (or if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of rights of the subsequent beneficiaries.

(iv) *Certain revocable and testamentary trusts which wind up.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries is not considered a split-interest trust under section 4947(a)(2) for a reasonable period of settlement (within the meaning of paragraph (c)(6)(iii) of this section) after becoming irrevocable. After that period, the trust is considered a split-interest trust under section 4947(a)(2) (or a charitable trust under section 4947(a)(1), if applicable).

(d) *Cross references; Governing instrument requirements and charitable deduction limitations.* For the application of section 642(c)(6) (relating to section 170 limitations on charitable deductions of non-exempt private foundation trusts) to a trust described in section 4947(a)(1), see § 1.642(c)–4. For the denial of a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 for a gift, a bequest, or an amount paid to (and the denial of a deduction under section 642(c) for an amount set aside in) a trust described in section 4947(a)(1) or (2) that fails to meet the applicable governing instrument requirements of section 508(e) by the end of the taxable year of the trust, see section 508(d)(2) and § 1.508–2(b). Since a charitable remainder trust (as defined in section 664) is not exempt under section 501(a), it is subject to section 4947(a)(2), and thus to the governing instrument requirements of section 508(e) to the extent they are applicable.

(e) *Application of section 507(a)*—(1) *General rule.* The provisions of section 507(a) shall not apply to a trust described in section 4947(a) (1) or (2) by reason of any payment to a beneficiary that is directed by the terms of the governing instrument of the trust and is not discretionary with the trustee or, in the case of a discretionary payment, by reason of, or following, the expiration of the last remaining charitable interest in the trust.

(2) *Examples.* The provisions of this (e) may be illustrated by the following examples:

Example 1. H creates a section 4947(a)(1) trust under which the income is to be paid for 15 years to R, a section 501(c)(3) organization. Upon the expiration of 15 years, the trust is to terminate and distribute all of its assets to S, another section 501(c)(3) organization. Distribution of the corpus of the trust to S will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

Example 2. H creates a trust under which X, a section 501(c)(3) organization, receives $20,000 per year for a period of 20 years, remainder to S, H's son. H is allowed a deduction under section 2522 for the present value of X's interest.

When the final payment to X has been made at the end of the 20-year period in accordance with the terms of the trust, the provisions of section 4947(a)(2) will cease to apply to the trust because the trust no longer retains any amounts for which the deduction under section 2522 was allowed. However, the final payment to X will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

Example 3. J creates a charitable remainder annuity trust described in section 664(d)(1) under which S, J's son, receives $10,000 per year for life, remainder to be distributed outright to P, an organization described in section 501(c)(3). J is allowed a deduction under section 170 for the value of the remainder interest placed in trust for the benefit of P, and the provisions of section 4947(a)(2) apply to the trust. At the death of S, the trust will terminate and all assets will be distributed to P. However, such final distribution to P will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

[T.D. 7431, 41 FR 35515, Aug. 23, 1976]

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00228 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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§ 53.4947–2 Special rules.

(a) *Limit to segregated amounts.* If any amounts held in trust are segregated within the meaning of § 53.4947–1(c)(3), the value of the net assets for purposes of section 507(c)(2) and (g) shall be limited to the segregated amounts with respect to which a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 was allowed. See the regulations under section 507(c)(2) and (g).

(b) *Applicability of section 4943 and 4944 to split-interests trusts*—(1) *General rule.* Under section 4947(b)(3), section 4943 and 4944 do not apply to a split-interest trust described in section 4947(a)(2) if:

(i) All the income interest (and none of the remainder interest) of the trust is devoted solely to one or more of the purposes described in section 170(c)(2)(B) and all amounts in the trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 have an aggregate value (at the time for which the deduction was allowed) of not more than 60 percent of the aggregate fair market value of all amounts in the trust (after the payment of estate taxes and all other liabilities), or

(ii) A deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2) or 2522 for amounts payable under the terms of the trust to every remainder beneficiary, but not to any income beneficiary.

This (1) shall apply to a trust described in paragraph (b)(1)(ii) of this section only if all amounts payable under the terms of the trust to every remainder beneficiary are to be devoted solely to one or more of the purposes described in section 170(c)(2)(B). After the expiration of all income interests in a trust described in paragraph (b)(1)(ii) of this section, the trust shall become subject to section 4947(a)(1) under § 53.4947–1(b)(2), and section 4947(b)(3) shall no longer apply to the trust. A pooled income fund described in section 642(c)(5) will generally meet the requirements of paragraph (b)(1)(ii) of this section, as will a charitable remainder trust described in section 664(d)(1), if in either case it does not make payments to any income beneficiary described in section 170(c).

(2) *Definitions.* (i) For purposes of section 4947(b)(3)(A), the term ''income interest'' shall include an interest in property transferred in trust which is in the form of a guaranteed annuity interest or unitrust interest as described in § 1.170A–6(c), § 20.2055–2(e)(2) or § 25.2522(c)–3(c)(2) and the term ''remainder interest'' shall include an interest which succeeds an ''income interest'' within the meaning of this (i).

(ii) For purposes of section 4947(b)(3)(B), the term ''income beneficiary'' shall include a recipient of payments described in section 642(c)(5)(F) from a pooled income fund, payments described in section 664(d)(1)(A) from a charitable remainder annuity trust, or payments described in section 664(d)(2)(A) or (3) from a charitable remainder unitrust. The term ''remainder beneficiary'' shall include a beneficiary of a remainder interest described in section 642(c)(5) or 664(d)(1)(C) or (2)(C).

(c) *Effective date.* Except as otherwise provided in §§ 53.4947–1 and 53.4947–2 and the regulations under sections 508 (d) and (e), §§ 53.4947–1 and 53.4947–2 shall take effect on January 1, 1970.

(Secs. 4947 and 7805, Internal Revenue Code of 1954 (68A Stat. 917: 26 U.S.C. 7805))

[T.D. 7431, 41 FR 35515, Aug. 23, 1976]

Subpart I—Tax on Investment Income of and Denial of Exemption to Certain Foreign Organizations

§ 53.4948–1 Application of taxes and denial of exemption with respect to certain foreign organizations.

(a) *Tax on income of certain foreign organizations.* (1) In lieu of the tax imposed by section 4940 and the regulations thereunder, there is hereby imposed for each taxable year beginning after December 31, 1969, on the gross investment income (within the meaning of section 4940(c)(2) and the regulations thereunder) derived from sources within the United States (within the meaning of section 861 and the regulations thereunder) by every foreign organization which is a private foundation (within the meaning of section 509 and the regulations thereunder) and exempt from taxation under section

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00229 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

501(a) for the taxable year a tax equal to 4 percent of such income, except as provided in subparagraph (3) of this paragraph. The tax (if any) will be reported on the form the foundation is required to file under section 6033 and will be paid annually for the taxable year, at the time prescribed for filing such annual return (determined without regard to any extension of time for filing). For purposes of this section, the term *foreign organization* means any organization which is not described in section 170(o)(2)(A).

(2) With respect to the deduction and withholding of tax imposed by section 4948(a), see section 1443(b) and the regulations thereunder.

(3) Whenever there exists a tax treaty between the United States and a foreign country, and a foreign private foundation subject to section 4948(a) is a resident of such country or is otherwise entitled to the benefits of such treaty (whether or not such benefits are available to all residents), if the treaty provides that any item or items (or all items with respect to an organization exempt from income taxation) of gross investment income (within the meaning of section 4940(c)(2)) shall be exempt from income tax, such item or items shall not be taken into account by such foundation in computing the tax to be imposed under section 4948(a) for any taxable year for which the treaty is effective.

(b) *Certain sections inapplicable.* Section 507 (relating to termination of private foundation status), section 508 (relating to special rules with respect to section 501(c)(3) organizations), and Chapter 42 (other than section 4948) of the Code shall not apply to any foreign organization which from the date of its creation has received at least 85 percent of its support (as defined in section 509(d), other than section 509(d)(4)) from sources outside the United States. For purposes of this paragraph, gifts, grants, contributions, or membership fees directly or indirectly from a United States person (as defined in section 7701(a)(30)) are from sources within the United States.

(c) *Denial of exemption to foreign organizations engaged in prohibited transactions*—(1) *In general.* A foreign private foundation described in section 4948(b) and paragraph (b) of this section shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction (within the meaning of subparagraph (2) of this paragraph) after December 31, 1969.

(2) *Prohibited transactions.* (i) For purposes of this section, the term ''prohibited transaction'' means any act or failure to act (other than with respect to section 4942(e), relating to minimum investment return) which would subject a foreign private foundation described in paragraph (b) of this section, or a disqualified person (as defined in section 4946) with respect thereto, to liability for a penalty under section 6684 (relating to assessable penalties with respect to liability for tax under Chapter 42) or a tax under section 507 (relating to termination of private foundation status) if such foreign private foundation were a domestic private foundation.

(ii) For purposes of subdivision (i) of this subparagraph:

(*a*) Approval by an appropriate foreign government of grants by the foreign private foundation to individuals is sufficient to satisfy the requirements of section 4945(g) and the regulations thereunder.

(*b*) In determining whether a grantee of the foreign organization is a private foundation which is not an operating foundation for purposes of section 4942(g)(1)(A)(ii) or is an organization which is not described in section 509(a) (1), (2), or (3) for purposes of section 4945 (d)(4) and (h), a determination made by such foreign organization will be accepted if such determination is made in good faith after a reasonable effort to identify the status of its grantee.

(iii) For purposes of subdivision (i) of this subparagraph, in order for an act or failure to act (without regard to section 4942(e)) to be treated as a prohibited transaction under section 4948(c)(2) by reason of the application of section 6684(1), there must have been a prior act or failure to act (without regard to section 4942(e)), which:

(*a*) Would have resulted in liability for tax under Chapter 42 (other than section 4940 or 4948(a)) if the foreign private foundation had been a domestic private foundation, and

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00230 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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(*b*) Had been the subject of a warning from the Commissioner that a second act or failure to act (without regard to section 4942(e)) would result in a prohibited transaction.

The second act or failure to act (with respect to which a warning described in subparagraph (3)(i) of this paragraph is given) need not be related to the prior act or failure to act with respect to which a warning from the Commissioner was given under (*b*) of this subdivision.

(3) *Taxable years affected.* (i) Except as provided in subdivision (ii) of this subparagraph, a foreign private foundation described in paragraph (b) of this section shall be denied exemption from taxation under section 501(a) by reason of subparagraph (1) of this paragraph for all taxable years beginning with the taxable year during which it is notified by the Commissioner that it has engaged in a prohibited transaction. The Commissioner shall publish such notice in the FEDERAL REGISTER on the day on which he so notifies such foreign private foundation. In the case of an act or failure to act (without regard to section 4942(e)) which would result in a penalty under section 6684(1) if the foreign private foundation were a domestic private foundation, before giving notice under this subdivision the Commissioner shall warn such foreign private foundation that such act or failure to act may be treated as a prohibited transaction. However, such act or failure to act will not be treated as a prohibited transaction if it is corrected (within the meaning of Chapter 42 and the regulations thereunder) within 90 days after the making of such warning.

(ii)(*a*) Any foreign private foundation described in paragraph (b) of this section which is denied exemption from taxation under section 501(a) by reason of subparagraph (1) of this paragraph may, with respect to the second taxable year following the taxable year in which notice is given under subdivision (i) of this subparagraph (or any taxable year subsequent to such second taxable year), file a request for exemption from taxation under section 501(a) on Form 1023. In addition to the information generally required of an organization requesting exemption as an organization described in section 501(a), a request under this subdivision must contain or have attached to it a written declaration, made under the penalties of perjury, by a principal officer of such organization authorized to make such declaration, that the organization will not knowingly again engage in a prohibited transaction.

(*b*) If the Commissioner is satisfied that such organization will not knowingly again engage in a prohibited transaction and that the organization has satisfied all other requirements under section 501, the organization will be so notified in writing. In such case the organization shall not, with respect to taxable years beginning with the taxable year with respect to which a request under this subdivision is filed, be denied exemption from taxation under section 501(a) by reason of any prohibited transaction which was engaged in before the date on which notice was given under subdivision (i) of this subparagraph. Section 4948(c) provides that an organization denied exemption under such section will not be exempt from taxation under section 501(a) for the taxable year in which notice of loss of exemption is given and at least one immediately subsequent taxable year.

(d) *Disallowance of certain charitable deductions.* No gift, bequest, legacy, devise, or transfer shall be allowed as a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if made:

(1) To a foreign private foundation described in paragraph (b) of this section after the date on which the Commissioner publishes notice under paragraph (c)(3)(i) of this section that he has notified such organization that it has engaged in a prohibited transaction, and

(2) In a taxable year of such organization for which it is not exempt from taxation under section 501(a) by reason of paragraph (c)(1) of this section.

For purposes of this paragraph, a bequest, legacy, devise, or transfer under section 2055 or 2106(a)(2) shall be treated as made on the date of death of the decedent. For example, assume that an individual gives money to a foreign private foundation described in section 4948(b) in January 1970, January 1971, and January 1972. The organization has

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00231 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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a taxable year from June 1 through May 31. In February 1970, notice is duly published that the foreign organization has engaged in a prohibited transaction. In December 1970, the organization duly submits a request for exemption under paragraph (c)(3)(ii)(*a*) of this section which is granted for the taxable year ending May 31, 1972. The January 1970 gift is allowable as a deduction under section 2522 since it was made before the notice (February 1970). The January 1971 gift is not allowable as a deduction because the taxable year ending May 31, 1971, is a nonexempt year (the first taxable year subsequent to the taxable year of the notice) for the foreign organization. The January 1972 gift is allowable as a deduction under section 2522 because the taxable year ending May 31, 1972, is an exempt year for the organization.

[T.D. 7218, 37 FR 23918, Nov. 10, 1972; 37 FR 24748, Nov. 21, 1972; 38 FR 4324, Feb. 13, 1973]

Subpart J—Black Lung Benefit Trust Excise Taxes

SOURCE: T.D. 7644, 44 FR 52198, Sept. 7, 1979, unless otherwise noted.

§ 53.4951–1 Black lung trusts—taxes on self-dealing.

(a) *In general.* Section 4951 contains provisions that correspond to provisions of section 4941 (relating to taxes on foundation self-dealing) and section 4946 (relating to definitions and special rules). Regulations and rulings under these corresponding provisions apply to section 4951 where appropriate.

(b) *Transfer of property to trust.* A transfer of personal property without consideration to a trust for which a deduction is allowable under section 192 does not constitute a sale or exchange for purposes of section 4951 unless the property is subject to a mortgage or similar lien within section 4951(d)(2)(A). The transfer to a trust of a note or other evidence of indebtedness constitutes an extension of credit to the obligor for purposes of section 4951(d)(1)(B).

(c) *Deposits.* A time or demand deposit made with a bank or credit union that is a trustee or other disqualified person with respect to a trust constitutes a lending of money for purposes of section 4951(d)(1)(B) even though the deposit is of a kind generally authorized for investments by the trust.

(d) *Trustee.* The term ''trustee'' as used in section 4951(e)(5)(B) includes any person having powers or responsibilities with respect to a trust similar to those of trustees.

(e) *Misallocation of insurance premium.* Under section 501(c)(21)(A)(ii) and § 1.501(c)(21)-1(d), a trust may pay a portion of a premium for insurance which covers both black lung liabilities and other liabilities, so long as the requirements of section 501(c)(21)(A)(i) concerning allocation of the total premium are met. However, if an insurance company misallocates the total premium in a manner which benefits a disqualified person, the amount of misallocation constitutes a use of trust assets for the benefit of the disqualified person within section 4951(d)(1)(D). For these purposes, it is irrelevant whether the combination of insurance is sold under one policy or more than one policy.

(f) *Effective date.* Section 4951 applies with respect to acts that occur after December 31, 1977, in and for trust *taxable* years beginning after December 31, 1977.

§ 53.4952–1 Black lung trusts—taxes on taxable expenditures.

(a) *In general.* Section 4952 contains provisions that generally correspond to provisions of section 4945 (relating to taxes on taxable expenditures by private foundations) and section 4946 (relating to definitions and special rules). Regulations and rulings under these corresponding provisions apply to section 4952 where appropriate. See section 4952(e)(1) for the definition of *correction*.

(b) *Unauthorized investments.* The term ''taxable expenditure'' in section 4952(d) includes an investment that is not authorized under section 501(c)(21)(B)(ii).

(c) *Effective date.* Section 4952 applies with respect to expenditures made after December 31, 1977, in and for trust taxable years beginning after December 31, 1977.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00232 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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Subpart K—Second Tier Excise Taxes

SOURCE: T.D. 8084, 51 FR 16303, May 2, 1986, unless otherwise noted.

§ 53.4955–1 Tax on political expenditures.

(a) *Relationship between section 4955 excise taxes and substantive standards for exemption under section 501(c)(3).* The excise taxes imposed by section 4955 do not affect the substantive standards for tax exemption under section 501(c)(3), under which an organization is described in section 501(c)(3) only if it does not participate or intervene in any political campaign on behalf of any candidate for public office.

(b) *Imposition of initial taxes on organization managers*—(1) *In general.* The excise tax under section 4955(a)(2) on the agreement of any organization manager to the making of a political expenditure by a section 501(c)(3) organization is imposed only in cases where—

(i) A tax is imposed by section 4955(a)(1);

(ii) The organization manager knows that the expenditure to which the manager agrees is a political expenditure; and

(iii) The agreement is willful and is not due to reasonable cause.

(2) *Type of organization managers covered*—(i) *In general.* The tax under section 4955(a)(2) is imposed only on those organization managers who are authorized to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the organization and on those organization managers who are members of a group (such as the organization's board of directors or trustees) which is so authorized.

(ii) *Officer.* For purposes of section 4955(f)(2)(A), a person is an officer of an organization if—

(A) That person is specifically so designated under the certificate of incorporation, bylaws, or other constitutive documents of the foundation; or

(B) That person regularly exercises general authority to make administrative or policy decisions on behalf of the organization. Independent contractors, acting in a capacity as attorneys, accountants, and investment managers and advisors, are not officers. With respect to any expenditure, any person described in this paragraph (b)(2)(ii)(B) who has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer.

(iii) *Employee.* For purposes of section 4955(f)(2)(B), an individual rendering services to an organization is an employee of the organization only if that individual is an employee within the meaning of section 3121(d)(2). With respect to any expenditure, an employee (other than an officer, director, or trustee of the organization) is described in section 4955(f)(2)(B) only if he or she has final authority or responsibility (either officially or effectively) with respect to such expenditure.

(3) *Type of agreement required.* An organization manager agrees to the making of a political expenditure if the manager manifests approval of the expenditure which is sufficient to constitute an exercise of the organization manager's authority to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the organization. The manifestation of approval need not be the final or decisive approval on behalf of the organization.

(4) *Knowing*—(i) *General rule.* For purposes of section 4955, an organization manager is considered to have agreed to an expenditure *knowing* that it is a political expenditure only if—

(A) The manager has actual knowledge of sufficient facts so that, based solely upon these facts, the expenditure would be a political expenditure;

(B) The manager is aware that such an expenditure under these circumstances may violate the provisions of federal tax law governing political expenditures; and

(C) The manager negligently fails to make reasonable attempts to ascertain whether the expenditure is a political expenditure, or the manager is aware that it is a political expenditure.

(ii) *Amplification of general rule.* For purposes of section 4955, knowing does not mean having reason to know. However, evidence tending to show that an organization manager has reason to know of a particular fact or particular

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00233 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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rule is relevant in determining whether the manager had actual knowledge of the fact or rule. Thus, for example, evidence tending to show that an organization manager has reason to know of sufficient facts so that, based solely upon those facts, an expenditure would be a political expenditure is relevant in determining whether the manager has actual knowledge of the facts.

(5) *Willful.* An organization manager's agreement to a political expenditure is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an agreement willful. However, an organization manager's agreement to a political expenditure is not willful if the manager does not know that it is a political expenditure.

(6) *Due to reasonable cause.* An organization manager's actions are due to reasonable cause if the manager has exercised his or her responsibility on behalf of the organization with ordinary business care and prudence.

(7) *Advice of counsel.* An organization manager's agreement to an expenditure is ordinarily not considered knowing or willful and is ordinarily considered due to reasonable cause if the manager, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of counsel expressed in a reasoned written legal opinion that an expenditure is not a political expenditure under section 4955 (or that expenditures conforming to certain guidelines are not political expenditures). For this purpose, a written legal opinion is considered reasoned even if it reaches a conclusion which is subsequently determined to be incorrect, so long as the opinion addresses itself to the facts and applicable law. A written legal opinion is not considered reasoned if it does nothing more than recite the facts and express a conclusion. However, the absence of advice of counsel with respect to an expenditure does not, by itself, give rise to any inference that an organization manager agreed to the making of the expenditure knowingly, willfully, or without reasonable cause.

(8) *Cross reference.* For provisions relating to the burden of proof in cases involving the issue of whether an organization manager has knowingly agreed to the making of a political expenditure, see section 7454(b).

(c) *Amplification of political expenditure definition*—(1) *General rule.* Any expenditure that would cause an organization that makes the expenditure to be classified as an action organization by reason of § 1.501(c)(3)–1(c)(3)(iii) of this chapter is a political expenditure within the meaning of section 4955(d)(1).

(2) *Other political expenditures*—(i) For purposes of section 4955(d)(2), an organization is effectively controlled by a candidate or prospective candidate only if the individual has a continuing, substantial involvement in the day-to-day operations or management of the organization. An organization is not effectively controlled by a candidate or a prospective candidate merely because it is affiliated with the candidate, or merely because the candidate knows the directors, officers, or employees of the organization. The effectively controlled test is not met merely because the organization carries on its research, study, or other educational activities with respect to subject matter or issues in which the individual is interested or with which the individual is associated.

(ii) For purposes of section 4955(d)(2), a determination of whether the primary purpose of an organization is promoting the candidacy or prospective candidacy of an individual for public office is made on the basis of all the facts and circumstances. The factors to be considered include whether the surveys, studies, materials, etc. prepared by the organization are made available only to the candidate or are made available to the general public; and whether the organization pays for speeches and travel expenses for only one individual, or for speeches or travel expenses of several persons. The fact that a candidate or prospective candidate utilizes studies, papers, materials, etc., prepared by the organization (such as in a speech by the candidate) is not to be considered as a factor indicating that the organization has a purpose of promoting the candidacy or

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00234 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

prospective candidacy of that individual where such studies, papers, materials, etc. are not made available only to that individual.

(iii) Expenditures for voter registration, voter turnout, or voter education constitute other expenses, treated as political expenditures by reason of section 4955(d)(2)(E), only if the expenditures violate the prohibition on political activity provided in section 501(c)(3).

(d) *Abatement, refund, or no assessment of initial tax.* No initial (first-tier) tax will be imposed under section 4955(a), or the initial tax will be abated or refunded, if the organization or an organization manager establishes to the satisfaction of the IRS that—

(1) The political expenditure was not willful and flagrant; and

(2) The political expenditure was corrected.

(e) *Correction*—(1) *Recovery of expenditure.* For purposes of section 4955(f)(3) and this section, correction of a political expenditure is accomplished by recovering part or all of the expenditure to the extent recovery is possible, and, where full recovery cannot be accomplished, by any additional corrective action which the Commissioner may prescribe. The organization making the political expenditure is not under any obligation to attempt to recover the expenditure by legal action if the action would in all probability not result in the satisfaction of execution on a judgment.

(2) *Establishing safeguards.* Correction of a political expenditure must also involve the establishment of sufficient safeguards to prevent future political expenditures by the organization. The determination of whether safeguards are sufficient to prevent future political expenditures by the organization is made by the District Director.

(f) *Effective date.* This section is effective December 5, 1995.

[T.D. 8628, 60 FR 62210, Dec. 5, 1995]

§ 53.4958–0 Table of contents.

This section lists the major captions contained in §§ 53.4958–1 through 53.4958–8.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00235 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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(B) Profits or beneficial interest.
(c) Persons having substantial influence.
(1) Voting members of the governing body.
(2) Presidents, chief executive officers, or chief operating officers.
(3) Treasurers and chief financial officers.
(4) Persons with a material financial interest in a provider-sponsored organization.
(d) Persons deemed not to have substantial influence.
(1) Tax-exempt organizations described in section 501(c)(3).
(2) Certain section 501(c)(4) organizations.
(3) Employees receiving economic benefits of less than a specified amount in a taxable year.
(e) Facts and circumstances govern in all other cases.
(1) In general.
(2) Facts and circumstances tending to show substantial influence.
(3) Facts and circumstances tending to show no substantial influence.
(f) Affiliated organizations.
(g) Examples.

§ 53.4958–4 Excess benefit transaction

(a) Definition of excess benefit transaction.
(1) In general.
(2) Economic benefit provided indirectly.
(i) In general.
(ii) Through a controlled entity.
(A) In general.
(B) Definition of control.
(*1*) In general.
(*2*) Constructive ownership.
(iii) Through an intermediary.
(iv) Examples.
(3) Exception for fixed payments made pursuant to an initial contract.
(i) In general.
(ii) Fixed payment.
(A) In general.
(B) Special rules.
(iii) Initial contract.
(iv) Substantial performance required.
(v) Treatment as a new contract.
(vi) Evaluation of non-fixed payments.
(vii) Examples.
(4) Certain economic benefits disregarded for purposes of section 4958.
(i) Nontaxable fringe benefits.
(ii) Expense reimbursement payments pursuant to accountable plans.
(iii) Certain economic benefits provided to a volunteer for the organization.
(iv) Certain economic benefits provided to a member of, or donor to, the organization.
(v) Economic benefits provided to a charitable beneficiary.
(vi) Certain economic benefits provided to a governmental unit.
(5) Exception for certain payments made pursuant to an exemption granted by the Department of Labor under ERISA.
(b) Valuation standards.
(1) In general.
(i) Fair market value of property.
(ii) Reasonable compensation.
(A) In general.
(B) Items included in determining the value of compensation for purposes of determining reasonableness under section 4958.
(C) Inclusion in compensation for reasonableness determination does not govern income tax treatment.
(2) Timing of reasonableness determination.
(i) In general.
(ii) Treatment as a new contract.
(iii) Examples.
(c) Establishing intent to treat economic benefit as consideration for the performance of services.
(1) In general.
(2) Nontaxable benefits.
(3) Contemporaneous substantiation.
(i) Reporting of benefit.
(A) In general.
(B) Failure to report due to reasonable cause.
(ii) Other written contemporaneous evidence.
(4) Examples.

§ 53.4958–5 Transaction in which the amount of the economic benefit is determined in whole or in part by the revenues of one or more activities of the organization. [Reserved]

§ 53.4958–6 Rebuttable presumption that a transaction is not an excess benefit transaction.

(a) In general.
(b) Rebutting the presumption.
(c) Requirements for invoking rebuttable presumption.
(1) Approval by an authorized body.
(i) In general.
(ii) Individuals not included on authorized body.
(iii) Absence of conflict of interest.
(2) Appropriate data as to comparability.
(i) In general.
(ii) Special rule for compensation paid by small organizations.
(iii) Application of special rule for small organizations.
(iv) Examples.
(3) Documentation.
(d) No presumption with respect to non-fixed payments until amounts are determined.
(1) In general.
(2) Special rule for certain non-fixed payments subject to a cap.
(e) No inference from absence of presumption.
(f) Period of reliance on rebuttable presumption.

§ 53.4958–7 Correction.

(a) In general.
(b) Form of correction.
(1) Cash or cash equivalents.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00236 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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(2) Anti-abuse rule.
(3) Special rule relating to nonqualified deferred compensation.
(4) Return of specific property.
(i) In general.
(ii) Payment not equal to correction amount.
(iii) Disqualified person may not participate in decision.
(c) Correction amount.
(d) Correction where contract has been partially performed.
(e) Correction in the case of an applicable tax-exempt organization that has ceased to exist, or is no longer tax-exempt.
(1) In general.
(2) Section 501(c)(3) organizations.
(3) Section 501(c)(4) organizations.
(f) Examples.

§ 53.4958–8 Special rules.

(a) Substantive requirements for exemption still apply.
(b) Interaction between section 4958 and section 7611 rules for church tax inquiries and examinations.
(c) Other substantiation requirements.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–1 Taxes on excess benefit transactions.

(a) *In general.* Section 4958 imposes excise taxes on each excess benefit transaction (as defined in section 4958(c) and § 53.4958–4) between an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958–2) and a disqualified person (as defined in section 4958(f)(1) and § 53.4958–3). A disqualified person who receives an excess benefit from an excess benefit transaction is liable for payment of a section 4958(a)(1) excise tax equal to 25 percent of the excess benefit. If an initial tax is imposed by section 4958(a)(1) on an excess benefit transaction and the transaction is not corrected (as defined in section 4958(f)(6) and § 53.4958–7) within the taxable period (as defined in section 4958(f)(5) and paragraph (c)(2)(ii) of this section), then any disqualified person who received an excess benefit from the excess benefit transaction on which the initial tax was imposed is liable for an additional tax of 200 percent of the excess benefit. An organization manager (as defined in section 4958(f)(2) and paragraph (d) of this section) who participates in an excess benefit transaction, knowing that it was such a transaction, is liable for payment of a section 4958(a)(2) excise tax equal to 10 percent of the excess benefit, unless the participation was not willful and was due to reasonable cause. If an organization manager also receives an excess benefit from an excess benefit transaction, the manager may be liable for both taxes imposed by section 4958(a).

(b) *Excess benefit defined.* An excess benefit is the amount by which the value of the economic benefit provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person exceeds the value of the consideration (including the performance of services) received for providing such benefit.

(c) *Taxes paid by disqualified person*—(1) *Initial tax.* Section 4958(a)(1) imposes a tax equal to 25 percent of the excess benefit on each excess benefit transaction. The section 4958(a)(1) tax shall be paid by any disqualified person who received an excess benefit from that excess benefit transaction. With respect to any excess benefit transaction, if more than one disqualified person is liable for the tax imposed by section 4958(a)(1), all such persons are jointly and severally liable for that tax.

(2) *Additional tax on disqualified person*—(i) *In general.* Section 4958(b) imposes a tax equal to 200 percent of the excess benefit in any case in which section 4958(a)(1) imposes a 25-percent tax on an excess benefit transaction and the transaction is not corrected (as defined in section 4958(f)(6) and § 53.4958–7) within the taxable period (as defined in section 4958(f)(5) and paragraph (c)(2)(ii) of this section). If a disqualified person makes a payment of less than the full correction amount under the rules of § 53.4958–7, the 200-percent tax is imposed only on the unpaid portion of the correction amount (as described in § 53.4958–7(c)). The tax imposed by section 4958(b) is payable by any disqualified person who received an excess benefit from the excess benefit transaction on which the initial tax was imposed by section 4958(a)(1). With respect to any excess benefit transaction, if more than one disqualified person is liable for the tax imposed by section 4958(b), all such persons are jointly and severally liable for that tax.

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00237 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

(ii) *Taxable period.* *Taxable period* means, with respect to any excess benefit transaction, the period beginning with the date on which the transaction occurs and ending on the earlier of—

(A) The date of mailing a notice of deficiency under section 6212 with respect to the section 4958(a)(1) tax; or

(B) The date on which the tax imposed by section 4958(a)(1) is assessed.

(iii) *Abatement if correction during the correction period.* For rules relating to abatement of taxes on excess benefit transactions that are corrected within the correction period, as defined in section 4963(e), see sections 4961(a), 4962(a), and the regulations thereunder. The abatement rules of section 4961 specifically provide for a 90-day correction period after the date of mailing a notice of deficiency under section 6212 with respect to the section 4958(b) 200-percent tax. If the excess benefit is corrected during that correction period, the 200-percent tax imposed shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment. For special rules relating to abatement of the 25-percent tax, see section 4962.

(d) *Tax paid by organization managers*—(1) *In general.* In any case in which section 4958(a)(1) imposes a tax, section 4958(a)(2) imposes a tax equal to 10 percent of the excess benefit on the participation of any organization manager who knowingly participated in the excess benefit transaction, unless such participation was not willful and was due to reasonable cause. Any organization manager who so participated in the excess benefit transaction must pay the tax.

(2) *Organization manager defined*—(i) *In general.* An organization manager is, with respect to any applicable tax-exempt organization, any officer, director, or trustee of such organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization, regardless of title. A person is an officer of an organization if that person—

(A) Is specifically so designated under the certificate of incorporation, by-laws, or other constitutive documents of the organization; or

(B) Regularly exercises general authority to make administrative or policy decisions on behalf of the organization. A contractor who acts solely in a capacity as an attorney, accountant, or investment manager or advisor, is not an officer. For purposes of this paragraph (d)(2)(i)(B), any person who has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer.

(ii) *Special rule for certain committee members.* An individual who is not an officer, director, or trustee, yet serves on a committee of the governing body of an applicable tax-exempt organization (or as a designee of the governing body described in § 53.4958–6(c)(1)) that is attempting to invoke the rebuttable presumption of reasonableness described in § 53.4958–6 based on the committee's (or designee's) actions, is an organization manager for purposes of the tax imposed by section 4958(a)(2).

(3) *Participation.* For purposes of section 4958(a)(2) and this paragraph (d), participation includes silence or inaction on the part of an organization manager where the manager is under a duty to speak or act, as well as any affirmative action by such manager. An organization manager is not considered to have participated in an excess benefit transaction, however, where the manager has opposed the transaction in a manner consistent with the fulfillment of the manager's responsibilities to the applicable tax-exempt organization.

(4) *Knowing*—(i) *In general.* For purposes of section 4958(a)(2) and this paragraph (d), a manager participates in a transaction knowingly only if the person—

(A) Has actual knowledge of sufficient facts so that, based solely upon those facts, such transaction would be an excess benefit transaction;

(B) Is aware that such a transaction under these circumstances may violate the provisions of Federal tax law governing excess benefit transactions; and

(C) Negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.

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(ii) *Amplification of general rule. Knowing* does not mean having reason to know. However, evidence tending to show that a manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of such a fact or rule. Thus, for example, evidence tending to show that a manager has reason to know of sufficient facts so that, based solely upon such facts, a transaction would be an excess benefit transaction is relevant in determining whether the manager has actual knowledge of such facts.

(iii) *Reliance on professional advice.* An organization manager's participation in a transaction is ordinarily not considered knowing within the meaning of section 4958(a)(2), even though the transaction is subsequently held to be an excess benefit transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional with respect to elements of the transaction within the professional's expertise. For purposes of section 4958(a)(2) and this paragraph (d), a written opinion is reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards. However, a written opinion is not reasoned if it does nothing more than recite the facts and express a conclusion. The absence of a written opinion of an appropriate professional with respect to a transaction shall not, by itself, however, give rise to any inference that an organization manager participated in the transaction knowingly. For purposes of this paragraph, appropriate professionals on whose written opinion an organization manager may rely, are limited to—

(A) Legal counsel, including in-house counsel;

(B) Certified public accountants or accounting firms with expertise regarding the relevant tax law matters; and

(C) Independent valuation experts who—

(*1*) Hold themselves out to the public as appraisers or compensation consultants;

(*2*) Perform the relevant valuations on a regular basis;

(*3*) Are qualified to make valuations of the type of property or services involved; and

(*4*) Include in the written opinion a certification that the requirements of paragraphs (d)(4)(iii)(C)(*1*) through (*3*) of this section are met.

(iv) *Satisfaction of rebuttable presumption of reasonableness.* An organization manager's participation in a transaction is ordinarily not considered knowing within the meaning of section 4958(a)(2), even though the transaction is subsequently held to be an excess benefit transaction, if the appropriate authorized body has met the requirements of § 53.4958–6(a) with respect to the transaction.

(5) *Willful.* For purposes of section 4958(a)(2) and this paragraph (d), participation by an organization manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by an organization manager is not willful if the manager does not know that the transaction in which the manager is participating is an excess benefit transaction.

(6) *Due to reasonable cause.* An organization manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.

(7) *Limits on liability for management.* The maximum aggregate amount of tax collectible under section 4958(a)(2) and this paragraph (d) from organization managers with respect to any one excess benefit transaction is $10,000.

(8) *Joint and several liability.* In any case where more than one person is liable for a tax imposed by section 4958(a)(2), all such persons shall be jointly and severally liable for the taxes imposed under section 4958(a)(2) with respect to that excess benefit transaction.

(9) *Burden of proof.* For provisions relating to the burden of proof in cases involving the issue of whether an organization manager has knowingly participated in an excess benefit transaction, see section 7454(b) and

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00239 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

§ 301.7454–2 of this chapter. In these cases, the Commissioner bears the burden of proof.

(e) *Date of occurrence*—(1) *In general.* Except as otherwise provided, an excess benefit transaction occurs on the date on which the disqualified person receives the economic benefit for Federal income tax purposes. When a single contractual arrangement provides for a series of compensation or other payments to (or for the use of) a disqualified person over the course of the disqualified person's taxable year (or part of a taxable year), any excess benefit transaction with respect to these aggregate payments is deemed to occur on the last day of the taxable year (or if the payments continue for part of the year, the date of the last payment in the series).

(2) *Special rules.* In the case of benefits provided pursuant to a qualified pension, profit-sharing, or stock bonus plan, the transaction occurs on the date the benefit is vested. In the case of a transfer of property that is subject to a substantial risk of forfeiture or in the case of rights to future compensation or property (including benefits under a nonqualified deferred compensation plan), the transaction occurs on the date the property, or the rights to future compensation or property, is not subject to a substantial risk of forfeiture. However, where the disqualified person elects to include an amount in gross income in the taxable year of transfer pursuant to section 83(b), the general rule of paragraph (e)(1) of this section applies to the property with respect to which the section 83(b) election is made. Any excess benefit transaction with respect to benefits under a deferred compensation plan which vest during any taxable year of the disqualified person is deemed to occur on the last day of such taxable year. For the rules governing the timing of the reasonableness determination for deferred, contingent, and certain other noncash compensation, see § 53.4958–4(b)(2).

(3) *Statute of limitations rules.* See sections 6501(e)(3) and (l) and the regulations thereunder for statute of limitations rules as they apply to section 4958 excise taxes.

(f) *Effective date for imposition of taxes*—(1) *In general.* The section 4958 taxes imposed on excess benefit transactions or on participation in excess benefit transactions apply to transactions occurring on or after September 14, 1995.

(2) *Existing binding contracts.* The section 4958 taxes do not apply to any transaction occurring pursuant to a written contract that was binding on September 13, 1995, and at all times thereafter before the transaction occurs. A written binding contract that is terminable or subject to cancellation by the applicable tax-exempt organization without the disqualified person's consent (including as the result of a breach of contract by the disqualified person) and without substantial penalty to the organization, is no longer treated as a binding contract as of the earliest date that any such termination or cancellation, if made, would be effective. If a binding written contract is materially changed, it is treated as a new contract entered into as of the date the material change is effective. A material change includes an extension or renewal of the contract (other than an extension or renewal that results from the person contracting with the applicable tax-exempt organization unilaterally exercising an option expressly granted by the contract), or a more than incidental change to any payment under the contract.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–2 Definition of applicable tax-exempt organization.

(a) *Organizations described in section 501(c)(3) or (4) and exempt from tax under section 501(a)*—(1) *In general.* An applicable tax-exempt organization is any organization that, without regard to any excess benefit, would be described in section 501(c)(3) or (4) and exempt from tax under section 501(a). An applicable tax-exempt organization also includes any organization that was described in section 501(c)(3) or (4) and was exempt from tax under section 501(a) at any time during a five-year period ending on the date of an excess benefit transaction (the lookback period).

(2) *Exceptions from definition of applicable tax-exempt organization*—(i) *Private*

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foundation. A private foundation as defined in section 509(a) is not an applicable tax-exempt organization for section 4958 purposes.

(ii) *Governmental unit or affiliate*. A governmental unit or an affiliate of a governmental unit is not an applicable tax-exempt organization for section 4958 purposes if it is—

(A) Exempt from (or not subject to) taxation without regard to section 501(a); or

(B) Relieved from filing an annual return pursuant to the authority of § 1.6033–2(g)(6).

(3) *Organizations described in section 501(c)(3)*. An organization is described in section 501(c)(3) for purposes of section 4958 only if the organization—

(i) Provides the notice described in section 508; or

(ii) Is described in section 501(c)(3) and specifically is excluded from the requirements of section 508 by that section.

(4) *Organizations described in section 501(c)(4)*. An organization is described in section 501(c)(4) for purposes of section 4958 only if the organization—

(i) Has applied for and received recognition from the Internal Revenue Service as an organization described in section 501(c)(4); or

(ii) Has filed an application for recognition under section 501(c)(4) with the Internal Revenue Service, has filed an annual information return as a section 501(c)(4) organization under the Internal Revenue Code or regulations promulgated thereunder, or has otherwise held itself out as being described in section 501(c)(4) and exempt from tax under section 501(a).

(5) *Effect of non-recognition or revocation of exempt status*. An organization is not described in paragraph (a)(3) or (4) of this section during any period covered by a final determination or adjudication that the organization is not exempt from tax under section 501(a) as an organization described in section 501(c)(3) or (4), so long as that determination or adjudication is not based upon participation in inurement or one or more excess benefit transactions. However, the organization may be an applicable tax-exempt organization for that period as a result of the five-year lookback period described in paragraph (a)(1) of this section.

(6) *Examples*. The following examples illustrate the principles of this section, which defines an applicable tax-exempt organization for purposes of section 4958:

Example 1. O is a nonprofit corporation formed under state law. O filed its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). In its application, O described its plans for purchasing property from some of its directors at prices that would exceed fair market value. After reviewing the application, the IRS determined that because of the proposed property purchase transactions, O failed to establish that it met the requirements for an organization described in section 501(c)(3). Accordingly, the IRS denied O's application. While O's application was pending, O engaged in the purchase transactions described in its application at prices that exceeded the fair market values of the properties. Although these transactions would constitute excess benefit transactions under section 4958, because the IRS never recognized O as an organization described in section 501(c)(3), O was never an applicable tax-exempt organization under section 4958. Therefore, these transactions are not subject to the excise taxes provided in section 4958.

Example 2. O is a nonprofit corporation formed under state law. O files its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). The IRS issues a favorable determination letter in Year 1 that recognizes O as an organization described in section 501(c)(3). Subsequently, in Year 5 of O's operations, O engages in certain transactions that constitute excess benefit transactions under section 4958 and violate the proscription against inurement under section 501(c)(3) and § 1.501(c)(3)–1(c)(2). The IRS examines the Form 990, ''Return of Organization Exempt From Income Tax'', that O filed for Year 5. After considering all the relevant facts and circumstances in accordance with § 1.501(c)(3)–1(f), the IRS concludes that O is no longer described in section 501(c)(3) effective in Year 5. The IRS does not examine the Forms 990 that O filed for its first four years of operations and, accordingly, does not revoke O's exempt status for those years. Although O's tax-exempt status is revoked effective in Year 5, under the *lookback* rules in paragraph (a)(1) of this section and § 53.4958–3(a)(1) of this chapter, during the five-year period prior to the excess benefit transactions that occurred in Year 5, O was an applicable tax-exempt organization and O's directors were disqualified persons as to O. Therefore, the transactions between O and

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its directors during Year 5 are subject to the applicable excise taxes provided in section 4958.

(b) *Special rules*—(1) *Transition rule for lookback period.* In the case of any excess benefit transaction occurring before September 14, 2000, the lookback period described in paragraph (a)(1) of this section begins on September 14, 1995, and ends on the date of the transaction.

(2) *Certain foreign organizations.* A foreign organization, recognized by the Internal Revenue Service or by treaty, that receives substantially all of its support (other than gross investment income) from sources outside of the United States is not an organization described in section 501(c)(3) or (4) for purposes of section 4958.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002, as amended by T.D. 9390, 73 FR 16524, Mar. 28, 2008]

§ 53.4958–3 Definition of disqualified person.

(a) *In general*—(1) *Scope of definition.* Section 4958(f)(1) defines *disqualified person*, with respect to any transaction, as any person who was in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization at any time during the five-year period ending on the date of the transaction (the lookback period). Paragraph (b) of this section describes persons who are defined to be disqualified persons under the statute, including certain family members of an individual in a position to exercise substantial influence, and certain 35-percent controlled entities. Paragraph (c) of this section describes persons in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization by virtue of their powers and responsibilities or certain interests they hold. Paragraph (d) of this section describes persons deemed not to be in a position to exercise substantial influence. Whether any person who is not described in paragraph (b), (c) or (d) of this section is a disqualified person with respect to a transaction for purposes of section 4958 is based on all relevant facts and circumstances, as described in paragraph (e) of this section. Paragraph (f) of this section describes special rules for affiliated organizations. Examples in paragraph (g) of this section illustrate these categories of persons.

(2) *Transition rule for lookback period.* In the case of any excess benefit transaction occurring before September 14, 2000, the lookback period described in paragraph (a)(1) of this section begins on September 14, 1995, and ends on the date of the transaction.

(b) *Statutory categories of disqualified persons*—(1) *Family members.* A person is a disqualified person with respect to any transaction with an applicable tax-exempt organization if the person is a member of the family of a person who is a disqualified person described in paragraph (a) of this section (other than as a result of this paragraph) with respect to any transaction with the same organization. For purposes of the following sentence, a legally adopted child of an individual is treated as a child of such individual by blood. A person's family is limited to—

(i) Spouse;

(ii) Brothers or sisters (by whole or half blood);

(iii) Spouses of brothers or sisters (by whole or half blood);

(iv) Ancestors;

(v) Children;

(vi) Grandchildren;

(vii) Great grandchildren; and

(viii) Spouses of children, grandchildren, and great grandchildren.

(2) *Thirty-five percent controlled entities*—(i) *In general.* A person is a disqualified person with respect to any transaction with an applicable tax-exempt organization if the person is a 35-percent controlled entity. A 35-percent controlled entity is—

(A) A corporation in which persons described in this section (except in paragraphs (b)(2) and (d) of this section) own more than 35 percent of the combined voting power;

(B) A partnership in which persons described in this section (except in paragraphs (b)(2) and (d) of this section) own more than 35 percent of the profits interest; or

(C) A trust or estate in which persons described in this section (except in paragraphs (b)(2) and (d) of this section) own more than 35 percent of the beneficial interest.

(ii) *Combined voting power.* For purposes of this paragraph (b)(2), combined

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voting power includes voting power represented by holdings of voting stock, direct or indirect, but does not include voting rights held only as a director, trustee, or other fiduciary.

(iii) *Constructive ownership rules*—(A) *Stockholdings*. For purposes of section 4958(f)(3) and this paragraph (b)(2), indirect stockholdings are taken into account as under section 267(c), except that in applying section 267(c)(4), the family of an individual shall include the members of the family specified in section 4958(f)(4) and paragraph (b)(1) of this section.

(B) *Profits or beneficial interest*. For purposes of section 4958(f)(3) and this paragraph (b)(2), the ownership of profits or beneficial interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) (other than section 267(c)(3)), except that in applying section 267(c)(4), the family of an individual shall include the members of the family specified in section 4958(f)(4) and paragraph (b)(1) of this section.

(c) *Persons having substantial influence*. A person who holds any of the following powers, responsibilities, or interests is in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization:

(1) *Voting members of the governing body*. This category includes any individual serving on the governing body of the organization who is entitled to vote on any matter over which the governing body has authority.

(2) *Presidents, chief executive officers, or chief operating officers*. This category includes any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization. A person who serves as president, chief executive officer, or chief operating officer has this ultimate responsibility unless the person demonstrates otherwise. If this ultimate responsibility resides with two or more individuals (e.g., co-presidents), who may exercise such responsibility in concert or individually, then each individual is in a position to exercise substantial influence over the affairs of the organization.

(3) *Treasurers and chief financial officers*. This category includes any person who, regardless of title, has ultimate responsibility for managing the finances of the organization. A person who serves as treasurer or chief financial officer has this ultimate responsibility unless the person demonstrates otherwise. If this ultimate responsibility resides with two or more individuals who may exercise the responsibility in concert or individually, then each individual is in a position to exercise substantial influence over the affairs of the organization.

(4) *Persons with a material financial interest in a provider-sponsored organization*. For purposes of section 4958, if a hospital that participates in a provider-sponsored organization (as defined in section 1855(e) of the Social Security Act, 42 U.S.C. 1395w–25) is an applicable tax-exempt organization, then any person with a material financial interest (within the meaning of section 501(o)) in the provider-sponsored organization has substantial influence with respect to the hospital.

(d) *Persons deemed not to have substantial influence*. A person is deemed not to be in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization if that person is described in one of the following categories:

(1) *Tax-exempt organizations described in section 501(c)(3)*. This category includes any organization described in section 501(c)(3) and exempt from tax under section 501(a).

(2) *Certain section 501(c)(4) organizations*. Only with respect to an applicable tax-exempt organization described in section 501(c)(4) and § 53.4958–2(a)(4), this category includes any other organization so described.

(3) *Employees receiving economic benefits of less than a specified amount in a taxable year*. This category includes, for the taxable year in which benefits are provided, any full- or part-time employee of the applicable tax-exempt organization who—

(i) Receives economic benefits, directly or indirectly from the organization, of less than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i);

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(ii) Is not described in paragraph (b) or (c) of this section with respect to the organization; and

(iii) Is not a substantial contributor to the organization within the meaning of section 507(d)(2)(A), taking into account only contributions received by the organization during its current taxable year and the four preceding taxable years.

(e) *Facts and circumstances govern in all other cases*—(1) *In general*. Whether a person who is not described in paragraph (b), (c) or (d) of this section is a disqualified person depends upon all relevant facts and circumstances.

(2) *Facts and circumstances tending to show substantial influence*. Facts and circumstances tending to show that a person has substantial influence over the affairs of an organization include, but are not limited to, the following—

(i) The person founded the organization;

(ii) The person is a substantial contributor to the organization (within the meaning of section 507(d)(2)(A)), taking into account only contributions received by the organization during its current taxable year and the four preceding taxable years;

(iii) The person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls;

(iv) The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees;

(v) The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole;

(vi) The person owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person; or

(vii) The person is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons.

(3) *Facts and circumstances tending to show no substantial influence*. Facts and circumstances tending to show that a person does not have substantial influence over the affairs of an organization include, but are not limited to, the following—

(i) The person has taken a bona fide vow of poverty as an employee, agent, or on behalf, of a religious organization;

(ii) The person is a contractor (such as an attorney, accountant, or investment manager or advisor) whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the contractor will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered);

(iii) The direct supervisor of the individual is not a disqualified person;

(iv) The person does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or

(v) Any preferential treatment a person receives based on the size of that person's contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.

(f) *Affiliated organizations*. In the case of multiple organizations affiliated by common control or governing documents, the determination of whether a person does or does not have substantial influence shall be made separately for each applicable tax-exempt organization. A person may be a disqualified person with respect to transactions with more than one applicable tax-exempt organization.

(g) *Examples*. The following examples illustrate the principles of this section. A finding that a person is a disqualified person in the following examples does not indicate that an excess benefit transaction has occurred. If a person is a disqualified person, the rules of section 4958(c) and § 53.4958–4 apply to determine whether an excess benefit

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transaction has occurred. The examples are as follows:

Example 1. N, an artist by profession, works part-time at R, a local museum. In the first taxable year in which R employs N, R pays N a salary and provides no additional benefits to N except for free admission to the museum, a benefit R provides to all of its employees and volunteers. The total economic benefits N receives from R during the taxable year are less than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i). The part-time job constitutes N's only relationship with R. N is not related to any other disqualified person with respect to R. N is deemed not to be in a position to exercise substantial influence over the affairs of R. Therefore, N is not a disqualified person with respect to R in that year.

Example 2. The facts are the same as in *Example 1,* except that in addition to the salary that R pays N for N's services during the taxable year, R also purchases one of N's paintings for $x. The total of N's salary plus $x exceeds the amount referenced for highly compensated employees in section 414(q)(1)(B)(i). Consequently, whether N is in a position to exercise substantial influence over the affairs of R for that taxable year depends upon all of the relevant facts and circumstances.

Example 3. Q is a member of K, a section 501(c)(3) organization with a broad-based public membership. Members of K are entitled to vote only with respect to the annual election of directors and the approval of major organizational transactions such as a merger or dissolution. Q is not related to any other disqualified person of K. Q has no other relationship to K besides being a member of K and occasionally making modest donations to K. Whether Q is a disqualified person is determined by all relevant facts and circumstances. Q's voting rights, which are the same as granted to all members of K, do not place Q in a position to exercise substantial influence over K. Under these facts and circumstances, Q is not a disqualified person with respect to K.

Example 4. E is the headmaster of Z, a school that is an applicable tax-exempt organization for purposes of section 4958. E reports to Z's board of trustees and has ultimate responsibility for supervising Z's day-to-day operations. For example, E can hire faculty members and staff, make changes to the school's curriculum and discipline students without specific board approval. Because E has ultimate responsibility for supervising the operation of Z, E is in a position to exercise substantial influence over the affairs of Z. Therefore, E is a disqualified person with respect to Z.

Example 5. Y is an applicable tax-exempt organization for purposes of section 4958 that decides to use bingo games as a method of generating revenue. Y enters into a contract with B, a company that operates bingo games. Under the contract, B manages the promotion and operation of the bingo activity, provides all necessary staff, equipment, and services, and pays Y *q* percent of the revenue from this activity. B retains the balance of the proceeds. Y provides no goods or services in connection with the bingo operation other than the use of its hall for the bingo games. The annual gross revenue earned from the bingo games represents more than half of Y's total annual revenue. B's compensation is primarily based on revenues from an activity B controls. B also manages a discrete activity of Y that represents a substantial portion of Y's income compared to the organization as a whole. Under these facts and circumstances, B is in a position to exercise substantial influence over the affairs of Y. Therefore, B is a disqualified person with respect to Y.

Example 6. The facts are the same as in *Example 5,* with the additional fact that P owns a majority of the stock of B and is actively involved in managing B. Because P owns a controlling interest (measured by either vote or value) in and actively manages B, P is also in a position to exercise substantial influence over the affairs of Y. Therefore, under these facts and circumstances, P is a disqualified person with respect to Y.

Example 7. A, an applicable tax-exempt organization for purposes of section 4958, owns and operates one acute care hospital. B, a for-profit corporation, owns and operates a number of hospitals. A and B form C, a limited liability company. In exchange for proportional ownership interests, A contributes its hospital, and B contributes other assets, to C. All of A's assets then consist of its membership interest in C. A continues to be operated for exempt purposes based almost exclusively on the activities it conducts through C. C enters into a management agreement with a management company, M, to provide day to day management services to C. Subject to supervision by C's board, M is given broad discretion to manage C's day to day operation and has ultimate responsibility for supervising the management of the hospital. Because M has ultimate responsibility for supervising the management of the hospital operated by C, A's ownership interest in C is its primary asset, and C's activities form the basis for A's continued exemption as an organization described in section 501(c)(3), M is in a position to exercise substantial influence over the affairs of A. Therefore, M is a disqualified person with respect to A.

Example 8. T is a large university and an applicable tax-exempt organization for purposes of section 4958. L is the dean of the College of Law of T, a substantial source of revenue for T, including contributions from alumni and foundations. L is not related to

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any other disqualified person of T. L does not serve on T's governing body or have ultimate responsibility for managing the university as whole. However, as dean of the College of Law, L plays a key role in faculty hiring and determines a substantial portion of the capital expenditures and operating budget of the College of Law. L's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. L's management of a discrete segment of T that represents a substantial portion of the income of T (as compared to T as a whole) places L in a position to exercise substantial influence over the affairs of T. Under these facts and circumstances L is a disqualified person with respect to T.

Example 9. S chairs a small academic department in the College of Arts and Sciences of the same university T described in *Example 8.* S is not related to any other disqualified person of T. S does not serve on T's governing body or as an officer of T. As department chair, S supervises faculty in the department, approves the course curriculum, and oversees the operating budget for the department. S's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. Even though S manages the department, that department does not represent a substantial portion of T's activities, assets, income, expenses, or operating budget. Therefore, S does not participate in any management decisions affecting either T as a whole, or a discrete segment or activity of T that represents a substantial portion of its activities, assets, income, or expenses. Under these facts and circumstances, S does not have substantial influence over the affairs of T, and therefore S is not a disqualified person with respect to T.

Example 10. U is a large acute-care hospital that is an applicable tax-exempt organization for purposes of section 4958. U employs X as a radiologist. X gives instructions to staff with respect to the radiology work X conducts, but X does not supervise other U employees or manage any substantial part of U's operations. X's compensation is primarily in the form of a fixed salary. In addition, X is eligible to receive an incentive award based on revenues of the radiology department. X's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. X is not related to any other disqualified person of U. X does not serve on U's governing body or as an officer of U. Although U participates in a provider-sponsored organization (as defined in section 1855(e) of the Social Security Act), X does not have a material financial interest in that organization. X does not receive compensation primarily based on revenues derived from activities of U that X controls. X does not participate in any management decisions affecting either U as a whole or a discrete segment of U that represents a substantial portion of its activities, assets, income, or expenses. Under these facts and circumstances, X does not have substantial influence over the affairs of U, and therefore X is not a disqualified person with respect to U.

Example 11. W is a cardiologist and head of the cardiology department of the same hospital U described in *Example 10.* The cardiology department is a major source of patients admitted to U and consequently represents a substantial portion of U's income, as compared to U as a whole. W does not serve on U's governing board or as an officer of U. W does not have a material financial interest in the provider-sponsored organization (as defined in section 1855(e) of the Social Security Act) in which U participates. W receives a salary and retirement and welfare benefits fixed by a three-year renewable employment contract with U. W's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. As department head, W manages the cardiology department and has authority to allocate the budget for that department, which includes authority to distribute incentive bonuses among cardiologists according to criteria that W has authority to set. W's management of a discrete segment of U that represents a substantial portion of its income and activities (as compared to U as a whole) places W in a position to exercise substantial influence over the affairs of U. Under these facts and circumstances, W is a disqualified person with respect to U.

Example 12. M is a museum that is an applicable tax-exempt organization for purposes of section 4958. D provides accounting services and tax advice to M as a contractor in return for a fee. D has no other relationship with M and is not related to any disqualified person of M. D does not provide professional advice with respect to any transaction from which D might economically benefit either directly or indirectly (aside from fees received for the professional advice rendered). Because D's sole relationship to M is providing professional advice (without having decision-making authority) with respect to transactions from which D will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered), under these facts and circumstances, D is not a disqualified person with respect to M.

Example 13. F is a repertory theater company that is an applicable tax-exempt organization for purposes of section 4958. F holds a fund-raising campaign to pay for the construction of a new theater. J is a regular subscriber to F's productions who has made

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modest gifts to F in the past. J has no relationship to F other than as a subscriber and contributor. F solicits contributions as part of a broad public campaign intended to attract a large number of donors, including a substantial number of donors making large gifts. In its solicitations for contributions, F promises to invite all contributors giving $*z* or more to a special opening production and party held at the new theater. These contributors are also given a special number to call in F's office to reserve tickets for performances, make ticket exchanges, and make other special arrangements for their convenience. J makes a contribution of $*z* to F, which makes J a substantial contributor within the meaning of section 507(d)(2)(A), taking into account only contributions received by F during its current and the four preceding taxable years. J receives the benefits described in F's solicitation. Because F offers the same benefit to all donors of $*z* or more, the preferential treatment that J receives does not indicate that J is in a position to exercise substantial influence over the affairs of the organization. Therefore, under these facts and circumstances, J is not a disqualified person with respect to F.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–4 Excess benefit transaction.

(a) *Definition of excess benefit transaction*—(1) *In general.* An *excess benefit transaction* means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit. Subject to the limitations of paragraph (c) of this section (relating to the treatment of economic benefits as compensation for the performance of services), to determine whether an excess benefit transaction has occurred, all consideration and benefits (except disregarded benefits described in paragraph (a)(4) of this section) exchanged between a disqualified person and the applicable tax-exempt organization and all entities the organization controls (within the meaning of paragraph (a)(2)(ii)(B) of this section) are taken into account. For example, in determining the reasonableness of compensation that is paid (or vests, or is no longer subject to a substantial risk of forfeiture) in one year, services performed in prior years may be taken into account. The rules of this section apply to all transactions with disqualified persons, regardless of whether the amount of the benefit provided is determined, in whole or in part, by the revenues of one or more activities of the organization. For rules regarding valuation standards, see paragraph (b) of this section. For the requirement that an applicable tax-exempt organization clearly indicate its intent to treat a benefit as compensation for services when paid, see paragraph (c) of this section.

(2) *Economic benefit provided indirectly*—(i) *In general.* A transaction that would be an excess benefit transaction if the applicable tax-exempt organization engaged in it directly with a disqualified person is likewise an excess benefit transaction when it is accomplished indirectly. An applicable tax-exempt organization may provide an excess benefit indirectly to a disqualified person through a controlled entity or through an intermediary, as described in paragraphs (a)(2)(ii) and (iii) of this section, respectively.

(ii) *Through a controlled entity*—(A) *In general.* An applicable tax-exempt organization may provide an excess benefit indirectly through the use of one or more entities it controls. For purposes of section 4958, economic benefits provided by a controlled entity will be treated as provided by the applicable tax-exempt organization.

(B) *Definition of control*—(*1*) *In general.* For purposes of this paragraph, *control* by an applicable tax-exempt organization means—

(*i*) In the case of a stock corporation, ownership (by vote or value) of more than 50 percent of the stock in such corporation;

(*ii*) In the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in the partnership;

(*iii*) In the case of a nonstock organization (*i.e.*, an entity in which no person holds a proprietary interest), that at least 50 percent of the directors or trustees of the organization are either representatives (including trustees, directors, agents, or employees) of, or directly or indirectly controlled by, an applicable tax-exempt organization; or

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ownership of more than 50 percent of the beneficial interest in the entity.

(*2*) *Constructive ownership*. Section 318 (relating to constructive ownership of stock) shall apply for purposes of determining ownership of stock in a corporation. Similar principles shall apply for purposes of determining ownership of interests in any other entity.

(iii) *Through an intermediary*. An applicable tax-exempt organization may provide an excess benefit indirectly through an intermediary. An intermediary is any person (including an individual or a taxable or tax-exempt entity) who participates in a transaction with one or more disqualified persons of an applicable tax-exempt organization. For purposes of section 4958, economic benefits provided by an intermediary will be treated as provided by the applicable tax-exempt organization when—

(A) An applicable tax-exempt organization provides an economic benefit to an intermediary; and

(B) In connection with the receipt of the benefit by the intermediary—

(*1*) There is evidence of an oral or written agreement or understanding that the intermediary will provide economic benefits to or for the use of a disqualified person; or

(*2*) The intermediary provides economic benefits to or for the use of a disqualified person without a significant business purpose or exempt purpose of its own.

(iv) *Examples*. The following examples illustrate when economic benefits are provided indirectly under the rules of this paragraph (a)(2):

Example 1. K is an applicable tax-exempt organization for purposes of section 4958. L is a wholly-owned taxable subsidiary of K. J is employed by K, and is a disqualified person with respect to K. K pays J an annual salary of $*12m*, and reports that amount as compensation during calendar year 2001. Although J only performed services for K for nine months of 2001, J performed equivalent services for L during the remaining three months of 2001. Taking into account all of the economic benefits K provided to J, and all of the services J performed for K and L, $*12m* does not exceed the fair market value of the services J performed for K and L during 2001. Therefore, under these facts, K does not provide an excess benefit to J directly or indirectly.

Example 2. F is an applicable tax-exempt organization for purposes of section 4958. D is an entity controlled by F within the meaning of paragraph (a)(2)(ii)(B) of this section. T is the chief executive officer (CEO) of F. As CEO, T is responsible for overseeing the activities of F. T's duties as CEO make him a disqualified person with respect to F. T's compensation package with F represents the maximum reasonable compensation for T's services as CEO. Thus, any additional economic benefits that F provides to T without T providing additional consideration constitute an excess benefit. D contracts with T to provide enumerated consulting services to D. However, the contract does not require T to perform any additional services for D that T is not already obligated to perform as F's chief executive officer. Therefore, any payment to T pursuant to the consulting contract with D represents an indirect excess benefit that F provides through a controlled entity, even if F, D, or T treats the additional payment to T as compensation.

Example 3. P is an applicable tax-exempt organization for purposes of section 4958. S is a taxable entity controlled by P within the meaning of paragraph (a)(2)(ii)(B) of this section. V is the chief executive officer of S, for which S pays V $*w* in salary and benefits. V also serves as a voting member of P's governing body. Consequently, V is a disqualified person with respect to P. P provides V with $*x* representing compensation for the services V provides P as a member of its governing body. Although $*x* represents reasonable compensation for the services V provides directly to P as a member of its governing body, the total compensation of $*w* + $*x* exceeds reasonable compensation for the services V provides to P and S collectively. Therefore, the portion of total compensation that exceeds reasonable compensation is an excess benefit provided to V.

Example 4. G is an applicable tax-exempt organization for section 4958 purposes. F is a disqualified person who was last employed by G in a position of substantial influence three years ago. H is an entity engaged in scientific research and is unrelated to either F or G. G makes a grant to H to fund a research position. H subsequently advertises for qualified candidates for the research position. F is among several highly qualified candidates who apply for the research position. H hires F. There was no evidence of an oral or written agreement or understanding with G that H will use G's grant to provide economic benefits to or for the use of F. Although G provided economic benefits to H, and in connection with the receipt of such benefits, H will provide economic benefits to or for the use of F, H acted with a significant business purpose or exempt purpose of its own. Under these facts, G did not provide an economic benefit to F indirectly through the use of an intermediary.

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(3) *Exception for fixed payments made pursuant to an initial contract*—(i) *In general.* Except as provided in paragraph (a)(3)(iv) of this section, section 4958 does not apply to any fixed payment made to a person pursuant to an initial contract.

(ii) *Fixed payment*—(A) *In general.* For purposes of paragraph (a)(3)(i) of this section, *fixed payment* means an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property. A fixed formula may incorporate an amount that depends upon future specified events or contingencies, provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus). A specified event or contingency may include the amount of revenues generated by (or other objective measure of) one or more activities of the applicable tax-exempt organization. A fixed payment does not include any amount paid to a person under a reimbursement (or similar) arrangement where discretion is exercised by any person with respect to the amount of expenses incurred or reimbursed.

(B) *Special rules.* Amounts payable pursuant to a qualified pension, profit-sharing, or stock bonus plan under section 401(a), or pursuant to an employee benefit program that is subject to and satisfies coverage and nondiscrimination rules under the Internal Revenue Code (e.g., sections 127 and 137), other than nondiscrimination rules under section 9802, are treated as fixed payments for purposes of this section, regardless of the applicable tax-exempt organization's discretion with respect to the plan or program. The fact that a person contracting with an applicable tax-exempt organization is expressly granted the choice whether to accept or reject any economic benefit is disregarded in determining whether the benefit constitutes a fixed payment for purposes of this paragraph.

(iii) *Initial contract.* For purposes of paragraph (a)(3)(i) of this section, *initial contract* means a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 immediately prior to entering into the contract.

(iv) *Substantial performance required.* Paragraph (a)(3)(i) of this section does not apply to any fixed payment made pursuant to the initial contract during any taxable year of the person contracting with the applicable tax-exempt organization if the person fails to perform substantially the person's obligations under the initial contract during that year.

(v) *Treatment as a new contract.* A written binding contract that provides that the contract is terminable or subject to cancellation by the applicable tax-exempt organization (other than as a result of a lack of substantial performance by the disqualified person, as described in paragraph (a)(3)(iv) of this section) without the other party's consent and without substantial penalty to the organization is treated as a new contract as of the earliest date that any such termination or cancellation, if made, would be effective. Additionally, if the parties make a material change to a contract, it is treated as a new contract as of the date the material change is effective. A material change includes an extension or renewal of the contract (other than an extension or renewal that results from the person contracting with the applicable tax-exempt organization unilaterally exercising an option expressly granted by the contract), or a more than incidental change to any amount payable under the contract. The new contract is tested under paragraph (a)(3)(iii) of this section to determine whether it is an initial contract for purposes of this section.

(vi) *Evaluation of non-fixed payments.* Any payment that is not a fixed payment (within the meaning of paragraph (a)(3)(ii) of this section) is evaluated to determine whether it constitutes an excess benefit transaction under section 4958. In making this determination, all payments and consideration exchanged between the parties are taken into account, including any fixed payments made pursuant to an initial contract with respect to which section 4958 does not apply.

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ples illustrate the rules governing fixed payments made pursuant to an initial contract. Unless otherwise stated, assume that the person contracting with the applicable tax-exempt organization has performed substantially the person's obligations under the contract with respect to the payment. The examples are as follows:

Example 1. T is an applicable tax-exempt organization for purposes of section 4958. On January 1, 2002, T hires S as its chief financial officer by entering into a five-year written employment contract with S. S was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 immediately prior to entering into the January 1, 2002, contract (initial contract). S's duties and responsibilities under the contract make S a disqualified person with respect to T (see § 53.4958–3(c)(3)). Under the initial contract, T agrees to pay S an annual salary of $200,000, payable in monthly installments. The contract provides that, beginning in 2003, S's annual salary will be adjusted by the increase in the Consumer Price Index (CPI) for the prior year. Section 4958 does not apply because S's compensation under the contract is a fixed payment pursuant to an initial contract within the meaning of paragraph (a)(3) of this section. Thus, for section 4958 purposes, it is unnecessary to evaluate whether any portion of the compensation paid to S pursuant to the initial contract is an excess benefit transaction.

Example 2. The facts are the same as in *Example 1,* except that the initial contract provides that, in addition to a base salary of $200,000, T may pay S an annual performance-based bonus. The contract provides that T's governing body will determine the amount of the annual bonus as of the end of each year during the term of the contract, based on the board's evaluation of S's performance, but the bonus cannot exceed $100,000 per year. Unlike the base salary portion of S's compensation, the bonus portion of S's compensation is not a fixed payment pursuant to an initial contract, because the governing body has discretion over the amount, if any, of the bonus payment. Section 4958 does not apply to payment of the $200,000 base salary (as adjusted for inflation), because it is a fixed payment pursuant to an initial contract within the meaning of paragraph (a)(3) of this section. By contrast, the annual bonuses that may be paid to S under the initial contract are not protected by the initial contract exception. Therefore, each bonus payment will be evaluated under section 4958, taking into account all payments and consideration exchanged between the parties.

Example 3. The facts are the same as in *Example 1,* except that in 2003, T changes its payroll system, such that T makes biweekly, rather than monthly, salary payments to its employees. Beginning in 2003, T also grants its employees an additional two days of paid vacation each year. Neither change is a material change to S's initial contract within the meaning of paragraph (a)(3)(v) of this section. Therefore, section 4958 does not apply to the base salary payments to S due to the initial contract exception.

Example 4. The facts are the same as in *Example 1,* except that on January 1, 2003, S becomes the chief executive officer of T and a new chief financial officer is hired. At the same time, T's board of directors approves an increase in S's annual base salary from $200,000 to $240,000, effective on that day. These changes in S's employment relationship constitute material changes of the initial contract within the meaning of paragraph (a)(3)(v) of this section. As a result, S is treated as entering into a new contract with T on January 1, 2003, at which time S is a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3. T's payments to S made pursuant to the new contract will be evaluated under section 4958, taking into account all payments and consideration exchanged between the parties.

Example 5. J is a performing arts organization and an applicable tax-exempt organization for purposes of section 4958. J hires W to become the chief executive officer of J. W was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 immediately prior to entering into the employment contract with J. As a result of this employment contract, W's duties and responsibilities make W a disqualified person with respect to J (see § 53.4958–3(c)(2)). Under the contract, J will pay W $*x* (a specified amount) plus a bonus equal to 2 percent of the total season subscription sales that exceed $*100z*. The $*x* base salary is a fixed payment pursuant to an initial contract within the meaning of paragraph (a)(3) of this section. The bonus payment is also a fixed payment pursuant to an initial contract within the meaning of paragraph (a)(3) of this section, because no person exercises discretion when calculating the amount of the bonus payment or deciding whether the bonus will be paid. Therefore, section 4958 does not apply to any of J's payments to W pursuant to the employment contract due to the initial contract exception.

Example 6. Hospital B is an applicable tax-exempt organization for purposes of section 4958. Hospital B hires E as its chief operating officer. E was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 immediately prior to entering into the employment contract with Hospital B. As a result of this employment contract, E's

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duties and responsibilities make E a disqualified person with respect to Hospital B (see § 53.4958–3(c)(2)). E's initial employment contract provides that E will have authority to enter into hospital management arrangements on behalf of Hospital B. In E's personal capacity, E owns more than 35 percent of the combined voting power of Company X. Consequently, at the time E becomes a disqualified person with respect to B, Company X also becomes a disqualified person with respect to B (see § 53.4958–3(b)(2)(i)(A)). E, acting on behalf of Hospital B as chief operating officer, enters into a contract with Company X under which Company X will provide billing and collection services to Hospital B. The initial contract exception of paragraph (a)(3)(i) of this section does not apply to the billing and collection services contract, because at the time that this contractual arrangement was entered into, Company X was a disqualified person with respect to Hospital B. Although E's employment contract (which is an initial contract) authorizes E to enter into hospital management arrangements on behalf of Hospital B, the payments made to Company X are not made pursuant to E's employment contract, but rather are made by Hospital B pursuant to a separate contractual arrangement with Company X. Therefore, even if payments made to Company X under the billing and collection services contract are fixed payments (within the meaning of paragraph (a)(3)(ii) of this section), section 4958 nonetheless applies to payments made by Hospital B to Company X because the billing and collection services contract itself does not constitute an initial contract under paragraph (a)(3)(iii) of this section. Accordingly, all payments made to Company X under the billing and collection services contract will be evaluated under section 4958.

Example 7. Hospital C, an applicable tax-exempt organization, enters into a contract with Company Y, under which Company Y will provide a wide range of hospital management services to Hospital C. Upon entering into this contractual arrangement, Company Y becomes a disqualified person with respect to Hospital C. The contract provides that Hospital C will pay Company Y a management fee of *x* percent of adjusted gross revenue (*i.e.*, gross revenue increased by the cost of charity care provided to indigents) annually for a five-year period. The management services contract specifies the cost accounting system and the standards for *indigents* to be used in calculating the cost of charity care. The cost accounting system objectively defines the direct and indirect costs of all health care goods and services provided as charity care. Because Company Y was not a disqualified person with respect to Hospital C immediately before entering into the management services contract, that contract is an initial contract within the meaning of paragraph (a)(3)(iii) of this section. The annual management fee paid to Company Y is determined by a fixed formula specified in the contract, and is therefore a fixed payment within the meaning of paragraph (a)(3)(ii) of this section. Accordingly, section 4958 does not apply to the annual management fee due to the initial contract exception.

Example 8. The facts are the same as in *Example 7*, except that the management services contract also provides that Hospital C will reimburse Company Y on a monthly basis for certain expenses incurred by Company Y that are attributable to management services provided to Hospital C (e.g., legal fees and travel expenses). Although the management fee itself is a fixed payment not subject to section 4958, the reimbursement payments that Hospital C makes to Company Y for the various expenses covered by the contract are not fixed payments within the meaning of paragraph (a)(3)(ii) of this section, because Company Y exercises discretion with respect to the amount of expenses incurred. Therefore, any reimbursement payments that Hospital C pays pursuant to the contract will be evaluated under section 4958.

Example 9. X, an applicable tax-exempt organization for purposes of section 4958, hires C to conduct scientific research. On January 1, 2003, C enters into a three-year written employment contract with X (initial contract). Under the terms of the contract, C is required to work full-time at X's laboratory for a fixed annual salary of $90,000. Immediately prior to entering into the employment contract, C was not a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3, nor did C become a disqualified person pursuant to the initial contract. However, two years after joining X, C marries D, who is the child of X's president. As D's spouse, C is a disqualified person within the meaning of section 4958(f)(1) and § 53.4958–3 with respect to X. Nonetheless, section 4958 does not apply to X's salary payments to C due to the initial contract exception.

Example 10. The facts are the same as in *Example 9*, except that the initial contract included a below-market loan provision under which C has the unilateral right to borrow up to a specified dollar amount from X at a specified interest rate for a specified term. After C's marriage to D, C borrows money from X to purchase a home under the terms of the initial contract. Section 4958 does not apply to X's loan to C due to the initial contract exception.

Example 11. The facts are the same as in *Example 9*, except that after C's marriage to D, C works only sporadically at the laboratory, and performs no other services for X. Notwithstanding that C fails to perform substantially C's obligations under the initial

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contract, X does not exercise its right to terminate the initial contract for nonperformance and continues to pay full salary to C. Pursuant to paragraph (a)(3)(iv) of this section, the initial contract exception does not apply to any payments made pursuant to the initial contract during any taxable year of C in which C fails to perform substantially C's obligations under the initial contract.

(4) *Certain economic benefits disregarded for purposes of section 4958.* The following economic benefits are disregarded for purposes of section 4958—

(i) *Nontaxable fringe benefits.* An economic benefit that is excluded from income under section 132, except any liability insurance premium, payment, or reimbursement that must be taken into account under paragraph (b)(1)(ii)(B)(*2*) of this section;

(ii) *Expense reimbursement payments pursuant to accountable plans.* Amounts paid under reimbursement arrangements that meet the requirements of § 1.62–2(c) of this chapter;

(iii) *Certain economic benefits provided to a volunteer for the organization.* An economic benefit provided to a volunteer for the organization if the benefit is provided to the general public in exchange for a membership fee or contribution of $75 or less per year;

(iv) *Certain economic benefits provided to a member of, or donor to, the organization.* An economic benefit provided to a member of an organization solely on account of the payment of a membership fee, or to a donor solely on account of a contribution for which a deduction is allowable under section 170 (charitable contribution), regardless of whether the donor is eligible to claim the deduction, if—

(A) Any non-disqualified person paying a membership fee or making a charitable contribution above a specified amount to the organization is given the option of receiving substantially the same economic benefit; and

(B) The disqualified person and a significant number of non-disqualified persons make a payment or charitable contribution of at least the specified amount;

(v) *Economic benefits provided to a charitable beneficiary.* An economic benefit provided to a person solely because the person is a member of a charitable class that the applicable tax-exempt organization intends to benefit as part of the accomplishment of the organization's exempt purpose; and

(vi) *Certain economic benefits provided to a governmental unit.* Any transfer of an economic benefit to or for the use of a governmental unit defined in section 170(c)(1), if the transfer is for exclusively public purposes.

(5) *Exception for certain payments made pursuant to an exemption granted by the Department of Labor under ERISA.* Section 4958 does not apply to any payment made pursuant to, and in accordance with, a final individual prohibited transaction exemption issued by the Department of Labor under section 408(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 854) (ERISA) with respect to a transaction involving a plan (as defined in section 3(3) of ERISA) that is an applicable tax exempt organization.

(b) *Valuation standards*—(1) *In general.* This section provides rules for determining the value of economic benefits for purposes of section 4958.

(i) *Fair market value of property.* The value of property, including the right to use property, for purposes of section 4958 is the fair market value (*i.e.*, the price at which property or the right to use property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of relevant facts).

(ii) *Reasonable compensation*—(A) *In general.* The value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (*i.e.*, reasonable compensation). Section 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than any benefits specifically disregarded under paragraph (a)(4) of this section) provided to a person and the rate at which any deferred compensation accrues. The fact that a compensation arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation. The fact that a State or local legislative or agency body or court has authorized or approved a particular compensation

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package paid to a disqualified person is not determinative of the reasonableness of compensation for purposes of section 4958.

(B) *Items included in determining the value of compensation for purposes of determining reasonableness under section 4958.* Except for economic benefits that are disregarded for purposes of section 4958 under paragraph (a)(4) of this section, compensation for purposes of determining reasonableness under section 4958 includes all economic benefits provided by an applicable tax-exempt organization in exchange for the performance of services. These benefits include, but are not limited to—

(*1*) All forms of cash and noncash compensation, including salary, fees, bonuses, severance payments, and deferred and noncash compensation described in § 53.4958–1(e)(2);

(*2*) Unless excludable from income as a *de minimis* fringe benefit pursuant to section 132(a)(4), the payment of liability insurance premiums for, or the payment or reimbursement by the organization of—

(*i*) Any penalty, tax, or expense of correction owed under section 4958;

(*ii*) Any expense not reasonably incurred by the person in connection with a civil judicial or civil administrative proceeding arising out of the person's performance of services on behalf of the applicable tax-exempt organization; or

(*iii*) Any expense resulting from an act or failure to act with respect to which the person has acted willfully and without reasonable cause; and

(*3*) All other compensatory benefits, whether or not included in gross income for income tax purposes, including payments to welfare benefit plans, such as plans providing medical, dental, life insurance, severance pay, and disability benefits, and both taxable and nontaxable fringe benefits (other than fringe benefits described in section 132), including expense allowances or reimbursements (other than expense reimbursements pursuant to an accountable plan that meets the requirements of § 1.62–2(c)), and the economic benefit of a below-market loan (within the meaning of section 7872(e)(1)). (For this purpose, the economic benefit of a below-market loan is the amount deemed transferred to the disqualified person under section 7872(a) or (b), regardless of whether section 7872 otherwise applies to the loan).

(C) *Inclusion in compensation for reasonableness determination does not govern income tax treatment.* The determination of whether any item listed in paragraph (b)(1)(ii)(B) of this section is included in the disqualified person's gross income for income tax purposes is made on the basis of the provisions of chapter 1 of Subtitle A of the Internal Revenue Code, without regard to whether the item is taken into account for purposes of determining reasonableness of compensation under section 4958.

(2) *Timing of reasonableness determination*—(i) *In general.* The facts and circumstances to be taken into consideration in determining reasonableness of a fixed payment (within the meaning of paragraph (a)(3)(ii) of this section) are those existing on the date the parties enter into the contract pursuant to which the payment is made. However, in the event of substantial non-performance, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment. In the case of any payment that is not a fixed payment under a contract, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment. In no event shall circumstances existing at the date when the payment is questioned be considered in making a determination of the reasonableness of the payment. These general timing rules also apply to property subject to a substantial risk of forfeiture. Therefore, if the property subject to a substantial risk of forfeiture satisfies the definition of fixed payment (within the meaning of paragraph (a)(3)(ii) of this section), reasonableness is determined at the time the parties enter into the contract providing for the transfer of the property. If the property is not a fixed payment, then reasonableness is determined based on all facts and circumstances up to and including circumstances as of the date of payment.

(ii) *Treatment as a new contract.* For purposes of paragraph (b)(2)(i) of this

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section, a written binding contract that provides that the contract is terminable or subject to cancellation by the applicable tax-exempt organization without the other party's consent and without substantial penalty to the organization is treated as a new contract as of the earliest date that any such termination or cancellation, if made, would be effective. Additionally, if the parties make a material change to a contract (within the meaning of paragraph (a)(3)(v) of this section), it is treated as a new contract as of the date the material change is effective.

(iii) *Examples.* The following examples illustrate the timing of the reasonableness determination under the rules of this paragraph (b)(2):

Example 1. G is an applicable tax-exempt organization for purposes of section 4958. H is an employee of G and a disqualified person with respect to G. H's new multi-year employment contract provides for payment of a salary and provision of specific benefits pursuant to a qualified pension plan under section 401(a) and an accident and health plan that meets the requirements of section 105(h)(2). The contract provides that H's salary will be adjusted by the increase in the Consumer Price Index (CPI) for the prior year. The contributions G makes to the qualified pension plan are equal to the maximum amount G is permitted to contribute under the rules applicable to qualified plans. Under these facts, all items comprising H's total compensation are treated as fixed payments within the meaning of paragraph (a)(3)(ii) of this section. Therefore, the reasonableness of H's compensation is determined based on the circumstances existing at the time G and H enter into the employment contract.

Example 2. The facts are the same as in *Example 1,* except that the multi-year employment contract provides, in addition, that G will transfer title to a car to H under the condition that if H fails to complete *x* years of service with G, title to the car will be forfeited back to G. All relevant information about the type of car to be provided (including the make, model, and year) is included in the contract. Although ultimate vesting of title to the car is contingent on H continuing to work for G for *x* years, the amount of property to be vested (*i.e.,* the type of car) is specified in the contract, and no person exercises discretion regarding the type of property or whether H will retain title to the property at the time of vesting. Under these facts, the car is a fixed payment within the meaning of paragraph (a)(3)(ii) of this section. Therefore, the reasonableness of H's compensation, including the value of the car, is determined based on the circumstances existing at the time G and H enter into the employment contract.

Example 3. N is an applicable tax-exempt organization for purposes of section 4958. On January 2, N's governing body enters into a new one-year employment contract with K, its executive director, who is a disqualified person with respect to N. The contract provides that K will receive a specified amount of salary, contributions to a qualified pension plan under section 401(a), and other benefits pursuant to a section 125 cafeteria plan. In addition, the contract provides that N's governing body may, in its discretion, declare a bonus to be paid to K at any time during the year covered by the contract. K's salary and other specified benefits constitute fixed payments within the meaning of paragraph (a)(3)(ii) of this section. Therefore, the reasonableness of those economic benefits is determined on the date when the contract was made. However, because the bonus payment is not a fixed payment within the meaning of paragraph (a)(3)(ii) of this section, the determination of whether any bonus awarded to N is reasonable must be made based on all facts and circumstances (including all payments and consideration exchanged between the parties), up to and including circumstances as of the date of payment of the bonus.

(c) *Establishing intent to treat economic benefit as consideration for the performance of services*—(1) *In general.* An economic benefit is not treated as consideration for the performance of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid. Except as provided in paragraph (c)(2) of this section, an applicable tax-exempt organization (or entity controlled by an applicable tax-exempt organization, within the meaning of paragraph (a)(2)(ii)(B) of this section) is treated as clearly indicating its intent to provide an economic benefit as compensation for services only if the organization provides written substantiation that is contemporaneous with the transfer of the economic benefit at issue. If an organization fails to provide this contemporaneous substantiation, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit for purposes of determining the reasonableness of the transaction. In no event shall an economic benefit that a disqualified person obtains by theft or fraud be treated as

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consideration for the performance of services.

(2) *Nontaxable benefits.* For purposes of section 4958(c)(1)(A) and this section, an applicable tax-exempt organization is not required to indicate its intent to provide an economic benefit as compensation for services if the economic benefit is excluded from the disqualified person's gross income for income tax purposes on the basis of the provisions of chapter 1 of Subtitle A of the Internal Revenue Code. Examples of these benefits include, but are not limited to, employer-provided health benefits and contributions to a qualified pension, profit-sharing, or stock bonus plan under section 401(a), and benefits described in sections 127 and 137. However, except for economic benefits that are disregarded for purposes of section 4958 under paragraph (a)(4) of this section, all compensatory benefits (regardless of the Federal income tax treatment) provided by an organization in exchange for the performance of services are taken into account in determining the reasonableness of a person's compensation for purposes of section 4958.

(3) *Contemporaneous substantiation*—(i) *Reporting of benefit*—(A) *In general.* An applicable tax-exempt organization provides contemporaneous written substantiation of its intent to provide an economic benefit as compensation if—

(*1*) The organization reports the economic benefit as compensation on an original Federal tax information return with respect to the payment (e.g., Form W-2, "Wage and Tax Statement", or Form 1099, "Miscellaneous Income") or with respect to the organization (e.g., Form 990, "Return of Organization Exempt From Income Tax"), or on an amended Federal tax information return filed prior to the commencement of an Internal Revenue Service examination of the applicable tax-exempt organization or the disqualified person for the taxable year in which the transaction occurred (as determined under § 53.4958–1(e)); or

(*2*) The recipient disqualified person reports the benefit as income on the person's original Federal tax return (e.g., Form 1040, "U.S. Individual Income Tax Return"), or on the person's amended Federal tax return filed prior to the earlier of the following dates—

(*i*) Commencement of an Internal Revenue Service examination described in paragraph (c)(3)(i)(A)(*1*) of this section; or

(*ii*) The first documentation in writing by the Internal Revenue Service of a potential excess benefit transaction involving either the applicable tax-exempt organization or the disqualified person.

(B) *Failure to report due to reasonable cause.* If an applicable tax-exempt organization's failure to report an economic benefit as required under the Internal Revenue Code is due to reasonable cause (within the meaning of § 301.6724–1 of this chapter), then the organization will be treated as having clearly indicated its intent to provide an economic benefit as compensation for services. To show that its failure to report an economic benefit that should have been reported on an information return was due to reasonable cause, an applicable tax-exempt organization must establish that there were significant mitigating factors with respect to its failure to report (as described in § 301.6724–1(b) of this chapter), or the failure arose from events beyond the organization's control (as described in § 301.6724–1(c) of this chapter), and that the organization acted in a responsible manner both before and after the failure occurred (as described in § 301.6724–1(d) of this chapter).

(ii) *Other written contemporaneous evidence.* In addition, other written contemporaneous evidence may be used to demonstrate that the appropriate decision-making body or an officer authorized to approve compensation approved a transfer as compensation for services in accordance with established procedures, including but not limited to—

(A) An approved written employment contract executed on or before the date of the transfer;

(B) Documentation satisfying the requirements of § 53.4958–6(a)(3) indicating that an authorized body approved the transfer as compensation for services on or before the date of the transfer; or

(C) Written evidence that was in existence on or before the due date of the applicable Federal tax return described in paragraph (c)(3)(i)(A)(*1*) or (*2*) of this section (including extensions but not amendments), of a reasonable belief by the applicable tax-exempt organization that a benefit was a nontaxable benefit as defined in paragraph (c)(2) of this section.

(4) *Examples.* The following examples illustrate the requirement that an organization contemporaneously substantiate its intent to provide an economic benefit as compensation for services, as defined in paragraph (c) of this section:

Example 1. G is an applicable tax-exempt organization for purposes of section 4958. G hires an individual contractor, P, who is also the child of a disqualified person of G, to design a computer program for it. G executes a contract with P for that purpose in accordance with G's established procedures, and pays P $1,000 during the year pursuant to the contract. Before January 31 of the next year, G reports the full amount paid to P under the contract on a Form 1099 filed with the Internal Revenue Service. G will be treated as providing contemporaneous written substantiation of its intent to provide the $1,000 paid to P as compensation for the services P performed under the contract by virtue of either the Form 1099 filed with the Internal Revenue Service reporting the amount, or by virtue of the written contract executed between G and P.

Example 2. G is an applicable tax-exempt organization for purposes of section 4958. D is the chief operating officer of G, and a disqualified person with respect to G. D receives a bonus at the end of the year. G's accounting department determines that the bonus is to be reported on D's Form W-2. Due to events beyond G's control, the bonus is not reflected on D's Form W-2. As a result, D fails to report the bonus on D's individual income tax return. G acts to amend Forms W-2 affected as soon as G is made aware of the error during an Internal Revenue Service examination. G's failure to report the bonus on an information return issued to D arose from events beyond G's control, and G acted in a responsible manner both before and after the failure occurred. Thus, because G had reasonable cause (within the meaning §301.6724–1 of this chapter) for failing to report D's bonus, G will be treated as providing contemporaneous written substantiation of its intent to provide the bonus as compensation for services when paid.

Example 3. H is an applicable tax-exempt organization and J is a disqualified person with respect to H. J's written employment agreement provides for a fixed salary of $*y*. J's duties include soliciting funds for various programs of H. H raises a large portion of its funds in a major metropolitan area. Accordingly, H maintains an apartment there in order to provide a place to entertain potential donors. H makes the apartment available exclusively to J to assist in the fundraising. J's written employment contract does not mention the use of the apartment. H obtains the written opinion of a benefits compensation expert that the rental value of the apartment is not includable in J's income by reason of section 119, based on the expectation that the apartment will be used for fundraising activities. Consequently, H does not report the rental value of the apartment on J's Form W-2, which otherwise correctly reports J's taxable compensation. J does not report the rental value of the apartment on J's individual Form 1040. Later, the Internal Revenue Service correctly determines that the requirements of section 119 were not satisfied. Because of the written expert opinion, H has written evidence of its reasonable belief that use of the apartment was a nontaxable benefit as defined in paragraph (c)(2) of this section. That evidence was in existence on or before the due date of the applicable Federal tax return. Therefore, H has demonstrated its intent to treat the use of the apartment as compensation for services performed by J.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002; 67 FR 12472, Mar. 19, 2002]

§ 53.4958–5 Transaction in which the amount of the economic benefit is determined in whole or in part by the revenues of one or more activities of the organization. [Reserved]

§ 53.4958–6 Rebuttable presumption that a transaction is not an excess benefit transaction.

(a) *In general.* Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if the following conditions are satisfied—

(1) The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt organization (or an entity controlled by the organization within the meaning of §53.4958–4(a)(2)(ii)(B)) composed entirely of individuals who do not have a conflict of interest (within the meaning of paragraph (c)(1)(iii) of this section) with respect to the compensation arrangement or property transfer, as described in paragraph (c)(1) of this section;

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(2) The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination, as described in paragraph (c)(2) of this section; and

(3) The authorized body adequately documented the basis for its determination concurrently with making that determination, as described in paragraph (c)(3) of this section.

(b) *Rebutting the presumption.* If the three requirements of paragraph (a) of this section are satisfied, then the Internal Revenue Service may rebut the presumption that arises under paragraph (a) of this section only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. With respect to any fixed payment (within the meaning of §53.4958–4(a)(3)(ii)), rebuttal evidence is limited to evidence relating to facts and circumstances existing on the date the parties enter into the contract pursuant to which the payment is made (except in the event of substantial nonperformance). With respect to all other payments (including non-fixed payments subject to a cap, as described in paragraph (d)(2) of this section), rebuttal evidence may include facts and circumstances up to and including the date of payment. See §53.4958–4(b)(2)(i).

(c) *Requirements for invoking rebuttable presumption*—(1) *Approval by an authorized body*—(i) *In general.* An authorized body means—

(A) The governing body (*i.e.*, the board of directors, board of trustees, or equivalent controlling body) of the organization;

(B) A committee of the governing body, which may be composed of any individuals permitted under State law to serve on such a committee, to the extent that the committee is permitted by State law to act on behalf of the governing body; or

(C) To the extent permitted under State law, other parties authorized by the governing body of the organization to act on its behalf by following procedures specified by the governing body in approving compensation arrangements or property transfers.

(ii) *Individuals not included on authorized body.* For purposes of determining whether the requirements of paragraph (a) of this section have been met with respect to a specific compensation arrangement or property transfer, an individual is not included on the authorized body when it is reviewing a transaction if that individual meets with other members only to answer questions, and otherwise recuses himself or herself from the meeting and is not present during debate and voting on the compensation arrangement or property transfer.

(iii) *Absence of conflict of interest.* A member of the authorized body does not have a conflict of interest with respect to a compensation arrangement or property transfer only if the member—

(A) Is not a disqualified person participating in or economically benefitting from the compensation arrangement or property transfer, and is not a member of the family of any such disqualified person, as described in section 4958(f)(4) or §53.4958–3(b)(1);

(B) Is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefitting from the compensation arrangement or property transfer;

(C) Does not receive compensation or other payments subject to approval by any disqualified person participating in or economically benefitting from the compensation arrangement or property transfer;

(D) Has no material financial interest affected by the compensation arrangement or property transfer; and

(E) Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or property transfer, who in turn has approved or will approve a transaction providing economic benefits to the member.

(2) *Appropriate data as to comparability*—(i) *In general.* An authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether, under the standards set forth in §53.4958–4(b), the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value. In the case of compensation, relevant information includes, but is

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not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person. In the case of property, relevant information includes, but is not limited to, current independent appraisals of the value of all property to be transferred; and offers received as part of an open and competitive bidding process.

(ii) *Special rule for compensation paid by small organizations.* For organizations with annual gross receipts (including contributions) of less than $1 million reviewing compensation arrangements, the authorized body will be considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. No inference is intended with respect to whether circumstances falling outside this safe harbor will meet the requirement with respect to the collection of appropriate data.

(iii) *Application of special rule for small organizations.* For purposes of determining whether the special rule for small organizations described in paragraph (c)(2)(ii) of this section applies, an organization may calculate its annual gross receipts based on an average of its gross receipts during the three prior taxable years. If any applicable tax-exempt organization is controlled by or controls another entity (as defined in § 53.4958–4(a)(2)(ii)(B)), the annual gross receipts of such organizations must be aggregated to determine applicability of the special rule stated in paragraph (c)(2)(ii) of this section.

(iv) *Examples.* The following examples illustrate the rules for appropriate data as to comparability for purposes of invoking the rebuttable presumption of reasonableness described in this section. In all examples, compensation refers to the aggregate value of all benefits provided in exchange for services. The examples are as follows:

Example 1. Z is a university that is an applicable tax-exempt organization for purposes of section 4958. Z is negotiating a new contract with Q, its president, because the old contract will expire at the end of the year. In setting Q's compensation for its president at $*600x* per annum, the executive committee of the Board of Trustees relies solely on a national survey of compensation for university presidents that indicates university presidents receive annual compensation in the range of $*100x* to $*700x*; this survey does not divide its data by any criteria, such as the number of students served by the institution, annual revenues, academic ranking, or geographic location. Although many members of the executive committee have significant business experience, none of the members has any particular expertise in higher education compensation matters. Given the failure of the survey to provide information specific to universities comparable to Z, and because no other information was presented, the executive committee's decision with respect to Q's compensation was not based upon appropriate data as to comparability.

Example 2. The facts are the same as *Example 1,* except that the national compensation survey divides the data regarding compensation for university presidents into categories based on various university-specific factors, including the size of the institution (in terms of the number of students it serves and the amount of its revenues) and geographic area. The survey data shows that university presidents at institutions comparable to and in the same geographic area as Z receive annual compensation in the range of $*200x* to $*300x*. The executive committee of the Board of Trustees of Z relies on the survey data and its evaluation of Q's many years of service as a tenured professor and high-ranking university official at Z in setting Q's compensation at $*275x* annually. The data relied upon by the executive committee constitutes appropriate data as to comparability.

Example 3. X is a tax-exempt hospital that is an applicable tax-exempt organization for purposes of section 4958. Before renewing the contracts of X's chief executive officer and chief financial officer, X's governing board commissioned a customized compensation survey from an independent firm that specializes in consulting on issues related to executive placement and compensation. The survey covered executives with comparable responsibilities at a significant number of taxable and tax-exempt hospitals. The survey data are sorted by a number of different variables, including the size of the hospitals and the nature of the services they provide, the level of experience and specific responsibilities of the executives, and the composition of the annual compensation packages. The board members were provided with the

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survey results, a detailed written analysis comparing the hospital's executives to those covered by the survey, and an opportunity to ask questions of a member of the firm that prepared the survey. The survey, as prepared and presented to X's board, constitutes appropriate data as to comparability.

Example 4. The facts are the same as *Example 3*, except that one year later, X is negotiating a new contract with its chief executive officer. The governing board of X obtains information indicating that the relevant market conditions have not changed materially, and possesses no other information indicating that the results of the prior year's survey are no longer valid. Therefore, X may continue to rely on the independent compensation survey prepared for the prior year in setting annual compensation under the new contract.

Example 5. W is a local repertory theater and an applicable tax-exempt organization for purposes of section 4958. W has had annual gross receipts ranging from $400,000 to $800,000 over its past three taxable years. In determining the next year's compensation for W's artistic director, the board of directors of W relies on data compiled from a telephone survey of three other unrelated performing arts organizations of similar size in similar communities. A member of the board drafts a brief written summary of the annual compensation information obtained from this informal survey. The annual compensation information obtained in the telephone survey is appropriate data as to comparability.

(3) *Documentation*—(i) For a decision to be documented adequately, the written or electronic records of the authorized body must note—

(A) The terms of the transaction that was approved and the date it was approved;

(B) The members of the authorized body who were present during debate on the transaction that was approved and those who voted on it;

(C) The comparability data obtained and relied upon by the authorized body and how the data was obtained; and

(D) Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.

(ii) If the authorized body determines that reasonable compensation for a specific arrangement or fair market value in a specific property transfer is higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination. For a decision to be documented concurrently, records must be prepared before the later of the next meeting of the authorized body or 60 days after the final action or actions of the authorized body are taken. Records must be reviewed and approved by the authorized body as reasonable, accurate and complete within a reasonable time period thereafter.

(d) *No presumption with respect to non-fixed payments until amounts are determined*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, in the case of a payment that is not a fixed payment (within the meaning of § 53.4958–4(a)(3)(ii)), the rebuttable presumption of this section arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption under paragraph (a) of this section subsequently are satisfied. See § 53.4958–4(b)(2)(i).

(2) *Special rule for certain non-fixed payments subject to a cap.* If the authorized body approves an employment contract with a disqualified person that includes a non-fixed payment (such as a discretionary bonus) subject to a specified cap, the authorized body may establish a rebuttable presumption with respect to the non-fixed payment at the time the employment contract is entered into if—

(i) Prior to approving the contract, the authorized body obtains appropriate comparability data indicating that a fixed payment of up to a certain amount to the particular disqualified person would represent reasonable compensation;

(ii) The maximum amount payable under the contract (taking into account both fixed and non-fixed payments) does not exceed the amount referred to in paragraph (d)(2)(i) of this section; and

(iii) The other requirements for the rebuttable presumption of reasonableness under paragraph (a) of this section are satisfied.

(e) *No inference from absence of presumption.* The fact that a transaction between an applicable tax-exempt organization and a disqualified person is

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not subject to the presumption described in this section neither creates any inference that the transaction is an excess benefit transaction, nor exempts or relieves any person from compliance with any Federal or state law imposing any obligation, duty, responsibility, or other standard of conduct with respect to the operation or administration of any applicable tax-exempt organization.

(f) *Period of reliance on rebuttable presumption.* Except as provided in paragraph (d) of this section with respect to non-fixed payments, the rebuttable presumption applies to all payments made or transactions completed in accordance with a contract, provided that the provisions of paragraph (a) of this section were met at the time the parties entered into the contract.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–7 Correction.

(a) *In general.* An excess benefit transaction is corrected by undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the applicable tax-exempt organization involved in the excess benefit transaction in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. Paragraph (b) of this section describes the acceptable forms of correction. Paragraph (c) of this section defines the correction amount. Paragraph (d) of this section describes correction where a contract has been partially performed. Paragraph (e) of this section describes correction where the applicable tax-exempt organization involved in the transaction has ceased to exist or is no longer tax-exempt. Paragraph (f) of this section provides examples illustrating correction.

(b) *Form of correction*—(1) *Cash or cash equivalents.* Except as provided in paragraphs (b)(3) and (4) of this section, a disqualified person corrects an excess benefit only by making a payment in cash or cash equivalents, excluding payment by a promissory note, to the applicable tax-exempt organization equal to the correction amount, as defined in paragraph (c) of this section.

(2) *Anti-abuse rule.* A disqualified person will not satisfy the requirements of paragraph (b)(1) of this section if the Commissioner determines that the disqualified person engaged in one or more transactions with the applicable tax-exempt organization to circumvent the requirements of this correction section, and as a result, the disqualified person effectively transferred property other than cash or cash equivalents.

(3) *Special rule relating to nonqualified deferred compensation.* If an excess benefit transaction results, in whole or in part, from the vesting (as described in § 53.4958–1(e)(2)) of benefits provided under a nonqualified deferred compensation plan, then, to the extent that such benefits have not yet been distributed to the disqualified person, the disqualified person may correct the portion of the excess benefit resulting from the undistributed deferred compensation by relinquishing any right to receive the excess portion of the undistributed deferred compensation (including any earnings thereon).

(4) *Return of specific property*—(i) *In general.* A disqualified person may, with the agreement of the applicable tax-exempt organization, make a payment by returning specific property previously transferred in the excess benefit transaction. In this case, the disqualified person is treated as making a payment equal to the lesser of—

(A) The fair market value of the property determined on the date the property is returned to the organization; or

(B) The fair market value of the property on the date the excess benefit transaction occurred.

(ii) *Payment not equal to correction amount.* If the payment described in paragraph (b)(4)(i) of this section is less than the correction amount (as described in paragraph (c) of this section), the disqualified person must make an additional cash payment to the organization equal to the difference. Conversely, if the payment described in paragraph (b)(4)(i) of this section exceeds the correction amount (as described in paragraph (c) of this section), the organization may make a cash payment to the disqualified person equal to the difference.

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(iii) *Disqualified person may not participate in decision.* Any disqualified person who received an excess benefit from the excess benefit transaction may not participate in the applicable tax-exempt organization's decision whether to accept the return of specific property under paragraph (b)(4)(i) of this section.

(c) *Correction amount.* The correction amount with respect to an excess benefit transaction equals the sum of the excess benefit (as defined in § 53.4958–1(b)) and interest on the excess benefit. The amount of the interest charge for purposes of this section is determined by multiplying the excess benefit by an interest rate, compounded annually, for the period from the date the excess benefit transaction occurred (as defined in § 53.4958–1(e)) to the date of correction. The interest rate used for this purpose must be a rate that equals or exceeds the applicable Federal rate (AFR), compounded annually, for the month in which the transaction occurred. The period from the date the excess benefit transaction occurred to the date of correction is used to determine whether the appropriate AFR is the Federal short-term rate, the Federal mid-term rate, or the Federal long-term rate. See section 1274(d)(1)(A).

(d) *Correction where contract has been partially performed.* If the excess benefit transaction arises under a contract that has been partially performed, termination of the contractual relationship between the organization and the disqualified person is not required in order to correct. However, the parties may need to modify the terms of any ongoing contract to avoid future excess benefit transactions.

(e) *Correction in the case of an applicable tax-exempt organization that has ceased to exist, or is no longer tax-exempt*—(1) *In general.* A disqualified person must correct an excess benefit transaction in accordance with this paragraph where the applicable tax-exempt organization that engaged in the transaction no longer exists or is no longer described in section 501(c)(3) or (4) and exempt from tax under section 501(a).

(2) *Section 501(c)(3) organizations.* In the case of an excess benefit transaction with a section 501(c)(3) applicable tax-exempt organization, the disqualified person must pay the correction amount, as defined in paragraph (c) of this section, to another organization described in section 501(c)(3) and exempt from tax under section 501(a) in accordance with the dissolution clause contained in the constitutive documents of the applicable tax-exempt organization involved in the excess benefit transaction, provided that—

(i) The organization receiving the correction amount is described in section 170(b)(1)(A) (other than in section 170(b)(1)(A)(vii) and (viii)) and has been in existence and so described for a continuous period of at least 60 calendar months ending on the correction date;

(ii) The disqualified person is not also a disqualified person (as defined in § 53.4958–3) with respect to the organization receiving the correction amount; and

(iii) The organization receiving the correction amount does not allow the disqualified person (or persons described in § 53.4958–3(b) with respect to that person) to make or recommend any grants or distributions by the organization.

(3) *Section 501(c)(4) organizations.* In the case of an excess benefit transaction with a section 501(c)(4) applicable tax-exempt organization, the disqualified person must pay the correction amount, as defined in paragraph (c) of this section, to a successor section 501(c)(4) organization or, if no tax-exempt successor, to any organization described in section 501(c)(3) or (4) and exempt from tax under section 501(a), provided that the requirements of paragraphs (e)(2)(i) through (iii) of this section are satisfied (except that the requirement that the organization receiving the correction amount is described in section 170(b)(1)(A) (other than in section 170(b)(1)(A)(vii) and (viii)) shall not apply if the organization is described in section 501(c)(4)).

(f) *Examples.* The following examples illustrate the principles of this section describing the requirements of correction:

Example 1. W is an applicable tax-exempt organization for purposes of section 4958. D is a disqualified person with respect to W. W

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00261 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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employed D in 1999 and made payments totaling $*12t* to D as compensation throughout the taxable year. The fair market value of D's services in 1999 was $*7t*. Thus, D received excess compensation in the amount of $*5t*, the excess benefit for purposes of section 4958. In accordance with § 53.4958–1(e)(1), the excess benefit transaction with respect to the series of compensatory payments during 1999 is deemed to occur on December 31, 1999, the last day of D's taxable year. In order to correct the excess benefit transaction on June 30, 2002, D must pay W, in cash or cash equivalents, excluding payment with a promissory note, $*5t* (the excess benefit) plus interest on $*5t* for the period from the date the excess benefit transaction occurred to the date of correction (*i.e.*, December 31, 1999, to June 30, 2002). Because this period is not more than three years, the interest rate D must use to determine the interest on the excess benefit must equal or exceed the short-term AFR, compounded annually, for December, 1999 (5.74%, compounded annually).

Example 2. X is an applicable tax-exempt organization for purposes of section 4958. B is a disqualified person with respect to X. On January 1, 2000, B paid X $*6v* for Property F. Property F had a fair market value of $*10v* on January 1, 2000. Thus, the sales transaction on that date provided an excess benefit to B in the amount of $*4v*. In order to correct the excess benefit on July 5, 2005, B pays X, in cash or cash equivalents, excluding payment with a promissory note, $*4v* (the excess benefit) plus interest on $*4v* for the period from the date the excess benefit transaction occurred to the date of correction (*i.e.*, January 1, 2000, to July 5, 2005). Because this period is over three but not over nine years, the interest rate B must use to determine the interest on the excess benefit must equal or exceed the mid-term AFR, compounded annually, for January, 2000 (6.21%, compounded annually).

Example 3. The facts are the same as in *Example 2*, except that B offers to return Property F. X agrees to accept the return of Property F, a decision in which B does not participate. Property F has declined in value since the date of the excess benefit transaction. On July 5, 2005, the property has a fair market value of $*9v*. For purposes of correction, B's return of Property F to X is treated as a payment of $*9v*, the fair market value of the property determined on the date the property is returned to the organization. If $*9v* is greater than the correction amount ($*4v* plus interest on $*4v* at a rate that equals or exceeds 6.21%, compounded annually, for the period from January 1, 2000, to July 5, 2005), then X may make a cash payment to B equal to the difference.

Example 4. The facts are the same as in *Example 3*, except that Property F has increased in value since January 1, 2000, the date the excess benefit transaction occurred, and on July 5, 2005, has a fair market value of $*13v*. For purposes of correction, B's return of Property F to X is treated as a payment of $*10v*, the fair market value of the property on the date the excess benefit transaction occurred. If $*10v* is greater than the correction amount ($*4v* plus interest on $*4v* at a rate that equals or exceeds 6.21%, compounded annually, for the period from January 1, 2000, to July 5, 2005), then X may make a cash payment to B equal to the difference.

Example 5. The facts are the same as in *Example 2*. Assume that the correction amount B paid X in cash on July 5, 2005, was $*5.58v*. On July 4, 2005, X loaned $*5.58v* to B, in exchange for a promissory note signed by B in the amount of $*5.58v*, payable with interest at a future date. These facts indicate that B engaged in the loan transaction to circumvent the requirement of this section that (except as provided in paragraph (b)(3) or (4) of this section), the correction amount must be paid only in cash or cash equivalents. As a result, the Commissioner may determine that B effectively transferred property other than cash or cash equivalents, and therefore did not satisfy the correction requirements of this section.

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4958–8 Special rules.

(a) *Substantive requirements for exemption still apply.* Section 4958 does not affect the substantive standards for tax exemption under section 501(c)(3) or (4), including the requirements that the organization be organized and operated exclusively for exempt purposes, and that no part of its net earnings inure to the benefit of any private shareholder or individual. Thus, regardless of whether a particular transaction is subject to excise taxes under section 4958, existing principles and rules may be implicated, such as the limitation on private benefit. For example, transactions that are not subject to section 4958 because of the initial contract exception described in § 53.4958–4(a)(3) may, under certain circumstances, jeopardize the organization's tax-exempt status.

(b) *Interaction between section 4958 and section 7611 rules for church tax inquiries and examinations.* The procedures of section 7611 will be used in initiating and conducting any inquiry or examination into whether an excess benefit transaction has occurred between a church and a disqualified person. For purposes of this rule, the reasonable

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00262 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

belief required to initiate a church tax inquiry is satisfied if there is a reasonable belief that a section 4958 tax is due from a disqualified person with respect to a transaction involving a church. See § 301.7611–1 Q&A 19 of this chapter.

(c) *Other substantiation requirements.* These regulations, in § 53.4958–4(c)(3), set forth specific substantiation rules. Compliance with the specific substantiation rules of that section does not relieve applicable tax-exempt organizations of other rules and requirements of the Internal Revenue Code, regulations, Revenue Rulings, and other guidance issued by the Internal Revenue Service (including the substantiation rules of sections 162 and 274, or § 1.6001–1(a) and (c) of this chapter).

[T.D. 8978, 67 FR 3083, Jan. 23, 2002]

§ 53.4959–1 Taxes on failures by hospital organizations to meet section 501(r)(3).

(a) *Excise tax for failure to meet the section 501(r)(3) requirements*—(1) *In general.* If a hospital organization (as defined in § 1.501(r)–1(b)(18)) fails to meet the requirements of section 501(r)(3) separately with respect to a hospital facility it operates in any taxable year, there is imposed on the hospital organization a tax equal to $50,000. If a hospital organization operates multiple hospital facilities and fails to meet the requirements of section 501(r)(3) with respect to more than one facility it operates, the $50,000 tax is imposed on the hospital organization separately for each hospital facility's failure. The tax is imposed for each taxable year that a hospital facility fails to meet the requirements of section 501(r)(3).

(2) *Examples.* The following examples illustrate this paragraph (a):

Example 1. (i) U is a hospital organization that operates only one hospital facility, V. In Year 1, V conducts a community health needs assessment (CHNA) and adopts an implementation strategy to meet the health needs identified through the CHNA. In Years 2 and 3, V does not conduct a CHNA. V fails to conduct a CHNA by the last day of Year 4. Accordingly, U has failed to meet the requirements of section 501(r)(3) with respect to V in Year 4 because V has failed to conduct a CHNA in Years 2, 3, and 4. U is subject to a tax equal to $50,000 for Year 4.

(ii) V also fails to conduct a CHNA by the last day of Year 5. Accordingly, U has failed to meet the requirements of section 501(r)(3) with respect to V in Year 5 because V has failed to conduct a CHNA in Years 3, 4, and 5. U is subject to a tax equal to $50,000 for Year 5.

Example 2. P is a hospital organization that operates only one hospital facility, Q. In Year 1, Q conducts a CHNA and adopts an implementation strategy to meet the health needs identified through the CHNA. In Years 2 and 3, Q does not conduct a CHNA. In Year 4, Q conducts a CHNA but does not adopt an implementation strategy to meet the health needs identified through that CHNA by the 15th day of the fifth month of Year 5. Accordingly, P has failed to meet the requirements of section 501(r)(3) with respect to Q in Year 4 because Q has failed to adopt an implementation strategy by the 15th day of the fifth month after the end of the taxable year in which Q conducted its CHNA. P is subject to a tax equal to $50,000 for Year 4.

Example 3. R is a hospital organization that operates two hospital facilities, S and T. In Year 1, S and T each conduct a CHNA and adopt an implementation strategy to meet the health needs identified through the CHNA. In Years 2 and 3, S and T do not conduct a CHNA. S and T each fail to conduct a CHNA by the last day of Year 4. Accordingly, R has failed to meet the requirements of section 501(r)(3) with respect to both S and T in Year 4. R is subject to a tax equal to $100,000 ($50,000 for S's failure plus $50,000 for T's failure) for Year 4.

(b) *Interaction with other provisions*—(1) *Correction.* Unless a hospital organization's failure to meet the requirements of section 501(r)(3) involves an omission or error that is described in and corrected in accordance with § 1.501(r)–2(b) (and is thus not considered a failure), a failure to meet the requirements of section 501(r)(3) will result in a tax being imposed on the organization under this section, notwithstanding the organization's correction and disclosure of the failure in accordance with the guidance described in § 1.501(r)–2(c).

(2) *Interaction with other taxes.* The tax imposed by this section is in addition to any tax imposed by § 1.501(r)–2(d) or as a result of revocation of a hospital organization's section 501(c)(3) status.

(c) *Effective/applicability date.* Paragraph (a) of this section applies on and after December 29, 2014.

[T.D. 9708, 79 FR 79015, Dec. 31, 2014, as amended at 80 FR 12765, Mar. 11, 2015]

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00263 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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§ 53.4960–0 Table of contents.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00264 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
sfrattini on LAPCK6H6L3 with DISTILLER

(i) In general.
(ii) Previously paid remuneration.
(A) New covered employee.
(B) Existing covered employee.
(iii) Earnings.
(iv) Losses.
(v) Net earnings.
(vi) Net losses.
(3) Remuneration paid for a taxable year before the employee becomes a covered employee.
(i) In general.
(ii) Examples.
(e) Calculation of present value.
(1) In general.
(2) Treatment of future payment amount as present value for certain amounts.
(f) Examples.

§53.4960–3 Determination of whether there is a parachute payment.

(a) Parachute payment.
(1) In general.
(2) Exclusions.
(i) Certain qualified plans.
(ii) Certain annuity contracts.
(iii) Compensation for medical services.
(iv) Payments to non-HCEs.
(3) Determination of HCEs for purposes of the exclusion from parachute payments.
(b) Payment in the nature of compensation.
(1) In general.
(2) Consideration paid by covered employee.
(c) When payment is considered to be made.
(1) In general.
(2) Transfers of section 83 property.
(3) Stock options.
(d) Payment contingent on an employee's separation from employment.
(1) In general.
(2) Employment agreements.
(i) In general.
(ii) Example.
(3) Noncompetition agreements.
(4) Payment of amounts previously included in income or excess remuneration.
(5) Window programs.
(6) Anti-abuse provision.
(e) Involuntary separation from employment.
(1) In general.
(2) Separation from employment for good reason.
(i) In general.
(ii) Material negative change required.
(iii) Deemed material negative change.
(A) Material diminution of compensation.
(B) Material diminution of responsibility.
(C) Material diminution of authority of a supervisor.
(D) Material diminution of a location.
(E) Material change of location.
(F) Other material breach.
(3) Separation from employment.
(f) Accelerated payment or accelerated vesting resulting from an involuntary separation from employment.
(1) In general.
(2) Nonvested payments subject to a nonservice vesting condition.
(3) Vested payments.
(4) Nonvested payments subject to a service vesting condition.
(i) In general.
(A) Vesting trigger.
(B) Vesting condition.
(C) Services condition.
(ii) Value of the lapse of the obligation to continue to perform services.
(iii) Accelerated vesting of equity compensation.
(5) Application to benefits under a nonqualified deferred compensation plan.
(6) Present value.
(7) Examples.
(g) Three-times-base-amount test for parachute payments.
(1) In general.
(2) Examples.
(h) Calculating present value.
(1) In general.
(2) Deferred payments.
(3) Health care.
(i) Discount rate.
(j) Present value of a payment to be made in the future that is contingent on an uncertain future event or condition.
(1) Treatment based on the estimated probability of payment.
(2) Correction of incorrect estimates.
(3) Initial option value estimate.
(4) Examples.
(k) Base amount.
(1) In general.
(2) Short or incomplete taxable years.
(3) Excludable fringe benefits.
(4) Section 83(b) income.
(l) Base period.
(1) In general.
(2) Determination of base amount if employee separates from employment in the year hired.
(3) Examples.

§53.4960–4 Liability for tax on excess remuneration and excess parachute payments.

(a) Liability, reporting, and payment of excise taxes.
(1) Liability.
(2) Reporting and payment.
(3) Arrangements between an ATEO and a related organization.
(4) Certain foreign related organizations.
(5) [Reserved]
(b) Amounts subject to tax.
(1) Excess remuneration.
(i) In general.
(ii) Exclusion for excess parachute payments.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00265 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
sfrattini on LAPCK6H6L3 with DISTILLER

(2) Excess parachute payment.

(c) Calculation of liability for tax on excess remuneration.

(1) In general.

(2) Calculation if liability is allocated from more than one ATEO with respect to an individual.

(3) Calculation if liability is allocated from an ATEO with a short applicable year.

(4) Examples.

(d) Calculation of liability for excess parachute payments.

(1) In general.

(2) Computation of excess parachute payments.

(3) Reallocation when the payment is disproportionate to base amount.

(4) Election to prepay tax.

(5) Liability after a redetermination of total parachute payments.

(6) Examples.

§ 53.4960–5 [Reserved]

§ 53.4960–6 Applicability date.

(a) General applicability date.

(b) [Reserved]

[T.D. 9938, 86 FR 6219, Jan. 19, 2021; 86 FR 23865, May 5, 2021]

§ 53.4960–1 Scope and definitions.

(a) *Scope.* This section provides definitions for purposes of section 4960, this section, and §§ 53.4960–2 through 53.4960–6. Section 53.4960–2 provides definitions and rules for determining the amount of remuneration paid for a taxable year. Section 53.4960–3 provides definitions and rules for determining whether a parachute payment is paid. Section 53.4960–4 provides definitions and rules for calculating the amount of excess remuneration paid for a taxable year, excess parachute payments paid in a taxable year, and liability for the excise tax. Section 53.4960–5 is reserved for rules on the coordination of sections 4960 and 162(m). Section 53.4960–6 provides rules regarding the applicability date for the regulations in §§ 53.4960–1 through 53.4960–5. The rules and definitions provided in this section through § 53.4960–6 apply solely for purposes of section 4960 unless specified otherwise.

(b) *Applicable tax-exempt organization*—(1) *In general. Applicable tax-exempt organization* or *ATEO* means any organization that is one of the following types of organizations:

(i) *Section 501(a) organization.* The organization is exempt from taxation under section 501(a) (except as provided in paragraph (b)(2) or (b)(3) of this section);

(ii) *Section 521 farmers' cooperative.* The organization is a farmers' cooperative organization described in section 521(b)(1);

(iii) *Section 115(1) organization.* The organization has income excluded from taxation under section 115(1); or

(iv) *Section 527 political organization.* The organization is a political organization described in section 527(e)(1).

(2) *Certain foreign organizations.* Any foreign organization described in section 4948(b) that either is exempt from tax under section 501(a) or is a taxable private foundation (section 4948(b) organization) is not an ATEO. A foreign organization is an organization not created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States. See section 4948(b) and § 53.4948–1. For purposes of this paragraph (b)(2) and the application of section 4960 to a taxable year, an organization's status as a section 4948(b) organization is determined at the end of its taxable year.

(c) *Applicable year*—(1) *In general. Applicable year* means the calendar year ending with or within the ATEO's taxable year. See § 53.4960–4 regarding how an ATEO's applicable year affects the liability of related organizations.

(2) *Examples.* The following examples illustrate the rules of paragraph (c)(1) of this section.

(i) *Example 1 (Calendar year taxpayer)*—(A) *Facts.* ATEO 1 uses the calendar year as its taxable year and became an ATEO before 2022.

(B) *Conclusion.* ATEO 1's applicable year for its 2022 taxable year is the period from January 1, 2022, through December 31, 2022 (that is, the 2022 calendar year).

(ii) *Example 2 (Fiscal year taxpayer)*—(A) *Facts.* ATEO 2 uses a taxable year that starts July 1 and ends June 30 and became an ATEO before 2022.

(B) *Conclusion.* ATEO 2's applicable year for the taxable year beginning July 1, 2022, and ending June 30, 2023, is the 2022 calendar year.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00266 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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(3) *Short applicable years*—(i) *In general.* An ATEO may have an applicable year that does not span the entire calendar year for the initial taxable year that the organization is an ATEO or for the taxable year in which the taxpayer ceases to be an ATEO. The beginning and end dates of the applicable year in the case of an ATEO's change in status depend on when the change in status occurs.

(ii) *Initial year of ATEO status.* For the taxable year in which an ATEO first becomes an ATEO, *applicable year* means the period beginning on the date the ATEO first becomes an ATEO and ending on the last day of the calendar year ending with or within such taxable year (or, if earlier, the date of termination of ATEO status, as described in paragraph (c)(3)(ii)(A) of this section). If the taxable year in which an ATEO first becomes an ATEO ends before the end of the calendar year in which the ATEO first becomes an ATEO, then there is no applicable year for the ATEO's first taxable year; however, for the ATEO's next taxable year, *applicable year* means the period beginning on the date the ATEO first becomes an ATEO and ending on December 31 of the calendar year (or, if earlier, the date of termination of ATEO status, as described in paragraph (c)(3)(ii)(A) of this section).

(iii) *Year of termination of ATEO status*—(A) *Termination on or before the close of the calendar year ending with or within the taxable year of termination.* If an ATEO has a termination of ATEO status during the taxable year and the termination of ATEO status occurs on or before the close of the calendar year ending with or within such taxable year, then, for the taxable year of termination of ATEO status, applicable year means the period starting January 1 of the calendar year of the termination of ATEO status and ending on the date of the termination of ATEO status.

(B) *Termination after the close of the calendar year ending in the taxable year of termination.* If an ATEO has a termination of ATEO status during the taxable year and the termination of ATEO status occurs after the close of the calendar year ending within such taxable year, then, for the taxable year of the termination of ATEO status, *applicable year* means both the calendar year ending within such taxable year and the period beginning January 1 of the calendar year of the termination of ATEO status and ending on the date of the termination of ATEO status. Both such applicable years are treated as separate applicable years. See § 53.4960–4(b)(2)(ii) for rules regarding calculation of the tax in the event there are multiple applicable years associated with a taxable year.

(4) *Examples.* The following examples illustrate the rules of paragraph (c)(3) of this section. For purposes of these examples, assume any entity referred to as "ATEO" is an ATEO and any entity referred to as "CORP" is not an ATEO.

(i) *Example 1 (Taxable year of formation ending after December 31)*—(A) *Facts.* ATEO 1, ATEO 2, and CORP 1 are related organizations that all use a taxable year that starts July 1 and ends June 30. ATEO 1 is recognized as a section 501(c)(3) organization by the IRS on May 8, 2023, effective as of October 1, 2022. ATEO 2 became an ATEO in 2017.

(B) *Conclusion (ATEO 1).* ATEO 1's applicable year for the taxable year beginning October 1, 2022, and ending June 30, 2023, is the period beginning October 1, 2022, and ending December 31, 2022. For purposes of determining the amount of remuneration paid by ATEO 1 and all related organizations for ATEO 1's taxable year beginning October 1, 2022, and ending June 30, 2023, (including for purposes of determining ATEO 1's covered employees), only remuneration paid between October 1, 2022, and December 31, 2022, is taken into account. Thus, any remuneration paid by ATEO 1, ATEO 2, and CORP 1 before October 1, 2022, is disregarded for purposes of ATEO 1's applicable year associated with its initial taxable year.

(C) *Conclusion (ATEO 2).* ATEO 2's applicable year for its taxable year beginning July 1, 2022, and ending June 30, 2023, is the 2022 calendar year. Thus, any remuneration paid by ATEO 1, ATEO 2, and CORP 1 during the 2022 calendar year is taken into account for purposes of determining ATEO 2's covered employees and remuneration paid

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00267 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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for ATEO 2's taxable year ending June 30, 2023.

(ii) *Example 2 (Taxable year of formation ending before December 31)*—(A) *Facts*. Assume the same facts as in paragraph (c)(4)(i)(A) of this section (Example 1), except that ATEO 1 is recognized as a section 501(c)(3) organization effective as of March 15, 2023.

(B) *Conclusion*. ATEO 1 has no applicable year for the taxable year starting March 15, 2023, and ending June 30, 2023, because no calendar year ends (or termination of ATEO status occurs) with or within the taxable year. ATEO 1's applicable year for the taxable year ending June 30, 2024, is the period beginning March 15, 2023, and ending December 31, 2023. For purposes of determining the amount of remuneration paid by ATEO 1 and all related organizations for ATEO 1's taxable year ending June 30, 2024 (including for purposes of determining ATEO 1's covered employees), only remuneration paid between March 15, 2023, and December 31, 2023, is taken into account. The conclusion for ATEO 2 is the same as in paragraph (c)(4)(i)(C) of this section (Example 1).

(iii) *Example 3 (Termination before the close of the calendar year ending in the taxable year of termination)*—(A) *Facts*. Assume the same facts as in paragraph (c)(4)(i)(A) of this section (Example 1). In addition, ATEO 1 has a termination of ATEO status on September 30, 2024.

(B) *Conclusion*. For ATEO 1's taxable year beginning July 1, 2024, and ending September 30, 2024, ATEO 1's applicable year is the period beginning January 1, 2024, and ending September 30, 2024.

(iv) *Example 4 (Termination after the close of the calendar year ending in the taxable year of termination)*—(A) *Facts*. Assume the same facts as in paragraph (c)(4)(i)(A) of this section (Example 1). In addition, ATEO 1 has a termination of ATEO status on March 31, 2025.

(B) *Conclusion*. For ATEO 1's taxable year beginning July 1, 2024, and ending March 31, 2025, ATEO 1 has two applicable years: the 2024 calendar year, and the period beginning on January 1, 2025, and ending on March 31, 2025.

(d) *Covered employee*—(1) *In general*. For each taxable year, *covered employee* means any individual who is one of the five highest-compensated employees of the ATEO for the taxable year or was a covered employee of the ATEO (or any predecessor) for any preceding taxable year beginning after December 31, 2016.

(2) *Five highest-compensated employees*—(i) *In general*. Except as otherwise provided in this paragraph (d)(2), an individual is one of an ATEO's five highest- compensated employees for the taxable year if the individual is among the five employees of the ATEO with the highest amount of remuneration paid during the applicable year, as determined under § 53.4960–2. However, remuneration for which the deduction is disallowed by reason of section 162(m) is taken into account for purposes of determining an ATEO's five highest-compensated employees. The five highest-compensated employees of an ATEO for the taxable year are identified on the basis of the total remuneration paid during the applicable year to the employee for services performed as an employee of the ATEO or any related organization. An ATEO may have fewer than five highest-compensated employees for a taxable year if it has fewer than five employees other than employees who are disregarded under paragraphs (d)(2)(ii) through (iv) of this section. For purposes of this paragraph (d)(2), a grant of a legally binding right (within the meaning of § 1.409A–1(b)) to vested remuneration is considered to be remuneration paid as of the date of grant, as described in § 53.4960–2(c)(2), and a person or governmental entity is considered to grant a legally binding right to nonvested remuneration if the person or governmental entity grants a legally binding right to remuneration that is not vested within the meaning of § 53.4960–2(c)(2). An employee is disregarded for purposes of determining an ATEO's five highest-compensated employees for a taxable year if, during the applicable year, neither the ATEO nor any related organization paid remuneration or granted a legally binding right to nonvested remuneration to the individual for services the individual performed as an employee of the ATEO or any related organization.

(ii) *Limited hours exception*—(A) *In general*. An individual is disregarded for purposes of determining an ATEO's five highest-compensated employees for a

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00268 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

taxable year if all of the following requirements are met:

(*1*) *Remuneration requirement.* Neither the ATEO nor any related ATEO paid remuneration or granted a legally binding right to nonvested remuneration to the individual for services the individual performed as an employee of the ATEO during the applicable year; and

(*2*) *Hours of service requirement.* The individual performed services as an employee of the ATEO and all related ATEOs for no more than 10 percent of the total hours the individual worked as an employee of the ATEO and any related organizations during the applicable year. An ATEO may instead make this determination based on the total days the individual worked as an employee of the ATEO and all related ATEOs as a percentage of the total days worked as an employee of the ATEO and all related organizations, provided that for purposes of the calculation, any day that the individual worked at least one hour as an employee of the ATEO or a related ATEO is treated as a day worked as an employee of the ATEO and not for any other organization.

(B) *Certain payments disregarded.* For purposes of paragraph (d)(2)(ii)(A)(*1*) of this section, a payment of remuneration made to the individual by a related organization that is an employer of the individual and for which the related organization is neither entitled to reimbursement by the ATEO nor entitled to any other consideration from the ATEO is not considered remuneration paid by the ATEO under § 53.4960–2(b)(1), and a payment of remuneration made to the individual by a related organization is not treated as remuneration paid by the ATEO under § 53.4960–2(b)(2).

(C) *Safe harbor.* For purposes of paragraph (d)(2)(ii)(A)(*2*) of this section, an individual is treated as having performed services as an employee of the ATEO and all related ATEOs for no more than 10 percent of the total hours the individual worked as an employee of the ATEO and all related organizations during the applicable year if the employee performed no more than 100 hours of service as an employee of the ATEO and all related ATEOs during the applicable year.

(iii) *Nonexempt funds exception*—(A) *In general.* An individual is disregarded for purposes of determining an ATEO's five highest-compensated employees for a taxable year if all the following requirements are met:

(*1*) *Remuneration requirement.* Neither the ATEO, nor any related ATEO, nor any taxable related organization controlled by the ATEO, or by one or more related ATEOs, either alone or together with the ATEO, paid remuneration or granted a legally binding right to nonvested remuneration to the individual for services the individual performed as an employee of an ATEO during the applicable year and the preceding applicable year. For this purpose, whether a taxable related organization is controlled by the ATEO (or one or more related ATEOs) is determined without regard to paragraph (i)(2)(vii)(B)(*2*) of this section and without regard to section 318(a)(3) for purposes of applying paragraph (i)(2)(vii)(A) of this section, so that an interest in a corporation or nonstock entity is not attributed downward in determining control of the corporation or nonstock entity;

(*2*) *Hours of service requirement.* The individual performed services as an employee of the ATEO and any related ATEOs for not more than 50 percent of the total hours worked as an employee of the ATEO and any related organizations during the applicable year and the preceding applicable year. An ATEO may instead make this determination based on the total days the individual worked as an employee of the ATEO and all related ATEOs as a percentage of the total days worked as an employee of the ATEO and all related organizations, provided that for purposes of the calculation, any day that the individual worked at least one hour as an employee of the ATEO or a related ATEO is treated as a day worked as an employee of the ATEO and not for any other organization; and

(*3*) *Related organizations requirement.* No related organization that paid remuneration or granted a legally binding right to nonvested remuneration to the individual during the applicable year and the preceding applicable year

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provided services for a fee to the ATEO, to any related ATEO, or to any taxable related organization controlled by the ATEO or by one or more related ATEOs, either alone or together with the ATEO, during the applicable year and the preceding applicable year. For purposes of this paragraph (d)(2)(iii)(A)(*3*), whether a taxable related organization is controlled by the ATEO (or one or more related ATEOs) is determined without regard to paragraph (i)(2)(vii)(B)(*2*) of this section and without regard to section 318(a)(3) for purposes of applying paragraph (i)(2)(vii)(A) of this section, so that an interest in a corporation or nonstock entity is not attributed downward in determining control of the corporation or nonstock entity.

(B) *Certain payments disregarded.* For purposes of paragraph (d)(2)(iii)(A)(*1*) of this section, a payment of remuneration made to an individual by a related organization that is an employer of the individual and for which the related organization is neither entitled to reimbursement by the ATEO nor entitled to any other consideration from the ATEO is not considered remuneration paid by the ATEO under § 53.4960–2(b)(1) and a payment of remuneration made to the individual by a related organization is not treated as paid by the ATEO under § 53.4960–2(b)(2).

(iv) *Limited services exception.* An individual is disregarded for purposes of determining an ATEO's five highest-compensated employees for a taxable year even though the ATEO paid remuneration to the individual if, disregarding § 53.4960–2(b)(2), all of the following requirements are met:

(A) *Remuneration requirement.* The ATEO did not pay 10 percent or more of the individual's total remuneration for services performed as an employee of the ATEO and all related organizations during the applicable year; and

(B) *Related ATEO requirement.* The ATEO had at least one related ATEO during the applicable year and one of the following conditions applies:

(*1*) *Ten percent remuneration condition.* A related ATEO paid at least 10 percent of the remuneration paid by the ATEO and any related organizations during the applicable year; or

(*2*) *Less remuneration condition.* No related ATEO paid at least 10 percent of the total remuneration paid by the ATEO and any related organizations and the ATEO paid less remuneration to the individual than at least one related ATEO during the applicable year.

(3) *Examples.* The following examples illustrate the rules of this paragraph (d). For purposes of these examples, assume any entity referred to as ''ATEO'' is an ATEO, any entity referred to as ''CORP'' is not an ATEO and is not a publicly held company within the meaning of section 162(m)(2) unless otherwise stated, and each taxpayer uses the calendar year as its taxable year.

(i) *Example 1 (Employee of two related ATEOs)*—(A) *Facts.* ATEO 1 and ATEO 2 are related organizations and have no other related organizations. Both employ Employee A during calendar year 2022 and pay remuneration to Employee A for Employee A's services. During 2022, Employee A performed services for 1,000 hours as an employee of ATEO 1 and 1,000 hours as an employee of ATEO 2.

(B) *Conclusion.* Employee A may be a covered employee of both ATEO 1 and ATEO 2 as one of the five highest-compensated employees for taxable year 2022 under paragraph (d)(2)(i) of this section because the exceptions in paragraphs (d)(2)(ii) through (iv) of this section do not apply. Because they are related organizations, ATEO 1 and ATEO 2 must each include the remuneration paid to Employee A by the other during each of their applicable years in determining their respective five highest-compensated employees for taxable year 2022.

(ii) *Example 2 (Employee of an ATEO and a related non-ATEO)*—(A) *Facts.* Assume the same facts as in paragraph (d)(3)(i) of this section (*Example 1*), except that ATEO 1 is instead CORP 1.

(B) *Conclusion (CORP 1).* For taxable year 2022, CORP 1 is not an ATEO and therefore does not need to identify covered employees.

(C) *Conclusion (ATEO 2).* Employee A may be a covered employee of ATEO 2 as one of its five highest-compensated employees for taxable year 2022 under paragraph (d)(2)(i) of this section because no exception in paragraphs

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(d)(2)(ii) through (iv) of this section applies. ATEO 2 must include the remuneration paid to Employee A by CORP 1 during its applicable year in determining ATEO 2's five highest-compensated employees for taxable year 2022.

(iii) *Example 3 (Amounts for which a deduction is disallowed under section 162(m) are taken into account for purposes of determining the five highest-compensated employees)*—(A) *Facts*. CORP 2 is a publicly held corporation within the meaning of section 162(m)(2) and is a related organization of ATEO 3. ATEO 3 is a corporation that is part of CORP 2's affiliated group (as defined in section 1504, without regard to section 1504(b)) and has no other related organizations. Employee B is a covered employee (as defined in section 162(m)(3)) of CORP 2 and an employee of ATEO 3. In 2022, CORP 2 paid Employee B $8 million of remuneration for services provided as an employee of CORP 2 and ATEO 3 paid Employee B $500,000 of remuneration for services provided as an employee of ATEO 3. $7.5 million of the remuneration is compensation for which a deduction is disallowed pursuant to section 162(m)(1).

(B) *Conclusion*. The $7.5 million of remuneration for which a deduction is disallowed under section 162(m)(1) is taken into account for purposes of determining ATEO 3's five highest-compensated employees. Thus, ATEO 3 is treated as paying Employee B $8.5 million of remuneration for purposes of determining its five highest-compensated employees.

(iv) *Example 4 (Employee disregarded due to receiving no remuneration)*—(A) *Facts*. Employee C is an officer of ATEO 4 who performs more than minor services for ATEO 4. In 2022, neither ATEO 4 nor any related organization paid remuneration or granted a legally binding right to any nonvested remuneration to Employee C. ATEO 4 paid premiums for insurance for liability arising from Employee C's service with ATEO 4, which is properly treated as a working condition fringe benefit excluded from gross income under § 1.132–5.

(B) *Conclusion*. Even though Employee C is an employee of ATEO 4, Employee C is disregarded for purposes of determining ATEO 4's five highest-compensated employees for taxable year 2022 under paragraph (d)(2)(i) of this section because neither ATEO 4 nor any related organization paid Employee C any remuneration (nor did they grant a legally binding right to nonvested remuneration) in applicable year 2022. The working condition fringe benefit is not wages within the meaning of section 3401(a), as provided in section 3401(a)(19), and thus is not remuneration within the meaning of § 53.4960–2(a).

(v) *Example 5 (Limited hours exception)*—(A) *Facts*. ATEO 5 and CORP 3 are related organizations. ATEO 5 has no other related organizations. Employee D is an employee of CORP 3. As part of Employee D's duties at CORP 3, Employee D serves as an officer of ATEO 5. Only CORP 3 paid remuneration (or granted a legally binding right to nonvested remuneration) to Employee D and ATEO 5 did not reimburse CORP 3 for any portion of Employee D's remuneration in any manner. During 2022, Employee D provided services as an employee for 2,000 hours to CORP 3 and 200 hours to ATEO 5.

(B) *Conclusion*. Even though Employee D is an employee of ATEO 5 because Employee D provided more than minor services as an officer, Employee D is disregarded for purposes of determining ATEO 5's five highest-compensated employees for taxable year 2022. Employee D is disregarded under paragraph (d)(2)(ii) of this section because only CORP 3 paid Employee D any remuneration or granted a legally binding right to nonvested remuneration in applicable year 2022 and Employee D provided services as an employee of ATEO 5 for 200 hours, which is not more than ten percent of the 2,200 total hours (2,000 + 200 = 2,200) worked as an employee of ATEO 5 and all related organizations.

(vi) *Example 6 (Limited hours exception)*—(A) *Facts*. Assume the same facts as in paragraph (d)(3)(v) of this section (*Example 5*), except that ATEO 5 also provides a reasonable allowance for expenses incurred by Employee D in executing Employee D's duties as an officer of ATEO 5, which is properly excluded from gross income under an accountable plan described in § 1.62–2.

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(B) *Conclusion*. The conclusion is the same as in paragraph (d)(3)(v)(B) of this section (*Example 5*). Specifically, even though Employee D is an employee of ATEO 5 because Employee D provided more than minor services for ATEO 5, Employee D is disregarded for purposes of determining ATEO 5's five highest-compensated employees for taxable year 2022 under paragraph (d)(2)(ii) of this section because the expense allowance under the accountable plan is excluded from wages within the meaning of section 3401(a), as provided in § 31.3401(a)-4, and thus is not remuneration within the meaning of § 53.4960–2(a).

(vii) *Example 7 (No exception applies due to source of payment)*—(A) *Facts*. Assume the same facts as in paragraph (d)(3)(v) of this section (*Example 5*), except that ATEO 5 has a contractual arrangement with CORP 3 to reimburse CORP 3 for the hours of service Employee D provides to ATEO 5 during applicable year 2022 by paying an amount equal to the total remuneration received by Employee D from both ATEO 5 and CORP 3, multiplied by a fraction equal to the hours of service Employee D provided ATEO 5 over Employee D's total hours of service to both ATEO 5 and CORP 3.

(B) *Conclusion*. Employee D may be one of ATEO 5's five highest-compensated employees for taxable year 2022 under paragraph (d)(2)(i) of this section because the exceptions in paragraphs (d)(2)(ii) through (iv) of this section do not apply. Pursuant to the contractual arrangement between CORP 3 and ATEO 5, ATEO 5 reimburses CORP 3 for a portion of Employee D's remuneration during applicable year 2022; thus, the exceptions under paragraphs (d)(2)(ii) and (iii) of this section do not apply. Further, while ATEO 5 paid Employee D less than 10 percent of the total remuneration from ATEO 5 and all related organizations (200 hours of service to ATEO 5/2,200 hours of service to ATEO 5 and all related organizations = 9 percent), it had no related ATEO; thus, the limited services exception under paragraph (d)(2)(iv) of this section does not apply.

(viii) *Example 8 (Nonexempt funds exception for part-time services)*—(A) *Facts*. ATEO 6 and CORP 4 are related organizations. ATEO 6 has no other related organizations and does not control CORP 4. During applicable year 2022, Employee E provided 2,000 hours of services as an employee of CORP 4 and 0 hours of services as an employee of ATEO 6; during applicable year 2023, Employee E provided 1,100 hours of services as an employee of CORP 4 and 900 hours of services as an employee of ATEO 6; during applicable year 2024, Employee E provided 1,100 hours of services as an employee of CORP 4 and 900 hours of services as an employee of ATEO 6. ATEO 6 neither paid any remuneration to Employee E nor paid a fee for services to CORP 4 during any applicable year. No exception under paragraphs (d)(2)(i), (ii), or (iv) applies to Employee E.

(B) *Conclusion (2023)*. Employee E is disregarded for purposes of determining ATEO 6's five highest-compensated employees for taxable year 2023 under paragraph (d)(2)(iii) of this section because for applicable years 2022 and 2023, Employee E provided services as an employee of ATEO 6 for not more than 50 percent of the total hours Employee E provided services as an employee of ATEO 6 and CORP 4 (900 hours/4,000 hours), and ATEO 6 neither paid any remuneration to Employee E nor paid a fee for services to CORP 4 during applicable years 2022 and 2023.

(C) *Conclusion (2024)*. Employee E is disregarded for purposes of determining ATEO 6's five highest-compensated employees for taxable year 2024 under paragraph (d)(2)(iii) of this section because for applicable years 2023 and 2024, Employee E provided services as an employee of ATEO 6 for not more than 50 percent of the total hours Employee E provided services as an employee of ATEO 6 and CORP 4 (1,800 hours/4,000 hours), and ATEO 6 neither paid any remuneration to Employee E nor paid a fee for services to CORP 4 during applicable years 2023 and 2024.

(ix) *Example 9 (Nonexempt funds for full-time services in one applicable year)*—(A) *Facts*. Assume the same facts as in paragraph (d)(3)(viii) of this section (*Example 8)*, except that during applicable year 2022, Employee E provided services as an employee for 2,000 hours to CORP 4 and for 0 hours to ATEO 6; during applicable year 2023, Employee

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00272 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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E provided services as an employee for 0 hours to CORP 4 and 2,000 hours to ATEO 6; and during applicable year 2024, Employee E resumes employment with CORP 4 so that Employee E provided services as an employee for 2,000 hours to CORP 4 and 0 hours to ATEO 6.

(B) *Conclusion (2023)*. Employee E is disregarded for purposes of determining ATEO 6's five highest-compensated employees for taxable year 2023 under paragraph (d)(2)(iii) of this section because for applicable years 2022 and 2023, Employee E provided services as an employee of ATEO 6 for not more than 50 percent of the total hours Employee E provided services as an employee of ATEO 6 and CORP 4 (2,000 hours/4,000 hours), and ATEO 6 neither paid any remuneration to Employee E nor paid a fee for services to CORP 4 during applicable years 2022 and 2023.

(C) *Conclusion (2024)*. Employee E is disregarded for purposes of determining ATEO 6's five highest-compensated employees for taxable year 2024 under paragraph (d)(2)(iii) of this section because for applicable years 2023 and 2024, Employee E provided services as an employee of ATEO 6 for not more than 50 percent of the total hours Employee E provided services as an employee of ATEO 6 and CORP 4 (2,000 hours/4,000 hours for ATEO 6 and CORP 4), and ATEO 6 neither paid any remuneration to Employee E nor paid a fee for services to CORP 4 during applicable years 2023 and 2024.

(x) *Example 10 (Nonexempt funds exception for full-time services across two applicable years)*—(A) *Facts*. Assume the same facts as in paragraph (d)(3)(viii)(A) of this section (*Example 8)*, except that during applicable year 2022, Employee E provided services as an employee for 2,000 hours to CORP 4 and for 0 hours to ATEO 6; during applicable year 2023, Employee E provided services as an employee for 600 hours to CORP 4 and for 1,400 hours to ATEO 6; and during applicable year 2024, Employee E provided services as an employee for 1,400 hours to CORP 4 and for 600 hours to ATEO 6.

(B) *Conclusion (2023)*. Employee E is disregarded for purposes of determining ATEO 6's five highest-compensated employees for taxable year 2023 under paragraph (d)(2)(iii) of this section because for applicable years 2022 and 2023, Employee E provided services as an employee of ATEO 6 for not more than 50 percent of the total hours Employee E provided services as an employee of ATEO 6 and CORP 4 (1,400 hours/4,000 hours), and ATEO 6 neither paid any remuneration to Employee E, nor paid a fee for services to CORP 4 during applicable years 2022 and 2023.

(C) *Conclusion (2024)*. Employee E is disregarded for purposes of determining ATEO 6's five highest-compensated employees for taxable year 2024 under paragraph (d)(2)(iii) of this section because for applicable years 2023 and 2024, Employee E provided services as an employee of ATEO 6 for not more than 50 percent of the total hours Employee E provided services as an employee of ATEO 6 and CORP 4 (2,000 hours/4,000 hours), and ATEO 6 neither paid any remuneration to Employee E, nor paid a fee for services to CORP 4 during applicable years 2023 and 2024.

(xi) *Example 11 (Failure under the nonexempt funds exception)*—(A) *Facts*. Assume the same facts as in paragraph (d)(3)(viii)(A) of this section (*Example 8)*, except that during applicable year 2022, Employee E provided services as an employee for 2,000 hours to CORP 4 and for 0 hours to ATEO 6; during applicable year 2023, Employee E provided services as an employee for 600 hours to CORP 4 and for 1,400 hours to ATEO 6; and during applicable year 2024, Employee E provided services as an employee for 1,300 hours to CORP 4 and for 700 hours to ATEO 6.

(B) *Conclusion (2023)*. Employee E is disregarded for purposes of determining ATEO 6's five highest-compensated employees for taxable year 2023 under paragraph (d)(2)(iii) of this section because for applicable years 2022 and 2023, Employee E provided services as an employee of ATEO 6 for less than 50 percent of the total hours Employee E provided services as an employee of ATEO 6 and CORP 4 (1,400 hours/4,000 hours), and ATEO 6 neither paid any remuneration to Employee E, nor paid a fee for services to CORP 4 during applicable years 2022 and 2023.

(C) *Conclusion (2024)*. Employee E may be a covered employee of ATEO 6 as one of its five highest-compensated

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employees for taxable year 2024 because the requirements under paragraph (d)(2)(iii) are not met and no other exception applies. For applicable years 2023 and 2024, Employee E provided services as an employee of ATEO 6 for more than 50 percent of the total hours Employee E provided services as an employee of ATEO 6 and CORP 4 (2,100 hours/4,000 hours).

(xii) *Example 12 (Limited services exception)*—(A) *Facts*. ATEO 7, ATEO 8, ATEO 9, and ATEO 10 are a group of related organizations, none of which have any other related organizations. During 2022, Employee F is an employee of ATEO 7, ATEO 8, ATEO 9, and ATEO 10. During applicable year 2022, ATEO 7 paid 5 percent of Employee F's remuneration, ATEO 8 paid 10 percent of Employee F's remuneration, ATEO 9 paid 25 percent of Employee F's remuneration, and ATEO 10 paid 60 percent of Employee F's remuneration. No exception under paragraph (d)(2)(i), (ii), or (iii) applies to Employee F for any of ATEO 7, ATEO 8, ATEO 9, or ATEO 10.

(B) *Conclusion (ATEO 7)*. Employee F is disregarded for purposes of determining ATEO 7's five highest-compensated employees for taxable year 2022 under paragraph (d)(2)(iv) of this section because ATEO 7 paid less than 10 percent of Employee F's total remuneration from ATEO 7 and all related organizations during applicable year 2022, and another related ATEO paid at least 10 percent of that total remuneration.

(C) *Conclusion (ATEO 8, ATEO 9, and ATEO 10)*. Employee F may be a covered employee of ATEO 8, ATEO 9, and ATEO 10 as one of their respective five highest-compensated employees for their taxable years 2022 because each of those ATEOs paid 10 percent or more of Employee F's remuneration during the 2022 applicable year. Thus, the limited services exception under paragraph (d)(2)(iv) of this section does not apply.

(xiii) *Example 13 (Limited services exception if no ATEO paid at least 10 percent of remuneration)*—(A) *Facts*. Assume the same facts as in paragraph (d)(3)(xii) of this section (*Example 12*), except that for applicable year 2022, ATEO 7 paid 6 percent of F's remuneration, ATEO 8, ATEO 9, and ATEO 10 each paid 5 percent of Employee F's remuneration, and Employee F also works as an employee of CORP 5, a related organization of ATEO 7, ATEO 8, ATEO 9, and ATEO 10 that paid 79 percent of Employee F's remuneration for applicable year 2022.

(B) *Conclusion (ATEO 7)*. Employee F may be one of ATEO 7's five highest-compensated employees for taxable year 2022. Although ATEO 7 did not pay Employee F 10 percent or more of the total remuneration paid by ATEO 7 and all of its related organizations, no related ATEO paid more than 10 percent of Employee F's remuneration, and ATEO 7 did not pay less remuneration to Employee F than at least one related ATEO. Thus, the limited services exception under paragraph (d)(2)(iv) of this section does not apply, and Employee F may be one of ATEO 7's five highest-compensated employees because ATEO 7 paid Employee F more remuneration than any other related ATEO.

(C) *Conclusion (ATEO 8, ATEO 9, and ATEO 10)*. Employee F is disregarded for purposes of determining the five highest-compensated employees of ATEO 8, ATEO 9, and ATEO 10 for taxable year 2022 under paragraph (d)(2)(iv) of this section because none paid 10 percent or more of Employee F's total remuneration, each had no related ATEO that paid at least 10 percent of Employee F's total remuneration, and each paid less remuneration than at least one related ATEO (ATEO 7).

(e) *Employee*—(1) *In general*. *Employee* means an employee as defined in section 3401(c) and § 31.3401(c)–1. Section 31.3401(c)–1 generally defines an employee as any individual performing services if the relationship between the individual and the person for whom the individual performs services is the legal relationship of employer and employee. As set forth in § 31.3401(c)–1, this includes common law employees, as well as officers and employees of government entities, whether or not elected. An employee generally also includes an officer of a corporation, but an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives, nor is entitled to receive,

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00274 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

any remuneration is not considered to be an employee of the corporation solely due to the individual's status as an officer of the corporation. Whether an individual is an employee depends on the facts and circumstances.

(2) *Directors*. A director of a corporation (or an individual holding a substantially similar position in a corporation or other entity) in the individual's capacity as such is not an employee of the corporation. See § 31.3401(c)–1(f).

(3) *Trustees*. The principles of paragraph (e)(2) of this section apply by analogy to a trustee of any arrangement classified as a trust for Federal tax purposes in § 301.7701–4(a).

(f) *Employer*—(1) *In general*. *Employer* means an employer within the meaning of section 3401(d), without regard to section 3401(d)(1) or (2), meaning generally the person or governmental entity for whom the services were performed as an employee. Whether a person or governmental entity is the employer depends on the facts and circumstances, but a person does not cease to be the employer through use of a payroll agent under section 3504, a common paymaster under section 3121(s), a person described in section 3401(d)(1) or (2), a certified professional employer organization under section 7705, or any similar arrangement.

(2) *Disregarded entities*. In the case of a disregarded entity described in § 301.7701–3, § 301.7701–2(c)(2)(iv) does not apply; thus, the sole owner of the disregarded entity is treated as the employer of any individual performing services as an employee of the disregarded entity.

(g) *Medical services*—(1) *Medical and veterinary services*—(i) *In general*. *Medical services* means services directly performed by a licensed medical professional (as defined in paragraph (g)(2) of this section) for the diagnosis, cure, mitigation, treatment, or prevention of disease in humans or animals; services provided for the purpose of affecting any structure or function of the human or animal body; and other services integral to providing such medical services. For purposes of section 4960, teaching and research services are not medical services except to the extent that they involve the services performed to directly diagnose, cure, mitigate, treat, or prevent disease or affect a structure or function of the body. Administrative services may be integral to directly providing medical services. For example, documenting the care and condition of a patient is integral to providing medical services, as is accompanying another licensed professional as a supervisor while that medical professional provides medical services. However, managing an organization's operations, including scheduling, staffing, appraising employee performance, and other similar functions that may relate to a particular medical professional or professionals who perform medical services, is not integral to providing medical services. See § 53.4960–2(a)(2)(ii) for rules regarding allocating remuneration paid to a medical professional who performs both medical services and other services.

(ii) *Examples*. The following examples illustrate the rules of this paragraph (g):

(A) *Example 1 (Administrative tasks that are integral to providing medical services)*—(*1*) *Facts*. Employee A is a doctor who is licensed to practice medicine in the state in which Employee A's place of employment is located. In the course of Employee A's practice, Employee A treats patients and performs some closely-related administrative tasks, such as examining and updating patient records.

(*2*) *Conclusion*. Employee A's administrative tasks are integral to providing medical services and thus are medical services.

(B) *Example 2 (Administrative tasks that are not integral to providing medical services)*—(*1*) *Facts*. Assume the same facts as in paragraph (g)(1)(ii)(A)(*1*) of this section (Example 1), except that Employee A also performs additional administrative tasks such as analyzing the budget, authorizing capital expenditures, and managing human resources for the organization by which Employee A is employed.

(*2*) *Conclusion*. Employee A's additional administrative tasks are not integral to providing medical services and thus are not medical services.

(C) *Example 3 (Teaching duties that are and are not medical services)*—(*1*) *Facts*. Employee B is a medical doctor who is

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00275 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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licensed to practice medicine in the state in which her place of employment, a university hospital, is located. Employee B's duties include overseeing and teaching a group of resident physicians who have restricted licenses to practice medicine. Those duties include supervising and instructing the resident physicians while they treat patients and instruction in a classroom setting.

(*2*) *Conclusion*. Employee B's supervision and instruction of resident physicians during the course of patient treatment are necessary for the treatment, and thus are medical services. Employee B's classroom instruction is not necessary for patient treatment, and thus is not medical services.

(D) *Example 4 (Research services that are and are not medical services)*—(*1*) *Facts*. Employee C is a licensed medical doctor who is employed to work on a research trial. Employee C provides an experimental treatment to patients afflicted by a disease and performs certain closely-related administrative tasks that ordinarily are performed by a medical professional in a course of patient treatment. As part of the research trial, Employee C also compiles and analyzes patient results and prepares reports and articles that would not ordinarily be prepared by a medical professional in the course of patient treatment.

(*2*) *Conclusion*. Employee C's services that are ordinarily performed by a medical professional in a course of treatment, including closely-related administrative tasks, are medical services. Because the compilation and analysis of patient results and the formulation of reports and articles are neither services ordinarily performed by a medical professional in a course of treatment nor necessary for such treatment, these services are not medical services.

(2) *Definition of licensed medical professional. Licensed medical professional* means an individual who is licensed under applicable state or local law to perform medical services, including as a doctor, nurse, nurse practitioner, dentist, veterinarian, or other licensed medical professional.

(h) *Predecessor*—(1) *Asset acquisitions*. If an ATEO (acquiror) acquires at least 80 percent of the operating assets or total assets (determined by fair market value on the date of acquisition) of another ATEO (target), then the target is a predecessor of the acquiror. For an acquisition of assets that occurs over time, only assets acquired within a 12-month period are taken into account to determine whether at least 80 percent of the target's operating assets or total assets were acquired. However, this 12-month period is extended to include any continuous period that ends or begins on any day during which the acquiror has an arrangement to acquire directly or indirectly, assets of the target. Additions to the assets of target made as part of a plan or arrangement to avoid the application of this subsection to acquiror's purchase of target's assets are disregarded in applying this paragraph. This paragraph (h)(1) applies for purposes of determining whether an employee is a covered employee under paragraph (d)(1) of this section only with respect to a covered employee of the target who commences the performance of services for the acquiror (or a related organization with respect to the acquiror) within the period beginning 12 months before and ending 12 months after the date of the transaction as defined in paragraph (h)(7) of this section.

(2) *Corporate reorganizations*. A predecessor of an ATEO includes another separate ATEO the stock or assets of which are acquired in a corporate reorganization as defined in section 368(a)(1)(A), (C), (D), (E), (F), or (G) (including by reason of section 368(a)(2)).

(3) *Predecessor change of form or of place of organization*. An ATEO that restructured by changing its organizational form or place of organization (or both) is a predecessor of the restructured ATEO.

(4) *ATEO that becomes a non-ATEO*—(i) *General rule*. An organization is a predecessor of an ATEO if it ceases to be an ATEO and then again becomes an ATEO effective on or before the predecessor end date. The *predecessor end date* is the date that is 36 months following the date that the organization's Federal information return under section 6033 (or, for an ATEO described in paragraph (b)(1)(ii) or (iii) of this section, its Federal income tax return

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under section 6011(a)) is due (or would be due if the organization were required to file), excluding any extension, for the last taxable year for which the organization previously was an ATEO. If the organization becomes an ATEO again effective after the predecessor end date, then the former ATEO is treated as a separate organization that is not a predecessor of the current ATEO.

(ii) *Intervening changes or entities.* If an ATEO that ceases to be an ATEO (former ATEO) would be treated as a predecessor to an organization that becomes an ATEO before the predecessor end date (successor ATEO), and if the former ATEO would be treated as a predecessor to each intervening entity (if such intervening entities had been ATEOs) under the rules of this paragraph (h), then the former ATEO is a predecessor of the successor ATEO. For example, if ATEO 1 loses its tax-exempt status and then merges into Corporation X, Corporation X then merges into Corporation Y, and Corporation Y becomes an ATEO before the predecessor end date, then ATEO 1 is a predecessor of Corporation Y.

(5) *Predecessor of a predecessor.* A reference to a predecessor includes any predecessor or predecessors of such predecessor, as determined under these rules.

(6) *Elections under sections 336(e) and 338.* For purposes of this paragraph (h), when an ATEO organized as a corporation makes an election to treat as an asset purchase either the sale, exchange, or distribution of stock pursuant to regulations under section 336(e) or the purchase of stock pursuant to regulations under section 338, the corporation that issued the stock is treated as the same corporation both before and after such transaction.

(7) *Date of transaction.* For purposes of this paragraph (h), the date that a transaction is treated as having occurred is the date on which all events necessary to complete the transaction described in the relevant provision have occurred.

(i) *Related organization*—(1) *In general. Related organization* means any person or governmental entity, domestic or foreign, that meets any of the following tests:

(i) *Controls or controlled by test.* The person or governmental entity controls, or is controlled by, the ATEO;

(ii) *Controlled by same persons test.* The person or governmental entity is controlled by one or more persons that control the ATEO;

(iii) *Supported organization test.* The person or governmental entity is a supported organization (as defined in section 509(f)(3)) with respect to the ATEO;

(iv) *Supporting organization test.* The person or governmental entity is a supporting organization described in section 509(a)(3) with respect to the ATEO; or

(v) *VEBA test.* With regard to an ATEO that is a voluntary employees' beneficiary association (VEBA) described in section 501(c)(9), the person or governmental entity establishes, maintains, or makes contributions to such VEBA.

(2) *Control*—(i) *In general.* Control may be direct or indirect. For rules concerning application of the principles of section 318 in applying this paragraph (i)(2), see paragraph (i)(2)(vii) of this section.

(ii) *Stock corporation.* A person or governmental entity controls a stock corporation if it owns (by vote or value) more than 50 percent of the stock in the stock corporation.

(iii) *Partnership.* A person or governmental entity controls a partnership if it owns more than 50 percent of the profits interests or capital interests in the partnership, determined in accordance with the rules and principles of § 1.706–1(b)(4)(ii) for a partner's interest in the profits of a partnership and § 1.706–1(b)(4)(iii) for a partner's interest in the capital of a partnership.

(iv) *Trust.* A person or governmental entity controls a trust if it owns more than 50 percent of the beneficial interests in the trust, determined by actuarial value.

(v) *Nonstock organization*—(A) *In general.* A person or governmental entity controls a nonstock organization if more than 50 percent of the trustees or directors of the nonstock organization are either representatives of, or directly or indirectly controlled by, the person or governmental entity. A

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nonstock organization is a nonprofit organization or other organization without owners and includes a governmental entity.

(B) *Control of a trustee or director of a nonstock organization.* A person or governmental entity controls a trustee or director of the nonstock organization if the person or governmental entity has the power (either at will or at regular intervals) to remove such trustee or director and designate a new one.

(C) *Representatives.* Trustees, directors, officers, employees, or agents of a person or governmental entity are deemed representatives of the person or governmental entity. However, an employee of a person or governmental entity (other than a trustee, director, or officer, or an employee who possesses at least the authority commonly exercised by an officer) who is a director or trustee of a nonstock organization (or acting in that capacity) will not be treated as a representative of the person or governmental entity if the employee does not act as a representative of the person or governmental entity and that fact is reported in the form and manner prescribed by the Commissioner in forms and instructions.

(vi) *Brother-sister related organizations.* Under paragraph (i)(1)(ii) of this section, an organization is a related organization with respect to an ATEO if one or more persons control both the ATEO and the other organization. In the case of control by multiple persons, the control tests described in this paragraph (i)(2) of this section apply to the persons as a group. For example, if 1,000 individuals who are members of both ATEO 1 and ATEO 2 elect a majority of the board members of each organization, then ATEO 1 and ATEO 2 are related to each other because the same group of 1,000 persons controls both ATEO 1 and ATEO 2.

(vii) *Section 318 principles*—(A) *In general.* Section 318 (relating to constructive ownership of stock) applies in determining ownership of stock in a corporation. The principles of section 318 also apply for purposes of determining ownership of interests in a partnership or in a trust with beneficial interests. For example, applying the principles of section 318(a)(1)(A), an individual is considered to own the partnership interest or trust interest owned, directly or indirectly, by or for the family members specified in such section.

(B) *Nonstock organizations*—(*1*) *Attribution of ownership interest from a nonstock organization to a controlling person.* If a person or governmental entity controls a nonstock organization, the person or governmental entity is treated as owning a percentage of the stock (or partnership interest or beneficial interest in a trust) owned by the nonstock organization in accordance with the percentage of trustees or directors of the nonstock organization that are representatives of, or directly or indirectly controlled by, the person or governmental entity.

(*2*) *Attribution of ownership interest from a controlling person to a nonstock organization.* If a person or governmental entity controls a nonstock organization, the nonstock organization is treated as owning a percentage of the stock (or partnership interest or beneficial interest in a trust) owned by the person or governmental entity in accordance with the percentage of trustees or directors of the nonstock organization that are representatives of, or directly or indirectly controlled by, the person or governmental entity.

(*3*) *Indirect control of a nonstock organization through another nonstock organization.* If a person or governmental entity controls one nonstock organization that controls a second nonstock organization, the person or governmental entity is treated as controlling the second nonstock organization if the product of the percentage of trustees or directors of the first nonstock organization that are representatives of, or directly or indirectly controlled by, the person or governmental entity, multiplied by the percentage of trustees or directors of the second nonstock organization that are representatives of, or directly or indirectly controlled by, the person or governmental entity or first nonstock organization, exceeds 50 percent. Similar principles apply to successive tiers of nonstock organizations.

(*4*) *Attribution of control of nonstock organization to family member.* An individual's control of a nonstock organization or of a trustee or director of a

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nonstock organization is attributed to the members of the individual's family (as set forth in section 318(a)(1) and the regulations thereunder), subject to the limitation of section 318(a)(5)(B) and the regulations thereunder.

(3) *Examples.* The following examples illustrate the principles of this paragraph (i). For purposes of these examples, assume any entity referred to as ''ATEO'' is an ATEO and any entity referred to as ''CORP'' is not an ATEO.

(i) *Example 1 (Related through a chain of control)*—(A) *Facts.* ATEO 1, ATEO 2, and ATEO 3 are nonstock organizations. ATEO 3 owns 80 percent of the stock (by value) of corporation CORP 1. Eighty percent of ATEO 2's directors are representatives of ATEO 1. In addition, 80 percent of ATEO 3's directors are representatives of ATEO 1.

(B) *Conclusion.* ATEO 1 is a related organization with respect to ATEO 2 (and vice versa) because more than 50 percent of ATEO 2's directors are representatives of ATEO 1; thus, ATEO 1 controls ATEO 2. Based on the same analysis, ATEO 1 is also a related organization with respect to ATEO 3 (and vice versa). CORP 1 is a related organization with respect to ATEO 3 because, as the owner of more than 50 percent of CORP 1's stock, ATEO 3 controls CORP 1. Applying the principles of section 318, ATEO 1 is deemed to own 64 percent of the stock of CORP 1 (80 percent of ATEO 3's stock in CORP 1). Thus, CORP 1 is a related organization with respect to ATEO 1 because ATEO 1 controls CORP 1. ATEO 2 is a related organization with respect to ATEO 3, ATEO 3 is a related organization with respect to ATEO 2, and CORP 1 is a related organization with respect to ATEO 2 because ATEO 2, ATEO 3, and CORP 1 are all controlled by the same person (ATEO 1).

(ii) *Example 2 (Not related through a chain of control)*—(A) *Facts.* ATEO 4, ATEO 5, and ATEO 6 are nonstock organizations. Sixty percent of ATEO 5's directors are representatives of ATEO 4. In addition, 60 percent of ATEO 6's directors are representatives of ATEO 5, but none are representatives of ATEO 4.

(B) *Conclusion.* ATEO 4 is a related organization with respect to ATEO 5 (and vice versa) because more than 50 percent of ATEO 5's directors are representatives of ATEO 4; thus, ATEO 4 controls ATEO 5. Based on the same analysis, ATEO 6 is a related organization with respect to ATEO 5 (and vice versa). Applying the principles of section 318, ATEO 4 is deemed to control 36 percent of ATEO 6's directors (60 percent of ATEO 5's 60 percent control over ATEO 6). Because less than 50 percent of ATEO 6's directors are representatives of ATEO 4, and absent any facts suggesting that ATEO 4 directly or indirectly controls ATEO 6, ATEO 4 and ATEO 6 are not related organizations with respect to each other.

[T.D. 9938, 86 FR 6219, Jan. 19, 2021]

§ 53.4960–2 Determination of remuneration paid for a taxable year.

(a) *Remuneration*—(1) *In general.* For purposes of section 4960, *remuneration* means any amount that is wages as defined in section 3401(a), excluding any designated Roth contribution (as defined in section 402A(c)) and including any amount required to be included in gross income under section 457(f). Remuneration includes amounts includible in gross income as compensation for services as an employee pursuant to a below-market loan described in section 7872(c)(1)(B)(i) (compensation-related loans) but does not include amounts excepted by section 7872(c)(3) ($10,000 de minimis exception). For example, see § 1.7872–15(e)(1)(i). Director's fees paid by a corporation to a director of the corporation are not remuneration, provided that if the director is also an employee of the corporation, the director's fees are excluded from remuneration only to the extent that they do not exceed fees paid to a director who is not an employee of the corporation or any related organization or, if there is no such director, they do not exceed reasonable director's fees. Remuneration does not include any amount that vested or was paid by a taxpayer before the start of the taxpayer's first taxable year that began on or after January 1, 2018.

(2) *Exclusion of remuneration for medical services*—(i) *In general. Remuneration* does not include the portion of any

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remuneration paid to a licensed medical professional that is for the performance of medical services by such professional.

(ii) *Allocation of remuneration for medical services and non-medical services.* If, during an applicable year, an employer pays a covered employee remuneration for providing both medical services and non-medical services, the employer must make a reasonable, good faith allocation between the remuneration for medical services and the remuneration for non-medical services. For example, if a medical doctor receives current remuneration (or vests in remuneration under a deferred compensation plan) for providing medical services and administrative or management services, the employer must make a reasonable, good faith allocation between the remuneration for the medical services and the remuneration for the administrative or management services. For this purpose, if an employment agreement or similar written arrangement sets forth the remuneration to be paid for particular services, that allocation of remuneration applies unless the facts and circumstances demonstrate that the amount allocated to medical services is unreasonable for those services or that the allocation was established for purposes of avoiding application of the excise tax under section 4960. If some or all of the remuneration is not reasonably allocated in an employment agreement or similar arrangement, an employer may use any reasonable allocation method. For example, an employer may use a representative sample of records, such as patient, insurance, and Medicare/Medicaid billing records or internal time reporting mechanisms to determine the time spent providing medical services, and then allocate remuneration to medical services in the proportion such time bears to the total hours the employee worked for the employer (and any related employer) for purposes of making a reasonable allocation of remuneration. Similarly, if some or all of the remuneration is not reasonably allocated in an employment agreement or other similar arrangement, an employer may use salaries or other remuneration paid by the employer or similarly situated employers for duties comparable to those the employee performs (for example, hospital administrator and physician) for purposes of making a reasonable allocation between remuneration for providing medical services and for providing non-medical services.

(iii) *Examples.* The following examples illustrate the rules of this paragraph (a)(2). For purposes of these examples, assume any entity referred to as ''ATEO'' is an ATEO.

(A) *Example 1 (Allocation based on employment agreement)*—(*1*) *Facts.* Employee A is a covered employee of ATEO 1. Employee A is a licensed medical professional who provides patient care services for ATEO 1 and also provides management and administrative services to ATEO 1 as the manager of a medical practice group within ATEO 1. The employment agreement between ATEO 1 and Employee A specifies that of Employee A's salary, 30 percent is allocable to Employee A's services as manager of the medical practice group and 70 percent is allocable to Employee A's services as a medical professional providing patient care services. The facts regarding Employee A's employment indicate the employment agreement provides a reasonable allocation and that the allocation was not established for purposes of avoiding application of the excise tax.

(*2*) *Conclusion.* Consistent with Employee A's employment agreement, ATEO 1 must allocate 30 percent of Employee A's salary to the provision of non-medical services and 70 percent of Employee A's salary to the provision of medical services. Accordingly, only the 30 percent portion of Employee A's salary allocated to the other, non-medical services is remuneration for purposes of paragraph (a) of this section.

(B) *Example 2 (Allocation based on billing records)*—(*1*) *Facts.* Assume the same facts as in paragraph (a)(2)(iii)(A) of this section (Example 1), except that the employment agreement does not allocate Employee A's salary between medical and non-medical services performed by Employee A. Based on a representative sample of insurance and Medicare billing records, as well as time reports that Employee A submits to ATEO 1, ATEO 1 determines that Employee A spends 50 percent of her

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work hours providing patient care and 50 percent of her work hours performing administrative and management services. ATEO 1 allocates 50 percent of Employee A's remuneration to medical services.

(*2*) *Conclusion*. ATEO 1's allocation of Employee A's salary is a reasonable, good faith allocation. Accordingly, only the 50 percent portion of Employee A's remuneration allocated to the non-medical services is remuneration for purposes of paragraph (a) of this section.

(b) *Source of payment*. For purposes of this section, the determination of the source of a payment of remuneration may involve the application of one or both of two separate rules described in this paragraph (b). Paragraph (b)(1) of this section addresses payments by a third party for services performed as an employee of a separate employer entity, while paragraph (b)(2) of this section addresses the application of section 4960(c)(4)(A) to treat certain remuneration paid by a related organization (after application of paragraph (b)(1) of this section, if applicable) as paid by the ATEO.

(1) *Remuneration paid by a third party for employment by an employer*. Remuneration paid (or a grant of a legally binding right to nonvested remuneration) by a third-party payor (whether a related organization, payroll agent, agent designated under section 3504, certified professional employer organization under section 7705, or other entity) during an applicable year for services performed as an employee of an employer is remuneration paid (or payable) by the employer, except as otherwise provided in § 53.4960–1(d)(2)(ii) and (iii).

(2) *Remuneration paid by a related organization for employment by the related organization*. Pursuant to section 4960(c)(4)(A), remuneration paid (or a grant of a legally binding right to nonvested remuneration) by a related organization to an ATEO's employee during an applicable year for services performed as an employee of the related organization is treated as remuneration paid (or payable) by the ATEO, except as otherwise provided in § 53.4960–1(d)(2)(ii) and (iii).

(c) *Applicable year in which remuneration is treated as paid*—(1) *In general*. Remuneration that is a regular wage within the meaning of § 31.3402(g)–1(a)(1)(ii) is treated as paid on the date it is actually or constructively paid and all other remuneration is treated as paid on the first date on which the remuneration is vested.

(2) *Vested remuneration*. Remuneration is *vested* if it is not subject to a substantial risk of forfeiture within the meaning of section 457(f)(3)(B) (regardless of whether the arrangement under which the remuneration is to be paid is deferred compensation described in section 457(f) or 409A). In general, an amount is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the future performance of substantial services or upon the occurrence of a condition that is related to a purpose of the remuneration if the possibility of forfeiture is substantial. Except as provided in paragraph (c)(1) of this section, remuneration that is never subject to a substantial risk of forfeiture is considered paid on the first date the service provider has a legally binding right to the payment. For purposes of this section, a *plan* means a plan within the meaning of § 1.409A–1(c), an *account balance plan* means an account balance plan within the meaning of § 1.409A–1(c)(2)(i)(A), and a *nonaccount balance plan* means a nonaccount balance plan within the meaning of § 1.409A–1(c)(2)(i)(C). Net earnings on previously paid remuneration (described in paragraph (d)(2) of this section) that are not subject to a substantial risk of forfeiture are vested (and, thus, treated as paid) at the earlier of the date actually or constructively paid to the employee or the close of the applicable year in which they accrue. For example, the present value of a principal amount accrued to an employee's account under an account balance plan (under which the earnings and losses attributed to the account are based solely on a predetermined actual investment as determined under § 31.3121(v)(2)–1(d)(2)(i)(B) or a reasonable market interest rate) is treated as paid on the date vested, but the present value of any net earnings subsequently accrued on that amount (the increase

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in value due to the predetermined actual investment or a reasonable market interest rate) is treated as paid at the close of the applicable year in which they accrue. Similarly, while the present value of an amount accrued under a nonaccount balance (including earnings that accrued while the amount was nonvested) is treated as paid on the date it is first vested, the present value of the net earnings on that amount (the increase in the present value) is treated as paid at the close of the applicable year in which they accrue.

(3) *Change in related status during the year*. If a taxpayer becomes or ceases to be a related organization with respect to an ATEO during an applicable year, then only the remuneration paid by the taxpayer to an employee with respect to services performed as an employee of the related organization during the portion of the applicable year during which the employer is a related organization is treated as paid by the ATEO. If an amount is treated as paid due to vesting in the year the taxpayer becomes or ceases to be a related organization with respect to the ATEO, then the amount is treated as paid by the ATEO only if the amount becomes vested during the portion of the applicable year that the taxpayer is a related organization with respect to the ATEO.

(d) *Amount of remuneration treated as paid*—(1) *In general*. For each applicable year, the amount of remuneration treated as paid by the employer to a covered employee is the sum of regular wages within the meaning of §31.3402(g)–1(a)(1)(ii) actually or constructively paid during the applicable year and the present value (as determined under paragraph (e) of this section) of all other remuneration that vested during the applicable year. The amount of remuneration that vests during an applicable year is determined on an employer-by-employer basis with respect to each covered employee.

(2) *Earnings and losses on previously paid remuneration*—(i) *In general*. The amount of net earnings or losses on previously paid remuneration paid by an employer is determined on an employee-by-employee basis, such that amounts accrued with regard to one employee do not affect amounts accrued with regard to a different employee. Similarly, losses accrued on previously paid remuneration from one employer do not offset earnings accrued on previously paid remuneration from another employer. The amount of net earnings or losses on previously paid remuneration paid by the employer is determined on a net aggregate basis for all plans maintained by the employer in which the employee participates for each applicable year. For example, losses under an account balance plan may offset earnings under a nonaccount balance plan for the same applicable year maintained by the same employer for the same employee.

(ii) *Previously paid remuneration*—(A) *New covered employee*. For an individual who was not a covered employee for any prior applicable year, *previously paid remuneration* means, for the applicable year for which the individual becomes a covered employee, the present value of vested remuneration that was not actually or constructively paid or otherwise includible in the employee's gross income before the start of the applicable year plus any remuneration that vested during the applicable year but that is not actually or constructively paid or otherwise includible in the employee's gross income before the close of the applicable year.

(B) *Existing covered employee*. For an individual who was a covered employee for any prior applicable year, *previously paid remuneration* means, for each applicable year, the amount of remuneration that the employer treated as paid in the applicable year or for a prior applicable year but that is not actually or constructively paid or otherwise includible in the employee's gross income before the close of the applicable year. Actual or constructive payment or another event causing an amount of previously paid remuneration to be includible in the employee's gross income thus reduces the amount of previously paid remuneration.

(iii) *Earnings*. *Earnings* means any increase in the vested present value of previously paid remuneration as of the close of the applicable year, regardless of whether the plan denominates the increase as earnings. For example, an

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increase in the vested account balance of a nonqualified deferred compensation plan based solely on the investment return of a predetermined actual investment (and disregarding any additional contributions) constitutes earnings. Similarly, an increase in the vested present value of a benefit under a nonqualified nonaccount balance plan due solely to the passage of time (and disregarding any additional benefit accruals) constitutes earnings. However, an increase in an account balance of a nonqualified deferred compensation plan due to a salary reduction contribution or an employer contribution does not constitute earnings (and therefore may not be offset with losses). Likewise, an increase in the benefit under a nonaccount balance plan due to an additional year of service or an increase in compensation that is reflected in a benefit formula does not constitute earnings.

(iv) *Losses. Losses* means any decrease in the vested present value of previously paid remuneration as of the close of the applicable year, regardless of whether the plan denominates that decrease as losses.

(v) *Net earnings. Net earnings* means, for each applicable year, the amount (if any) by which the earnings accrued for the applicable year on previously paid remuneration exceeds the sum of the losses accrued on previously paid remuneration for the applicable year and any net losses carried forward from a previous taxable year.

(vi) *Net losses. Net losses* means, for each applicable year, the amount (if any) by which the sum of the losses accrued on previously paid remuneration for the applicable year and any net losses carried forward from a previous taxable year exceed the earnings accrued for the applicable year on previously paid remuneration. Losses may only be used to offset earnings and thus do not reduce the remuneration treated as paid for an applicable year except to the extent of the earnings accrued for that applicable year. However, with regard to a covered employee, an employer may carry net losses forward to the next applicable year and offset vested earnings for purposes of determining net earnings or losses for that subsequent applicable year. For example, if a covered employee who participates in a nonaccount balance plan and an account balance plan vests in an amount of earnings under the nonaccount balance plan and has losses under the account balance plan that exceed the vested earnings treated as remuneration under the nonaccount balance plan, those excess losses are carried forward to the next applicable year and offset vested earnings for purposes of determining net earnings or losses for that applicable year. If, for the next applicable year, there are not sufficient earnings to offset the entire amount of losses carried forward from the previous year (and any additional losses), the offset process repeats for each subsequent applicable year until there are sufficient earnings for the applicable year to offset any remaining losses carried forward.

(3) *Remuneration paid for a taxable year before the employee becomes a covered employee*—(i) *In general.* In accordance with the payment timing rules of paragraph (c) of this section, any remuneration that is vested but is not actually or constructively paid or otherwise includible in an employee's gross income as of the close of the applicable year for the taxable year immediately preceding the taxable year in which the employee first becomes a covered employee of an ATEO is treated as previously paid remuneration for the taxable year in which the employee first becomes a covered employee. Net losses on this previously paid remuneration from any preceding applicable year do not carry forward to subsequent applicable years. However, net earnings and losses that vest on such previously paid remuneration in subsequent applicable years are treated as remuneration paid for a taxable year for which the employee is a covered employee.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(3). For purposes of these examples, assume any organization described as "ATEO" is an ATEO.

(A) *Example 1 (Earnings on pre-covered employee remuneration)*—(*1*) *Facts.* ATEO 1 uses a taxable year beginning July 1 and ending June 30. Employee A becomes a covered employee of ATEO 1

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for the taxable year beginning July 1, 2023, and ending June 30, 2024. During the 2022 applicable year, Employee A vests in $1 million of nonqualified deferred compensation. As of December 31, 2022, the present value of the amount deferred under the plan is $1.1 million. During the 2023 applicable year, ATEO 1 pays Employee A $1 million in regular wages. The present value as of December 31, 2023, of Employee A's nonqualified deferred compensation is $1.3 million.

(*2*) *Conclusion (Taxable year beginning July 1, 2022, and ending June 30, 2023).* ATEO 1 pays Employee A $1.1 million of remuneration in the 2022 applicable year. This is comprised of $1 million of vested nonqualified deferred compensation, and $100,000 of earnings, all of which is treated as paid for the taxable year beginning July 1, 2022, and ending June 30, 2023.

(*3*) *Conclusion (Taxable year beginning July 1, 2023, and ending June 30, 2024).* ATEO 1 pays Employee A $1.2 million of remuneration in the 2023 applicable year. This is comprised of $1 million regular wages and $200,000 of earnings ($1.3 million present value as of December 31, 2023, minus $1.1 million previously paid remuneration as of December 31, 2022).

(B) *Example 2 (Losses on pre-covered employee remuneration)*—(*1*) *Facts.* Assume the same facts as in paragraph (d)(3)(ii)(A) of this section (Example 1), except that the present value of the nonqualified deferred compensation as of December 31, 2022, is $900,000.

(*2*) *Conclusion (Taxable year beginning July 1, 2022, and ending June 30, 2023).* ATEO 1 pays Employee A $1 million of remuneration in the 2022 applicable year. This is comprised of $1 million of vested nonqualified deferred compensation. The present value of all vested deferred compensation as of December 31 of the 2022 applicable year ($900,000) is treated as previously paid remuneration for the next applicable year (as Employee A is a covered employee for the next taxable year). The $100,000 of losses accrued while Employee A was not a covered employee do not carry forward to the next applicable year.

(*3*) *Conclusion (Taxable year beginning July 1, 2023, and ending June 30, 2024).* ATEO 1 pays Employee A $1.4 million of remuneration in the 2023 applicable year. This is comprised of $1 million cash and $400,000 of earnings ($1.3 million present value as of December 31, 2023, minus $900,000 previously paid remuneration).

(e) *Calculation of present value*—(1) *In general.* The employer must determine present value using reasonable actuarial assumptions regarding the amount, time, and probability that a payment will be made. For this purpose, a discount for the probability that an employee will die before commencement of benefit payments is permitted, but only to the extent that benefits will be forfeited upon death. The present value may not be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan; the risk associated with any deemed or actual investment of amounts deferred under the plan; the risk that the employer, the trustee, or another party will be unwilling or unable to pay; the possibility of future plan amendments; the possibility of a future change in the law; or similar risks or contingencies. The present value of the right to future payments as of the vesting date includes any earnings that have accrued as of the vesting date that are not previously paid remuneration.

(2) *Treatment of future payment amount as present value for certain amounts.* For purposes of determining the present value of remuneration that is scheduled to be actually or constructively paid within 90 days of vesting, the employer may treat the future amount that is to be paid as the present value at vesting.

(f) *Examples.* The following examples illustrate the rules of this section. For purposes of these examples, assume any entity referred to as ''ATEO'' is an ATEO, anyentity referred to as ''CORP'' is not an ATEO, and all taxpayers use the calendar year as their taxable year.

(1) *Example 1 (Account balance plan)*—(i) *Facts.* Employee A is a covered employee of ATEO 1. Employee A participates in a nonqualified deferred compensation plan (the NQDC plan) in which the account balance is adjusted based on the investment returns on

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predetermined actual investments. On January 1, 2022, ATEO 1 credits $100,000 to Employee A's account under the plan, subject to the requirement that Employee A remain employed through June 30, 2024. On June 30, 2024, the vested account balance is $110,000. Due to earnings or losses on the account balance, the closing account balance on each of the following dates is: $115,000 on December 31, 2024, $120,000 on December 31, 2025, $100,000 on December 31, 2026, and $110,000 on December 31, 2027. During 2028, Employee A defers an additional $10,000 under the plan, all of which is vested at the time of deferral. On December 31, 2028, the closing account balance is $125,000. In 2029, ATEO 1 pays $10,000 to Employee A under the plan. On December 31, 2029, the closing account balance is $135,000 due to earnings on the account balance.

(ii) *Conclusion (2022 and 2023 applicable years—nonvested amounts).* For 2022 and 2023, ATEO 1 is not treated as paying Employee A any remuneration attributable to Employee A's participation in the NQDC plan because the amount deferred under the plan remains subject to a substantial risk of forfeiture within the meaning of section 457(f)(3)(B).

(iii) *Conclusion (2024 applicable year—amounts in year of vesting).* For 2024, ATEO 1 is treated as paying Employee A $115,000 of remuneration attributable to Employee A's participation in the NQDC plan, including $110,000 of remuneration on June 30, 2024, when the amount becomes vested, and an additional $5,000 of remuneration on December 31, 2024, which is earnings on the previously paid remuneration ($110,000).

(iv) *Conclusion (2025 applicable year—earnings).* For 2025, ATEO 1 is treated as paying Employee A $5,000 of remuneration attributable to Employee A's participation in the NQDC plan, which is the additional earnings on the previously paid remuneration ($115,000) as of December 31, 2025.

(v) *Conclusion (2026 applicable year—losses).* For 2026, ATEO 1 is not treated as paying Employee A any remuneration attributable to Employee A's participation in the NQDC plan because the present value of the previously paid remuneration ($120,000) decreased to $100,000 as of December 31, 2026. The $20,000 loss for 2026 does not reduce any amount previously treated as remuneration but is available for carryover to subsequent taxable years to offset earnings.

(vi) *Conclusion (2027 applicable year—recovery of losses).* For 2027, ATEO 1 is not treated as paying Employee A any remuneration attributable to Employee A's participation in the NQDC plan because the present value of the previously paid remuneration ($120,000) was $110,000 as of December 31, 2027. Due to increases on the account balance, ATEO 1 recovers $10,000 of the $20,000 of losses carried over from 2026. The net losses as of December 31, 2027, are $10,000, and none of the $10,000 in earnings during 2027 is treated as remuneration paid in 2027.

(vii) *Conclusion (2028 applicable year—no recovery of losses against additional deferrals of compensation).* For 2028, ATEO 1 is treated as paying Employee A $10,000 of remuneration attributable to Employee A's participation in the NQDC plan. The additional $10,000 deferral is vested and thus is treated as remuneration paid on the date credited to Employee A's account. This credit increases the amount of previously paid remuneration from $120,000 to $130,000. Additionally, due to earnings, ATEO 1 recovers $5,000 of the $10,000 loss carried over from 2027, none of which was remuneration paid for 2026, so that as of December 31, 2028, the net loss available for carryover to 2029 is $5,000.

(viii) *Conclusion (2029 applicable year—distributions, recovery of remainder of losses through earnings and additional earnings).* For 2029, ATEO 1 is treated as paying Employee A $15,000 of remuneration attributable to Employee A's participation in the NQDC plan. The $10,000 payment reduces the amount of previously paid remuneration (from $130,000 to $120,000) and the account balance (from $125,000 to $115,000). The present value of the vested account balance increases by $20,000 (from $115,000 to $135,000) as of December 31, 2029. Therefore, due to earnings, ATEO 1 recovers the remaining $5,000 loss carried over from 2028 (the difference between the $120,000 previously paid remuneration before earnings and the

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$115,000 account balance before earnings) and is treated as paying Employee A an additional $15,000 of remuneration as earnings (the difference between the $135,000 account balance after earnings and the $120,000 previously paid remuneration after loss recovery).

(2) *Example 2 (Nonaccount balance plan with earnings)*—(i) *Facts*. ATEO 2 and CORP 2 are related organizations. Employee B is a covered employee of ATEO 2 and is also employed by CORP 2. On January 1, 2022, CORP 2 and Employee B enter into an agreement under which CORP 2 will pay Employee B $100,000 on December 31, 2025, if B remains employed by CORP 2 through January 1, 2024. Employee B remains employed by CORP 2 through January 1, 2024. On January 1, 2024, the present value based on reasonable actuarial assumptions of the $100,000 to be paid on December 31, 2025, is $75,000. On December 31, 2024, the present value of the $100,000 future payment increases to $85,000 due solely to the passage of time. On December 31, 2025, CORP 2 pays Employee B $100,000.

(ii) *Conclusion (2022 and 2023 applicable years—nonvested amounts)*. For 2022 and 2023, CORP 2 is not treated as paying Employee B any remuneration attributable to the agreement because the amount deferred under the agreement remains subject to a substantial risk of forfeiture within the meaning of section 457(f)(3)(B).

(iii) *Conclusion (2024 applicable year—amounts in year of vesting)*. For 2024, CORP 2 is treated as paying Employee B $75,000 of remuneration attributable to the agreement on January 1, 2024, which is the present value on that date of the $100,000 payable on December 31, 2025. In addition, CORP 2 is treated as paying Employee B $10,000 of remuneration attributable to the agreement on December 31, 2024, which is earnings based on the increase in the present value of the previously paid remuneration (from $75,000 to $85,000) as of December 31, 2024.

(iv) *Conclusion (2025 applicable year—earnings and distribution of previously paid remuneration)*. For 2025, CORP 2 is treated as paying Employee B $15,000 in remuneration attributable to the agreement on December 31, 2025, which is earnings based on the increase in the present value of the previously paid remuneration (from $85,000 to $100,000) as of December 31, 2025. In addition, the $100,000 payment is treated as reducing the amount of previously paid remuneration ($100,000) to zero.

(3) *Example 3 (Treatment of amount payable as present value at vesting)*—(i) *Facts*. Employee C is a covered employee of ATEO 3. Under an agreement between ATEO 3 and Employee C, ATEO 3 agrees to pay Employee C $100,000 two months after the date Employee C meets a specified performance goal that is a substantial risk of forfeiture within the meaning of section 457(f)(3)(B). Employee C meets the performance goal on November 30, 2022, and ATEO 3 pays Employee C $100,000 on January 31, 2023. In accordance with § 53.4960–2(e)(2), because the payment is to be made within 90 days of vesting, ATEO 3 elects to treat the full payment amount as the amount of remuneration paid at vesting.

(ii) *Conclusion (2022 applicable year—election to treat amount payable within 90 days as paid at vesting)*. For taxable year 2022, ATEO 3 is treated as paying Employee C $100,000 of remuneration attributable to the agreement. Employee C vests in the $100,000 payment in 2022 upon meeting the performance goal. Under the general rule, ATEO 3 would be treated as paying for the taxable year 2022 the present value as of November 30, 2022, of $100,000 payable on January 31, 2023 (two months after the date of vesting), with adjustments to the present value as of the end of the year. However, because ATEO 3 elected to treat the full $100,000 amount payable within 90 days of vesting as the remuneration paid, the $100,000 payable to Employee C in 2023 is treated as remuneration paid in 2022 (and no additional amount related to the $100,000 paid on January 31, 2023, is treated as remuneration paid in 2023).

(4) *Example 4 (Aggregation of remuneration from related organizations)*—(i) *Facts*. Employee D is a covered employee of ATEO 4 and also an employee of CORP 4 and CORP 5. ATEO 4, CORP 4, and CORP 5 are related organizations. ATEO 4, CORP 4, and CORP 5 each pay Employee D $200,000 of salary during 2022 and 2023. On January 1,

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2022, ATEO 4 promises to pay Employee D $120,000 on December 31, 2023, under a nonaccount balance plan, the right to which is vested and the present value of which is $100,000 on January 1, 2022. On January 1, 2022, CORP 4 and CORP 5 each contribute $100,000 on Employee D's behalf to account balance plans of CORP 4 and CORP 5, respectively, under which all amounts deferred are vested. On December 31, 2022, the present value of the amounts deferred under the ATEO 4 plan is $110,000, the present value of the amounts deferred under the CORP 4 plan is $120,000, and the present value of the amounts deferred under the CORP 5 plan maintained is $90,000. On December 31, 2023, the present value of the amounts deferred under the ATEO 4 plan is $120,000, the present value of the amounts deferred under the CORP 4 plan is $130,000, and the present value of the amounts deferred under the CORP 5 plan is $110,000.

(ii) *Conclusion (2022 applicable year).* For 2022, before aggregation of remuneration paid by related organizations, ATEO 4 is treated as paying Employee D $310,000 of remuneration ($200,000 salary + $100,000 upon vesting of deferred amounts + $10,000 net earnings on vested deferred amounts). CORP 4 is treated as paying Employee D $320,000 of remuneration ($200,000 salary + $100,000 upon vesting of deferred amounts + $20,000 net earnings on vested deferred amounts). CORP 5 is treated as paying Employee D $300,000 of remuneration ($200,000 salary + $100,000 upon vesting of deferred amounts) and has $10,000 of net losses on vested deferred amounts, which are carried forward to 2023. Thus, ATEO 4 is treated as paying $930,000 of remuneration to Employee D for the applicable year.

(iii) *Conclusion (2023 applicable year).* For 2023, before aggregation of remuneration paid by related organizations, ATEO 4 is treated as paying Employee D $210,000 of remuneration ($200,000 salary + $10,000 earnings on previously paid remuneration). CORP 4 is treated as paying Employee D $210,000 of remuneration ($200,000 salary + $10,000 net earnings on previously paid remuneration). CORP 5 is treated as paying Employee D $210,000 of remuneration ($200,000 salary + $10,000 net earnings on previously paid remuneration after taking into account the loss carryforward). Thus, ATEO 4 is treated as paying $630,000 of remuneration to Employee D for the applicable year.

(5) *Example 5 (Treatment of regular wages for a pay period spanning applicable years)*—(i) *Facts.* ATEO 5 pays its employees' salaries in accordance with a two-week payroll period that begins Sunday of the first week and ends Saturday of the second week. Payment occurs the Friday following the end of the payroll period. The last payroll period of 2023 ends on December 31, 2023. For the last payroll period, Employee E earns $8,000 of salary. In addition, ATEO 5 awards Employee E a $10,000 bonus that vests on December 31, 2023. ATEO 5 pays Employee E $18,000 on Friday, January 5, 2024, reflecting Employee E's salary for the last payroll period of 2023 and the bonus, the right to which vested on December 31, 2023.

(ii) *Conclusion (Regular wages).* The $8,000 of salary is regular wages within the meaning of § 31.3402(g)–1(a)(1)(ii) because it is an amount paid at a periodic rate for the current payroll period. Thus, $8,000 is treated as remuneration paid on January 5, 2024 (when it is actually or constructively paid), and, therefore, is treated as remuneration paid in ATEO 5's 2024 applicable year.

(iii) *Conclusion (Amounts other than regular wages).* The $10,000 bonus is not regular wages within the meaning of § 31.3402(g)–1(a)(1)(ii) because it is not an amountpaid at a periodic rate for the current payroll period. Thus, $10,000 is treatedas remuneration paid on December 31, 2023 (when it is vested) and, therefore, is treated as remuneration paid in ATEO 5's 2023 applicable year.

[T.D. 9938, 86 FR 6219, Jan. 19, 2021]

§ 53.4960–3 Determination of whether there is a parachute payment.

(a) *Parachute payment*—(1) *In general.* Except as otherwise provided in paragraph (a)(2) of this section (relating to payments excluded from the definition of a parachute payment), *parachute payment* means any payment in the nature of compensation made by an ATEO (or a predecessor of the ATEO) or a related organization to (or for the benefit of) a covered employee if the

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payment is contingent on the employee's separation from employment with the employer, and the aggregate present value of the payments in the nature of compensation to (or for the benefit of) the individual that are contingent on the separation equals or exceeds an amount equal to 3-times the base amount.

(2) *Exclusions.* The following payments are not parachute payments:

(i) *Certain qualified plans.* A payment that is a contribution to or a distribution from a plan described in section 401(a) that includes a trust exempt from tax under section 501(a), an annuity plan described in section 403(a), a simplified employee pension (as defined in section 408(k)), or a simple retirement account described in section 408(p);

(ii) *Certain annuity contracts.* A payment made under or to an annuity contract described in section 403(b) or a plan described in section 457(b);

(iii) *Compensation for medical services.* A payment made to a licensed medical professional for the performance of medical services performed by such professional; and

(iv) *Payments to non-HCEs.* A payment made to an individual who is not a highly compensated employee (HCE) as defined in paragraph (a)(3) of this section.

(3) *Determination of HCEs for purposes of the exclusion from parachute payments.* For purposes of this section, *highly compensated employee* or *HCE* means, with regard to an ATEO that maintains a qualified retirement plan or other employee benefit plan described in § 1.414(q)–1T, Q/A–1, any person who is a highly compensated employee within the meaning of section 414(q) and, with regard to an ATEO that does not maintain such a plan, any person who would be a highly compensated employee within the meaning of section 414(q) if the ATEO did maintain such a plan. For purposes of determining the group of highly compensated employees for a determination year, consistent with § 1.414(q)–1T, Q/A–14(a)(1), the determination year calculation is made on the basis of the applicable plan year under § 1.414(q)–1T, Q/A–14(a)(2) of the plan or other entity for which a determination is made, and the look-back year calculation is made on the basis of the 12-month period immediately preceding that year. For an ATEO that does not maintain a plan described in § 1.414(q)–1T, Q/A–1, the rules are applied by analogy, substituting the calendar year for the plan year. Thus, for example, in 2022, an ATEO that does not maintain such a plan must use its employees' 2021 annual compensation (as defined in § 1.414(q)–1T, Q/A–13, including any of the safe harbor definitions if applied consistently to all employees) to determine which employees are HCEs for 2022, if any, for purposes of section 4960. If an employee is an HCE at the time of separation from employment, then for purposes of section 4960 any parachute payment that is contingent on the separation from employment (as defined in paragraph (d) of this section) is treated as paid to an HCE so that the exception from the term parachute payment under paragraph (a)(2)(iv) of this section does not apply, even if the payment occurs during one or more later taxable years (that is, taxable years after the taxable year during which the employee separated from employment).

(b) *Payment in the nature of compensation*—(1) *In general.* Any payment—in whatever form—is a payment in the nature of compensation if the payment arises out of an employment relationship, including holding oneself out as available to perform services and refraining from performing services. Thus, for example, a payment made under a covenant not to compete or a similar arrangement is a payment in the nature of compensation. A payment in the nature of compensation includes (but is not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits, and other deferred compensation (including any amount characterized by the parties as interest or earnings thereon). A payment in the nature of compensation also includes cash when paid, the value of the right to receive cash, the value of accelerated vesting, or a transfer of property. The vesting of an option, stock appreciation right, or similar form of compensation as a result of a covered employee's separation from employment is a payment in

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the nature of compensation. However, a payment in the nature of compensation does not include attorney's fees or court costs paid or incurred in connection with the payment of any parachute payment or a reasonable rate of interest accrued on any amount during the period the parties contest whether a parachute payment will be made.

(2) *Consideration paid by covered employee.* Any payment in the nature of compensation is reduced by the amount of any money or the fair market value of any property (owned by the covered employee without restriction) that is (or will be) transferred by the covered employee in exchange for the payment.

(c) *When payment is considered to be made*—(1) *In general.* A payment in the nature of compensation is considered made in the taxable year in which it is includible in the covered employee's gross income or, in the case of fringe benefits and other benefits that are excludable from income, in the taxable year the benefits are received. In the case of taxable non-cash fringe benefits provided in a calendar year, payment is considered made on the date or dates the employer chooses, but no later than December 31 of the calendar year in which the benefits are provided, except that when the fringe benefit is the transfer of personal property (either tangible or intangible) of a kind normally held for investment or the transfer of real property, payment is considered made on the actual date of transfer. If the fringe benefit is neither a transfer of personal property nor a transfer of real property, the employer may, in its discretion, treat the value of the benefit actually provided during the last two months of the calendar year as paid during the subsequent calendar year. However, an employer that treats the value of a benefit paid during the last two months of a calendar year as paid during the subsequent calendar year under this rule must treat the value of that fringe benefit as paid during the subsequent calendar year with respect to all employees who receive it.

(2) *Transfers of section 83 property.* A transfer of property in connection with the performance of services that is subject to section 83 is considered a payment made in the taxable year in which the property is transferred or would be includible in the gross income of the covered employee under section 83, disregarding any election made by the employee under section 83(b) or (i). Thus, in general, such a payment is considered made at the later of the date the property is transferred (as defined in § 1.83–3(a)) to the covered employee or the date the property becomes substantially vested (as defined in § 1.83–3(b) and (j)). The amount of the payment is the compensation as determined under section 83, disregarding any amount includible in income pursuant to an election made by an employee under section 83(b).

(3) *Stock options.* An option (including an option to which section 421 applies) is treated as property that is transferred when the option becomes vested (regardless of whether the option has a readily ascertainable fair market value as defined in § 1.83–7(b)). For purposes of determining the timing and amount of any payment related to the option, the principles of § 1.280G–1, Q/A–13 and any method prescribed by the Commissioner in published guidance of general applicability under § 601.601(d)(2) apply.

(d) *Payment contingent on an employee's separation from employment*—(1) *In general.* A payment is contingent on an employee's separation from employment if the facts and circumstances indicate that the employer would not make the payment in the absence of the employee's involuntary separation from employment. A payment generally would be made in the absence of the employee's involuntary separation from employment if it is substantially certain at the time of the involuntary separation from employment that the payment would be made whether or not the involuntary separation occurred. A payment the right to which is not subject to a substantial risk of forfeiture within the meaning of section 457(f)(3)(B) at the time of an involuntary separation from employment generally is a payment that would have been made in the absence of an involuntary separation from employment (and is therefore not contingent on a separation from employment), except

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that the increased value of an accelerated payment of a vested amount described in paragraph (f)(3) of this section resulting from an involuntary separation from employment is not treated as a payment that would have been made in the absence of an involuntary separation from employment. A payment the right to which is no longer subject to a substantial risk of forfeiture within the meaning of section 457(f)(3)(B) as a result of an involuntary separation from employment, including a payment the vesting of which is accelerated due to the separation from employment as described in paragraph (f)(3) of this section, is not treated as a payment that would have been made in the absence of an involuntary separation from employment (and thus is contingent on a separation from employment). A payment does not fail to be contingent on a separation from employment merely because the payment is conditioned upon the execution of a release of claims, noncompetition or nondisclosure provisions, or other similar requirements. See paragraph (d)(3) of this section for the treatment of a payment made pursuant to a covenant not to compete. If, after an involuntary separation from employment, the former employee continues to provide certain services as a nonemployee, payments for services rendered as a nonemployee are not payments that are contingent on a separation from employment to the extent those payments are reasonable and are not made on account of the involuntary separation from employment. Whether services are performed as an employee or nonemployee depends upon all the facts and circumstances. See § 53.4960–1(e). For rules on determining whether payments are reasonable compensation for services, the rules of § 1.280G–1, Q/A–40 through Q/A–42 (excluding Q/A–40(b) and Q/A–42(b)), and Q/A–44 are applied by analogy (substituting involuntary separation from employment for change in ownership or control).

(2) *Employment agreements*—(i) *In general*. If a covered employee involuntarily separates from employment before the end of a contract term and is paid damages for breach of contract pursuant to an *employment agreement*, the payment of damages is treated as a payment that is contingent on a separation from employment. An *employment agreement* is an agreement between an employee and employer that describes, among other things, the amount of compensation or remuneration payable to the employee for services performed during the term of the agreement.

(ii) *Example*. The following example illustrates the rules of this paragraph (d)(2). For purposes of this example, assume any entity referred to as ''ATEO'' is an ATEO.

(A) *Example*—(*1*) *Facts*. Employee A, a covered employee, has a 3-year employment agreement with ATEO 1. Under the agreement, Employee A will receive a salary of $200,000 for the first year and, for each succeeding year, an annual salary that is $100,000 more than the previous year. The agreement provides that, in the event of A's involuntary separation from employment without cause, Employee A will receive the remaining salary due under the agreement. At the beginning of the second year of the agreement, ATEO 1 involuntarily terminates Employee A's employment without cause and pays Employee A $700,000 representing the remaining salary due under the employment agreement ($300,000 for the second year of the agreement plus $400,000 for the third year of the agreement).

(*2*) *Conclusion*. The $700,000 payment is treated as a payment that is contingent on a separation from employment.

(3) *Noncompetition agreements*. A payment under an agreement requiring a covered employee to refrain from performing services (for example, a covenant not to compete) is a payment that is contingent on a separation from employment if the payment would not have been made in the absence of an involuntary separation from employment. For example, a payment contingent on compliance in whole or in part with a covenant not to compete negotiated as part of a severance arrangement arising from an involuntary separation from employment is contingent on a separation from employment. Similarly, one or more payments contingent on compliance in whole or in part with a covenant not to compete not negotiated as part of a severance

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arrangement arising from an involuntary separation from employment but that provides for a payment specific to an involuntary separation from employment (and not voluntary separation from employment) is contingent on a separation from employment. Payments made under an agreement requiring a covered employee to refrain from performing services that are contingent on separation from employment are not treated as paid in exchange for the performance of services and are not excluded from parachute payments.

(4) *Payment of amounts previously included in income or excess remuneration.* Actual or constructive payment of an amount that was previously included in gross income of the employee is not a payment contingent on a separation from employment. For example, payment of an amount included in income under section 457(f)(1)(A) due to the lapsing of a substantial risk of forfeiture on a date before the separation from employment generally is not a payment that is contingent on a separation from employment, even if the amount is paid in cash or otherwise to the employee because of the separation from employment. In addition, actual or constructive receipt of an amount treated as excess remuneration under § 53.4960–4(b)(1) is not a payment that is contingent on a separation from employment (and thus is not a parachute payment), even if the amount is paid to the employee because of the separation from employment.

(5) *Window programs.* A payment under a window program is contingent on a separation from employment. A *window program* is a program established by an employer in connection with an impending separation from employment to provide separation pay if the program is made available by the employer for a limited period of time (no longer than 12 months) to employees who separate from employment during that period or to employees who separate from service during that period under specified circumstances. A payment made under a window program is treated as a payment that is contingent on an employee's separation from employment notwithstanding that the employee may not have had an involuntary separation from employment.

(6) *Anti-abuse provision.* Notwithstanding paragraphs (d)(1) through (5) of this section, if the facts and circumstances demonstrate that either the vesting or the payment of an amount (whether before or after an employee's involuntary separation from employment) would not have occurred but for the involuntary nature of the separation from employment, the payment of the amount is contingent on a separation from employment. For example, an employer's exercise of discretion to accelerate vesting of an amount shortly before an involuntary separation from employment may indicate that the acceleration of vesting was due to the involuntary nature of the separation from employment and was therefore contingent on the employee's separation from employment. Similarly, payment of an amount in excess of an amount otherwise payable (for example, increased salary), shortly before or after an involuntary separation from employment, may indicate that the amount was paid because the separation was involuntary and was therefore contingent on the employee's separation from employment. If an ATEO becomes a predecessor as a result of a reorganization or other transaction described in § 53.4960–1(h), any payment to an employee by a successor organization that is contingent on the employee's separation from employment with the predecessor ATEO is treated as paid by the predecessor ATEO.

(e) *Involuntary separation from employment*—(1) *In general. Involuntary separation from employment*means a separation from employment due to the independent exercise of the employer's unilateral authority to terminate the employee's services, other than due to the employee's implicit or explicit request, if the employee was willing and able to continue performing services as an employee. An involuntary separation from employment may include an employer's failure to renew a contract at the time the contract expires, provided that the employee was willing and able to execute a new contract providing terms and conditions substantially

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similar to those in the expiring contract and to continue providing services. The determination of whether a separation from employment is involuntary is based on all the facts and circumstances.

(2) *Separation from employment for good reason*—(i) *In general.* Notwithstanding paragraph (e)(1) of this section, an employee's voluntary separation from employment is treated as an involuntary separation from employment if the separation occurs under certain bona fide conditions (referred to herein as a separation from employment for good reason).

(ii) *Material negative change required.* A separation from employment for good reason is treated as an involuntary separation from employment if the relevant facts and circumstances demonstrate that it was the result of unilateral employer action that caused a material negative change to the employee's relationship with the employer. Factors that may provide evidence of such a material negative change include a material reduction in the duties to be performed, a material negative change in the conditions under which the duties are to be performed, or a material reduction in the compensation to be received for performing such services.

(iii) *Deemed material negative change.* An involuntary separation from employment due to a material negative change is deemed to occur if the separation from employment occurs within 2 years following the initial existence of one or more of the following conditions arising without the consent of the employee:

(A) *Material diminution of compensation.* A material diminution in the employee's base compensation;

(B) *Material diminution of responsibility.* A material diminution in the employee's authority, duties, or responsibilities;

(C) *Material diminution of authority of supervisor.* A material diminution in the authority, duties, or responsibilities of the supervisor to whom the employee is required to report, including a requirement that an employee report to a corporate officer or employee instead of reporting directly to the board of directors (or similar governing body) of an organization;

(D) *Material diminution of budget.* A material diminution in the budget over which the employee retains authority;

(E) *Material change of location.* A material change in the geographic location at which the employee must perform services; or

(F) *Other material breach.* Any other action or inaction that constitutes a material breach by the employer of the agreement under which the employee provides services.

(3) *Separation from employment.* Except as otherwise provided in this paragraph, separation from employment has the same meaning as separation from service as defined in § 1.409A–1(h). Pursuant to § 1.409A–1(h), an employee generally separates from employment with the employer if the employee dies, retires, or otherwise has a termination of employment with the employer or experiences a sufficient reduction in the level of services provided to the employer. For purposes of applying the rules regarding reductions in the level of services set forth in the definition of termination of employment in § 1.409A–1(h)(1)(ii), the rules are modified for purposes of this paragraph such that an employer may not set the level of the anticipated reduction in future services that will give rise to a separation from employment, meaning that the default percentages set forth in § 1.409A–1(h)(1)(ii) apply in all circumstances. Thus, an anticipated reduction of the level of service of less than 50 percent is not treated as a separation from employment, an anticipated reduction of more than 80 percent is treated as a separation from employment, and the treatment of an anticipated reduction between those two levels is determined based on the facts and circumstances. The measurement of the anticipated reduction of the level of service is based on the average level of service for the prior 36 months (or shorter period for an employee employed for less than 36 months). In addition, an employee's separation from employment is determined without regard to § 1.409A–1(h)(2) and (5) (application to independent contractors), since, for purposes of this section, only an employee may have a

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separation from employment, and a change from bona fide employee status to bona fide independent contractor status is also a separation from employment. See § 53.4960–2(a)(1) regarding the treatment of an employee who also serves as a director of a corporation (or in a substantially similar position). The definition of separation from employment also incorporates the rules under § 1.409A–1(h)(1)(i) (addressing leaves of absence, including military leaves of absence), § 1.409A–1(h)(4) (addressing asset purchase transactions), and § 1.409A–1(h)(6) (addressing employees participating in collectively bargained plans covering multiple employers). The definition further incorporates the rules of § 1.409A–1(h)(3), under which an employee separates from employment only if the employee has a separation from employment with the employer and all employers that would be considered a single employer under section 414(b) and (c), except that the ''at least 80 percent'' rule under section 414(b) and (c) is used, rather than replacing it with ''at least 50 percent.'' However, for purposes of determining whether there has been a separation from employment, a purported ongoing employment relationship between a covered employee and an ATEO or a related organization is disregarded if the facts and circumstances demonstrate that the purported employment relationship is not bona fide, or the primary purpose of the establishment or continuation of the relationship is avoidance of the application of section 4960.

(f) *Accelerated payment or accelerated vesting resulting from an involuntary separation from employment*—(1) *In general.* If a payment or the lapse of a substantial risk of forfeiture is accelerated as a result of an involuntary separation from employment, generally only the value due to the acceleration of payment or vesting is treated as contingent on a separation from employment, as described in paragraphs (f)(3) and (4) of this section, except as otherwise provided in this paragraph (f). For purposes of this paragraph (f), the terms *vested* and *substantial risk of forfeiture* have the same meaning as provided in § 53.4960–2(c)(2).

(2) *Nonvested payments subject to a non-service vesting condition.* If (without regard to a separation from employment) vesting of a payment would depend on an event other than the performance of services, such as the attainment of a performance goal, and that vesting event does not occur prior to the employee's separation from employment and the payment vests due to the employee's involuntary separation from employment, the full amount of the payment is treated as contingent on the separation from employment.

(3) *Vested payments.* If an involuntary separation from employment accelerates actual or constructive payment of an amount that previously vested without regard to the separation, the portion of the payment, if any, that is contingent on the separation from employment is the amount by which the present value of the accelerated payment exceeds the present value of the payment absent the acceleration. The payment of an amount otherwise due upon a separation from employment (whether voluntary or involuntary) is not treated as an acceleration of the payment unless the payment timing was accelerated due to the involuntary nature of the separation from employment. If the value of the payment absent the acceleration is not reasonably ascertainable, and the acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, the present value of the payment absent the acceleration is the amount of the accelerated payment (so the amount contingent on the separation from employment is zero). If the present value of the payment absent the acceleration is not reasonably ascertainable but the acceleration significantly increases the present value of the payment, the future value of the payment contingent on the separation from employment is treated as equal to the amount of the accelerated payment. For purposes of this paragraph (f)(3), the acceleration of a payment by 90 days or less is not treated as significantly increasing the present value of the payment. For rules on determining present value, see paragraph (f)(6) and paragraphs (h), (i) and (j) of this section.

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(4) *Nonvested payments subject to a service vesting condition*—(i) *In general.* If an involuntary separation from employment accelerates vesting of a payment, the portion of the payment that is contingent on separation from employment is the amount described in paragraph (f)(3) of this section (if any) plus the value of the lapse of the obligation to continue to perform services described in paragraph (f)(4)(ii) of this section (but the amount cannot exceed the amount of the accelerated payment, or, if the payment is not accelerated, the present value of the payment), to the extent that all of the following conditions are satisfied with respect to the payment:

(A) *Vesting trigger.* The payment vests as a result of an involuntary separation from employment;

(B) *Vesting condition.* Disregarding the involuntary separation from employment, the vesting of the payment was contingent only on the continued performance of services for the employer for a specified period of time; and

(C) *Services condition.* The payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

(ii) *Value of the lapse of the obligation to continue to perform services.* The value of the lapse of the obligation to continue to perform services is one percent of the amount of the accelerated payment multiplied by the number of full months between the date that the employee's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. This paragraph (f)(4)(ii) applies to the accelerated vesting of a payment in the nature of compensation even if the time when the payment is made is not accelerated. In that case, the value of the lapse of the obligation to continue to perform services is one percent of the present value of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested.

(iii) *Accelerated vesting of equity compensation.* For purposes of this paragraph (f)(4), the acceleration of the vesting of a stock option or stock appreciation right (or similar arrangement) or the lapse of a restriction on restricted stock or a restricted stock unit (or a similar arrangement) is considered to significantly increase the value of the payment.

(5) *Application to benefits under a nonqualified deferred compensation plan.* In the case of a payment of benefits under a nonqualified deferred compensation plan, paragraph (f)(3) of this section applies to the extent benefits under the plan are vested without regard to the involuntary separation from employment, but the payment of benefits is accelerated due to the involuntary separation from employment. Paragraph (f)(4) of this section applies to the extent benefits under the plan are subject to the conditions described in paragraph (f)(4)(i) of this section. For any other payment of benefits under a nonqualified deferred compensation plan (such as a contribution made due to the employee's involuntary separation from employment), the full amount of the payment is contingent on the employee's separation from employment.

(6) *Present value.* For purposes of this paragraph (f), the present value of a payment is determined based on the payment date absent the acceleration and the date on which the accelerated payment is scheduled to be made. The amount that is treated as contingent on the separation from employment is the amount by which the present value of the accelerated payment exceeds the present value of the payment absent the acceleration.

(7) *Examples.* See § 1.280G Q/A–24(f) for examples that may be applied by analogy to illustrate the rules of this paragraph (f).

(g) *Three-times-base-amount test for parachute payments*—(1) *In general.* To determine whether payments in the nature of compensation made to a covered employee that are contingent on the covered employee separating from employment with the ATEO are parachute payments, the aggregate present value of the payments must be compared to the individual's base amount. To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made

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to (or for the benefit of) the same covered employee by an ATEO (or any predecessor of the ATEO) or related organization and that are contingent on the separation from employment must be determined. If this aggregate present value equals or exceeds the amount equal to 3-times the individual's base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3-times the individual's base amount, the payments are not parachute payments. See paragraphs (f)(6), (h), (i), and (j) of this section for rules on determining present value.

(2) *Examples.* The following examples illustrate the rules of this paragraph (g). For purposes of these examples, assume any entity referred to as ''ATEO'' is an ATEO.

(i) *Example 1 (Parachute payment)*—(A) *Facts.* Employee A is a covered employee and an HCE of ATEO 1. Employee A's base amount is $200,000. Payments in the nature of compensation that are contingent on a separation from employment with ATEO 1 totaling $800,000 are made to Employee A on the date of Employee A's separation from employment.

(B) *Conclusion.* The payments are parachute payments because they have an aggregate present value at the time of the separation from employment of $800,000, which is at least equal to 3-times Employee A's base amount of $200,000 (3 × $200,000 = $600,000).

(ii) *Example 2 (No parachute payment)*—(A) *Facts.* Assume the same facts as in paragraph (g)(2)(i) of this section (Example 1), except that the payments contingent on Employee A's separation from employment total $580,000.

(B) *Conclusion.* Because the aggregate present value of the payments ($580,000) is not at least equal to 3-times Employee A's base amount ($600,000), the payments are not parachute payments.

(h) *Calculating present value*—(1) *In general.* Except as otherwise provided in this paragraph (h), for purposes of determining if a payment contingent on a separation from employment exceeds 3-times the base amount, the present value of a payment is determined as of the date of the separation from employment or, if the payment is made prior to that date, the date on which the payment is made.

(2) *Deferred payments.* For purposes of determining whether a payment is a parachute payment, if a payment in the nature of compensation is the right to receive payments in a year (or years) subsequent to the year of the separation from employment, the value of the payment is the present value of the payment (or payments) calculated on the basis of reasonable actuarial assumptions and using the applicable discount rate for the present value calculation that is determined in accordance with paragraph (i) of this section.

(3) *Health care.* If the payment in the nature of compensation is an obligation to provide health care (including an obligation to purchase or provide health insurance), then, for purposes of this paragraph (h) and for applying the 3-times-base-amount test under paragraph (g) of this section, the present value of the obligation is calculated in accordance with generally accepted accounting principles. For purposes of paragraph (g) of this section and this paragraph (h), the obligation to provide health care is permitted to be measured by projecting the cost of premiums for health care insurance, even if no health care insurance is actually purchased. If the obligation to provide health care is made in coordination with a health care plan that the employer makes available to a group, then the premiums used for purposes of this paragraph (h)(3) may be the allocable portion of group premiums.

(i) *Discount rate.* Present value generally is determined by using a discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and the regulations in part 1 under section 1274(d)), compounded semiannually. The applicable Federal rate to be used is the Federal rate that is in effect on the date as of which the present value is determined, using the period until the payment is expected to be made as the term of the debt instrument under section 1274(d). See paragraph (h) of this section for rules with respect to the date as of which the present value is determined. However, for any payment, the employer and the covered employee may elect to use the applicable Federal

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00295 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

rate that is in effect on the date on which the parties entered into the contract that provides for the payment if that election is set forth in writing in the contract.

(j) *Present value of a payment to be made in the future that is contingent on an uncertain future event or condition*—(1) *Treatment based on the estimated probability of payment*. In certain cases, it may be necessary to apply the 3-times-base-amount test to a payment that is contingent on separation from employment at a time when the aggregate present value of all the payments is uncertain because the time, amount, or right to receive one or more of the payments is also contingent on the occurrence of an uncertain future event or condition. In that case, the employer must reasonably estimate whether it will make the payment. If the employer reasonably estimates there is a 50-percent or greater probability that it will make the payment, the full amount of the payment is considered for purposes of the 3-times-base-amount test and the allocation of the base amount. If the employer reasonably estimates there is a less than 50-percent probability that the payment will be made, the payment is not considered for either purpose.

(2) *Correction of incorrect estimates*. If an ATEO later determines that an estimate it made under paragraph (j)(1) of this section was incorrect, it must reapply the 3-times-base-amount test to reflect the actual time and amount of the payment. In reapplying the 3-times-base-amount test (and, if necessary, reallocating the base amount), the ATEO must determine the aggregate present value of payments paid or to be paid as of the date described in paragraph (h) of this section using the discount rate described in paragraph (i) of this section. This redetermination may affect the amount of any excess parachute payment for a prior taxable year. However, if, based on the application of the 3-times-base-amount test without regard to the payment described in this paragraph (j), an ATEO has determined it will pay an employee an excess parachute payment or payments, then the 3-times-base-amount test does not have to be reapplied when a payment described in this paragraph (j) is made (or becomes certain to be made) if no base amount is allocated to that payment under § 53.4960–4(d)(5).

(3) *Initial option value estimate*. To the extent provided in published guidance of general applicability under § 601.601(d)(2), an initial estimate of the value of an option subject to paragraph (c) of this section is permitted to be made, with the valuation subsequently redetermined and the 3-times-base-amount test reapplied. Until guidance is published under section 4960, published guidance of general applicability described in § 601.601(d)(2) that is issued under section 280G applies by analogy.

(4) *Examples*. See § 1.280G–1, Q/A–33(d) for examples that may be applied by analogy to illustrate the rules of this paragraph (j).

(k) *Base amount*—(1) *In general*. A covered employee's base amount is the average annual compensation for services performed as an employee of the ATEO (including compensation for services performed for a predecessor of the ATEO), and/or, if applicable, a related organization, with respect to which there has been a separation from employment, if the compensation was includible in the gross income of the individual for taxable years in the base period (including amounts that were excluded under section 911) or that would have been includible in the individual's gross income if the individual had been a United States citizen or resident. See paragraph (l) of this section for the definition of base period and for examples of base amount computations.

(2) *Short or incomplete taxable years*. If the base period of a covered employee includes a short taxable year or less than all of a taxable year of the employee, compensation for the short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. In annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized.

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(3) *Excludable fringe benefits*. Because the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that may constitute parachute payments. For example, payments in the form of excludable fringe benefits or excludable health care benefits are not included in the base amount but may be treated as parachute payments.

(4) *Section 83(b) income*. The base amount includes the amount of compensation included in income under section 83(b) during the base period.

(l) *Base period*—(1) *In general*. The base period of a covered employee is the covered employee's 5 most-recent taxable years ending before the date on which the separation from employment occurs. However, if the covered employee was not an employee of the ATEO for this entire 5-year period, the individual's base period is the portion of the 5-year period during which the covered employee performed services for the ATEO, a predecessor, or a related organization.

(2) *Determination of base amount if employee separates from employment in the year hired*. If a covered employee commences services as an employee and experiences a separation from employment in the same taxable year, the covered employee's base amount is the annualized compensation for services performed for the ATEO (or a predecessor or related organization) that was not contingent on the separation from employment and either was includible in the employee's gross income for that portion of the employee's taxable year prior to the employee's separation from employment (including amounts that were excluded under section 911) or would have been includible in the employee's gross income if the employee had been a United States citizen or resident.

(3) *Examples*. The following examples illustrate the rules of paragraph (k) of this section and this paragraph (l). For purposes of these examples, assume any entity referred to as ''ATEO'' is an ATEO, any entity referred to as ''CORP'' is not an ATEO, and all employees are HCEs of their respective employers.

(i) *Example 1 (Calculation with salary deferrals)*—(A) *Facts*. Employee A, a covered employee of ATEO 1, receives an annual salary of $500,000 per year during the 5-year base period. Employee A defers $100,000 of salary each year under a nonqualified deferred compensation plan (none of which is includible in Employee A's income until paid in cash to Employee A).

(B) *Conclusion*. Employee A's base amount is $400,000 (($400,000 × 5)/5).

(ii) *Example 2 (Calculation for less-than-5-year base period)*—(A) *Facts*. Employee B, a covered employee of ATEO 1, was employed by ATEO 1 for 2 years and 4 months preceding the year in which Employee B separates from employment. Employee B's compensation includible in gross income was $100,000 for the 4-month period, $420,000 for the first full year, and $450,000 for the second full year.

(B) *Conclusion*. Employee B's base amount is $390,000 (((3 × $100,000) + $420,000 + $450,000)/3). Any compensation Employee B receives in the year of separation from employment is not included in the base amount calculation.

(iii) *Example 3 (Calculation for less-than-5-year base period with signing bonus)*—(A) *Facts*. Assume the same facts as in paragraph (l)(3)(ii)(A) of this section (Example 2), except that Employee B also received a $60,000 signing bonus when Employee B's employment with ATEO 1 commenced at the beginning of the 4-month period.

(B) *Conclusion*. Employee B's base amount is $410,000 ((($60,000 + (3 × $100,000)) + $420,000 + $450,000)/3). Pursuant to paragraph (k)(2) of this section, because the bonus is a payment that will not be paid more often than once per year, the bonus is not taken into account in annualizing Employee B's compensation for the 4-month period.

(iv) *Example 4 (Effect of non-employee compensation)*—(A) *Facts*. Employee C, a covered employee of ATEO 1, was not an employee of ATEO 1 for the full 5-year base period. In 2024 and 2025, Employee C is only a director of ATEO 1 and receives $30,000 per year for services as a director. On January 1, 2026, Employee C becomes an officer and covered employee of ATEO 1. Employee C's includible compensation for services as an officer of ATEO 1 is $250,000

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00297 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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for each of 2026 and 2027, and $300,000 for 2028. In 2028, Employee C separates from employment with ATEO 1.

(B) *Conclusion*. Employee C's base amount is $250,000 ((2 × $250,000)/2). The $30,000 of director's fees paid to Employee C in each of 2024 and 2025 is not included in Employee C's base amount calculation because it was not for services performed as an employee of ATEO 1.

[T.D. 9938, 86 FR 6219, Jan. 19, 2021]

§ 53.4960–4 Liability for tax on excess remuneration and excess parachute payments.

(a) *Liability, reporting, and payment of excise taxes*—(1) *Liability*. For each taxable year, with respect to each covered employee, the taxpayer is liable for tax at the rate imposed under section 11 on the sum of the excess remuneration allocated to the taxpayer under paragraph (c) of this section and, if the taxpayer is an ATEO, any excess parachute payment paid by the taxpayer or a predecessor during the taxable year.

(2) *Reporting and payment*. The excise tax imposed by section 4960 is reported as provided in §§ 53.6011–1(b) and 53.6071–1(i) and paid in the form and manner prescribed by the Commissioner.

(3) *Arrangements between an ATEO and a related organization*. Calculation of, and liability for, the excise tax imposed by section 4960 is separate from, and unaffected by, any arrangement that an ATEO and any related organization may have for bearing the cost of any liability for the excise tax imposed by section 4960.

(4) *Certain foreign related organizations*. A related organization that is a foreign organization described in section 4948(b) that either is exempt from tax under section 501(a) or is a taxable private foundation (section 4948(b) related organization) is not liable for the excise tax imposed by section 4960. A foreign organization is an organization not created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States. See section 4948(b) and § 53.4948–1. For purposes of this paragraph (a)(4) and the application of section 4960 to a taxable year, an organization's status as a section 4948(b) related organization is determined at the end of its taxable year. However, remuneration that the section 4948(b) related organization pays to a covered employee of an ATEO must be taken into account by the ATEO and other related organizations for purposes of section 4960 generally, including for purposes of determining the five highest-compensated employees and the total remuneration paid to a covered employee. For example, if an ATEO and its related organization that is a section 4948(b) related organization each paid $600,000 remuneration to a covered employee during the applicable year, then the related organization would not be liable for the tax that would otherwise be allocable to it, and the ATEO would be liable for tax on $100,000 (50 percent of the $200,000 excess remuneration paid to the employee).

(5) [Reserved]

(b) *Amounts subject to tax*—(1) *Excess remuneration*—(i) *In general. Excess remuneration* means the amount of remuneration paid by an ATEO to any covered employee during an applicable year in excess of $1 million, as determined under § 53.4960–2.

(ii) *Exclusion for excess parachute payments*. Excess remuneration does not include any amount that is an excess parachute payment as defined in paragraph (b)(2) of this section.

(2) *Excess parachute payment. Excess parachute payment* means an amount equal to the excess (if any) of the amount of any parachute payment paid by an ATEO, a predecessor of the ATEO, or a related organization, or on behalf of any such person, during the taxable year over the portion of the base amount allocated to such payment.

(c) *Calculation of liability for tax on excess remuneration*—(1) *In general*. For each taxable year, an employer is liable for the tax on excess remuneration paid in the applicable year ending with or within the employer's taxable year. If, for the taxable year, remuneration paid during an applicable year by an ATEO or one or more related organizations to a covered employee is taken into account in determining the tax imposed on excess remuneration for that taxable year, then each employer

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is liable for the tax in an amount that bears the same ratio to the total tax determined under section 4960(a) as the amount of remuneration paid by the employer to the covered employee (including remuneration paid by the employer as described in § 53.4960–2(b)(1), but disregarding remuneration treated as paid by the employer under § 53.4960–2(b)(2)), bears to the total amount of remuneration paid by the ATEO under § 53.4960–2 (including remuneration treated as paid by the ATEO under § 53.4960–2(b)(2)).

(2) *Calculation if liability is allocated from more than one ATEO with regard to an individual.* If liability for the tax on excess remuneration is allocated to an employer from more than one ATEO in a taxable year with regard to an individual that is a covered employee of each ATEO, then the employer is liable for the tax only in the capacity in which it is liable for the greatest amount of the tax with respect to that individual for the taxable year. For example, assume ATEO 1 is a related organization to both ATEO 2 and ATEO 3 and pays excess remuneration to Employee D, and Employee D is a covered employee of ATEO 1, ATEO 2, and ATEO 3. In this case, ATEO 1's liability for the tax on excess remuneration to Employee D is the highest of its liability as an ATEO, as a related organization to ATEO 2, or as a related organization to ATEO 3.

(3) *Calculation if liability is allocated from an ATEO with a short applicable year.* If liability for the tax on excess remuneration paid to an individual is allocated to an employer from an ATEO with a short applicable year under § 53.4960–1(c)(3), then the liability with respect to the excess remuneration paid to that individual is allocated in accordance with the principles of this paragraph (c) adjusted as necessary to avoid, to the extent possible, duplication of application of the excise tax. The Commissioner may provide additional guidance of general applicability, published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), on the application of this paragraph (c)(3) to particular circumstances, including circumstances involving an ATEO with a short applicable year that has one or more related organizations and the ATEO's short applicable year and the preceding applicable year both end with or within the related organization's taxable year, such that the ATEO and related organizations are liable for the tax for multiple applicable years ending with or within the employer's taxable year.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c). For purposes of these examples, assume that the rate of excise tax under section 4960 is 21 percent, that any entity that is referred to as ''ATEO'' is an ATEO, that any entity referred to as ''CORP'' is not an ATEO and is not a publicly held corporation within the meaning of section 162(m)(2) or a covered health insurance provider within the meaning of section 162(m)(6)(C), that no related organization is a section 4948(b) related organization, all taxpayers use the calendar year as their taxable year unless otherwise stated, and that no parachute payments are made in any of the years at issue.

(i) *Example 1 (Remuneration from multiple employers)*—(A) *Facts.* ATEO 1 and CORP 1 are related organizations. Employee A is a covered employee of ATEO 1 and an employee of CORP 1. In the 2022 applicable year, ATEO 1 pays Employee A $1.2 million of remuneration, and CORP 1 pays A $800,000 of remuneration. Remuneration paid by each employer is for services performed by Employee A solely as an employee of that employer.

(B) *Conclusion.* For the 2022 taxable year, ATEO 1 is treated as paying Employee A $2 million of remuneration, $1 million of which is excess remuneration. The total excise tax is $210,000 (21 percent × $1 million). ATEO 1 paid ⅗ of Employee A's total remuneration ($1.2 million/$2 million); thus, ATEO 1 is liable for ⅗ of the excise tax, which is $126,000. CORP 1 paid ⅖ of Employee A's total remuneration ($800,000/$2 million); thus, CORP 1 is liable for ⅖ of the excise tax, which is $84,000.

(ii) *Example 2 (Application when taxpayers have different taxable years)*—(A) *Facts.* Assume the same facts as in paragraph (c)(4)(i) of this section (*Example 1*), except that CORP 2 uses a taxable year beginning July 1 and ending June 30.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00299 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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(B) *Conclusion*. The conclusion is the same as the conclusion in paragraph (c)(4)(i) of this section (*Example 1*), except that ATEO 1 is liable for the tax for its taxable year starting January 1, 2022, and ending December 31, 2022, and CORP 1 is liable for the tax for its taxable year beginning July 1, 2022, and ending June 30, 2023 (the taxable year with or within which ATEO 1's 2022 applicable year ends).

(iii) *Example 3 (Multiple liabilities for same applicable year due to multiple ATEOs)*—(A) *Facts*. The following facts are all with respect to the 2023 applicable year: ATEO 5 owns 60 percent of the stock of CORP 2. Sixty percent of ATEO 4's directors are representatives of ATEO 3. In addition, 60 percent of ATEO 5's directors are representatives of ATEO 4, but none are representatives of ATEO 3. Employee B is a covered employee of ATEO 3, ATEO 4, and ATEO 5 and is an employee of CORP 2. ATEO 3, ATEO 4, ATEO 5, and CORP 2 each pay Employee B $1.2 million of remuneration in the applicable year. ATEO 4's related organizations are ATEO 3 and ATEO 5. ATEO 3's only related organization is ATEO 4. ATEO 5's related organizations are ATEO 4 and CORP 2.

(B) *Calculation (ATEO 3)*. Under ATEO 3's calculation as an ATEO for the 2023 applicable year, ATEO 3 is treated as paying Employee B a total of $2.4 million in remuneration ($1.2 million from ATEO 3 + $1.2 million from ATEO 4). The total excise tax is $294,000 (21 percent × $1.4 million). ATEO 3 and ATEO 4 each paid ½ of Employee B's total remuneration ($1.2 million/$2.4 million); thus, under ATEO 3's calculation, ATEO 3 and ATEO 4 each would be liable for ½ of the excise tax, which is $147,000.

(C) *Calculation (ATEO 4)*. Under ATEO 4's calculation as an ATEO for the 2023 applicable year, ATEO 4 is treated as paying Employee B a total of $3.6 million in remuneration for the 2022 applicable year ($1.2 million from ATEO 3 + $1.2 million from ATEO 4 + $1.2 million from ATEO 5). The total excise tax is $546,000 (21 percent × $2.6 million). ATEO 3, ATEO 4, and ATEO 5 each paid ⅓ of the total remuneration to Employee B ($1.2 million/$3.6 million); thus, under ATEO 4's calculation, ATEO 3, ATEO 4, and ATEO 5 each would be liable for ⅓ of the excise tax, which is $182,000.

(D) *Calculation (ATEO 5)*. Under ATEO 5's calculation as an ATEO for the 2023 applicable year, ATEO 5 is treated as paying Employee B a total of $3.6 million in remuneration ($1.2 million from ATEO 4 + $1.2 million from ATEO 5 + $1.2 million from CORP 2). The total excise tax is $546,000 (21 percent × $2.6 million). ATEO 4, ATEO 5, and CORP 2 each paid ⅓ of the total remuneration to Employee B ($1.2 million/$3.6 million); thus, under ATEO 5's calculation, ATEO 4, ATEO 5, and CORP 2 each would be liable for ⅓ of the excise tax, which is $182,000.

(E) *Conclusion (Liability of ATEO 3)*. For the 2023 applicable year, ATEO 3 is liable for $182,000 of excise tax as a related organization under ATEO 4's calculation, which is greater than the $147,000 of excise tax under ATEO 3's own calculation. Thus, ATEO 3's excise tax liability with respect to Employee B is $182,000 for its 2023 taxable year.

(F) *Conclusion (Liability of ATEO 4)*. For the 2023 applicable year, ATEO 4 is liable as a related organization for $147,000 of excise tax according to ATEO 3's calculation, for $182,000 according to ATEO 4's own calculation, and for $182,000 according to ATEO 5's calculation. Thus, ATEO 4's excise tax liability with respect to Employee B is $182,000 for its 2023 taxable year.

(G) *Conclusion (Liability of ATEO 5)*. For the 2023 applicable year, ATEO 5 is liable as a related organization for $182,000 of excise tax under ATEO 4's calculation, and is liable for $182,000 of excise tax under ATEO 5's own calculation. Thus, ATEO 5's excise tax liability with respect to Employee B is $182,000 for its 2023 taxable year.

(H) *Conclusion (Liability of CORP 2)*. For the 2023 applicable year, CORP 2 is liable as a related organization for $182,000 of excise tax according to ATEO 5's calculation only. Thus, CORP 2's excise tax liability with respect to Employee B is $182,000 for its 2023 taxable year.

(d) *Calculation of liability for excess parachute payments*—(1) *In general*. Except as provided in paragraph (d)(3) of this section, only excess parachute payments made by or on behalf of an

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ATEO are subject to tax under this section. However, parachute payments made by related organizations that are not made by or on behalf of an ATEO are taken into account for purposes of determining the total amount of excess parachute payments.

(2) *Computation of excess parachute payments*—(i) *Calculation*. The amount of an excess parachute payment is the excess of the amount of any parachute payment made by an ATEO, a predecessor of the ATEO, or a related organization, or on behalf of any such person, over the portion of the covered employee's base amount that is allocated to the payment. The portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the present value of the parachute payment bears to the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same covered employee. Thus, the portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of the parachute payment and the denominator of which is the aggregate present value of all parachute payments.

(ii) *Examples*. The following examples illustrate the rules of this paragraph (d)(2). For purposes of these examples, assume any entity referred to as ''ATEO'' is an ATEO and all employees are HCEs of their respective employers.

(A) *Example 1 (Compensation from related organizations)*—(*1*) *Facts*. ATEO 1 and ATEO 2 are related organizations. Employee A is a covered employee of ATEO 1 and an employee of ATEO 2 who has an involuntary separation from employment with ATEO 1 and ATEO 2. Employee A's base amount is $200,000 with respect to ATEO 1 and $400,000 with respect to ATEO 2. A receives $1 million from ATEO 1 contingent upon Employee A's involuntary separation from employment from ATEO 1 and $1 million from ATEO 2 contingent upon Employee A's involuntary separation from employment from ATEO 2.

(*2*) *Conclusion*. Employee A has a base amount of $600,000 ($200,000 + $400,000). The two $1 million payments are parachute payments because their aggregate present value is at least 3-times Employee A's base amount (3 × $600,000 = $1.8 million). The portion of the base amount allocated to each parachute payment is $300,000 (($1 million/$2 million) × $600,000). Thus, the amount of each excess parachute payment is $700,000 ($1 million − $300,000).

(B) *Example 2 (Multiple parachute payments)*—(*1*) *Facts*. Employee B is a covered employee of ATEO 3 with a base amount of $200,000 who is entitled to receive two parachute payments: One of $200,000 and the other of $900,000. The $200,000 payment is made upon separation from employment, and the $900,000 payment is to be made on a date in a future taxable year. The present value of the $900,000 payment is $800,000 as of the date of the separation from employment.

(*2*) *Conclusion*. The portion of the base amount allocated to the first payment is $40,000 (($200,000 present value of the parachute payment/$1 million present value of all parachute payments) × $200,000 total base amount) and the portion of the base amount allocated to the second payment is $160,000 (($800,000 present value of the parachute payment/$1 million present value of all parachute payments) × $200,000 total base amount). Thus, the amount of the first excess parachute payment is $160,000 ($200,000 − $40,000) and that the amount of the second excess parachute payment is $740,000 ($900,000 − $160,000).

(3) *Reallocation when the payment is disproportionate to base amount*. In accordance with section 4960(d), the Commissioner may treat a parachute payment as paid by an ATEO if the facts and circumstances indicate that the ATEO and other payors of parachute payments structured the payments in a manner primarily to avoid liability under section 4960. For example, if an ATEO would otherwise be treated as paying a portion of an excess parachute payment in an amount that is materially lower in proportion to the total excess parachute payment than the proportion that the amount of average annual compensation paid by the ATEO (or any predecessor) during the base period bears to the total average

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annual compensation paid by the ATEO (or any predecessor) and any related organization (or organizations), and the lower amount is offset by payments from a non-ATEO or an unrelated ATEO, this may indicate that that the parachute payments were structured in a manner primarily to avoid liability under section 4960.

(4) *Election to prepay tax.* An ATEO may prepay the excise tax under paragraph (a)(1) of this section on any excess parachute payment for the taxable year of the separation from employment or any later taxable year before the taxable year in which the parachute payment is actually or constructively paid. However, an employer may not prepay the excise tax on a payment to be made in cash if the present value of the payment is not reasonably ascertainable under § 31.3121(v)(2)–1(e)(4) or on a payment related to health coverage. Any prepayment must be based on the present value of the excise tax that would be due for the taxable year in which the employer will pay the excess parachute payment, and be calculated using the discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and the regulations in part 1 under section 1274) and the tax rate in effect under section 11 for the year in which the excise tax is paid. For purposes of projecting the future value of a payment that provides for interest to be credited at a variable interest rate, the employer may make a reasonable assumption regarding the variable rate. An employer is not required to adjust the excise tax paid merely because the actual future interest rates are not the same as the rate used for purposes of projecting the future value of the payment.

(5) *Liability after a redetermination of total parachute payments.* If an ATEO determines that an estimate made under § 53.4960–3(j)(1) was incorrect, it must reapply the 3-times-base-amount test to reflect the actual time and amount of the payment. In reapplying the 3-times-base-amount test (and, if necessary, reallocating the base amount), the ATEO must determine the correct base amount allocable to any parachute payment paid in the taxable year. See § 1.280G–1, Q/A–33(d) for examples that may be applied by analogy to illustrate the rules of this paragraph (d)(5).

(6) *Examples.* The following examples illustrate the rules of this paragraph (d). For purposes of these examples, assume any entity referred to as ''ATEO'' is an ATEO, any entity referred to as ''CORP'' is not an ATEO, and all employees are HCEs of their respective employers.

(i) *Example 1 (Excess parachute payment paid by a non-ATEO)*—(A) *Facts.* ATEO 1 and CORP 1 are related organizations that are treated as the same employer for purposes of § 53.4960–3(e)(3) (defining separation from employment) and are both calendar year taxpayers. For 2022 through 2026, ATEO 1 and CORP 1 each pay Employee A $250,000 of compensation per year for services performed as an employee of each organization ($500,000 total per year). In 2027, ATEO 1 and CORP 1 each pay Employee A $1 million payment ($2 million total) that is contingent on Employee A's separation from employment with both ATEO 1 and CORP 1, all of which is remuneration, and no other compensation. Employee A is a covered employee of ATEO 1 in 2027.

(B) *Conclusion.* Employee A's base amount in 2027 is $500,000 (Employee A's average annual compensation from both ATEO 1 and CORP 1 for the previous 5 years). ATEO 1 makes a parachute payment of $2 million in 2027, the amount paid by both ATEO 1 and CORP 1 that is contingent on Employee A's separation from employment with ATEO 1 and all organizations that are treated as the same employer under § 53.4960–3(e)(3). Employee A's $2 million payment exceeds 3-times the base amount ($1.5 million). ATEO 1 makes a $1.5 million excess parachute payment (the amount by which $2 million exceeds the $500,000 base amount). However, ATEO 1 is liable for tax only on the excess parachute payment paid by ATEO 1 ($1 million parachute payment − $250,000 base amount = $750,000) that is subject to tax under § 53.4960–4(a). CORP 1 is not liable for tax under § 53.4960–4(a) in 2027.

(ii) *Example 2 (Election to prepay tax on excess parachute payments and effect on excess remuneration)*—(A) *Facts.* Employee B is a covered employee of

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00302 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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ATEO 2 with a base amount of $200,000 who is entitled to receive two parachute payments from ATEO 2, one of $200,000 and the other of $900,000. The $200,000 payment is made upon separation from employment, and the $900,000 payment is to be made on a date in a future taxable year. The present value of the $900,000 payment is $800,000 as of the date of the separation from employment. ATEO 2 elects to prepay the excise tax on the $900,000 future parachute payment (of which $740,000 is an excess parachute payment). The tax rate under section 11 is 21 percent for the taxable year the excise tax is paid and, using a discount rate determined under § 53.4960–3(i), the present value of the $155,400 ($740,000 × 21 percent) excise tax on the $740,000 future excess parachute payment is $140,000.

(B) *Conclusion.* The excess parachute payment is thus $800,000 ($200,000 plus $800,000 present value of the $900,000 future payment, less $200,000 base amount), with $40,000 of the base amount allocable to the $200,000 payment and $160,000 of the base amount allocable to the $900,000 payment. To prepay the excise tax on the $740,000 future excess parachute payment, the employer must satisfy its $140,000 obligation under section 4960 with respect to the future payment, in addition to the $33,600 excise tax ($160,000 × 21 percent) on the $160,000 excess parachute payment made upon separation from employment. For purposes of determining the amount of excess remuneration (if any) under section 4960(a)(1), the amount of remuneration paid by the employer to the covered employee for the taxable year of the separation from employment is reduced by the $900,000 of total excess parachute payments ($160,000 + $740,000).

[T.D. 9938, 86 FR 6219, Jan. 19, 2021]

§ 53.4960–5 [Reserved]

§ 53.4960–6 Applicability date.

(a) *General applicability date.* Sections 53.4960–0 through 53.4960–4 apply to taxable years beginning after December 31, 2021. Taxpayers may choose to apply §§ 53.4960–0 through 53.4960–4 to taxable years beginning after December 31, 2017, and on or before December 31, 2021, provided the taxpayer applies §§ 53.4960–0 through 53.4960–4 in their entirety and in a consistent manner.

(b) [Reserved]

[T.D. 9938, 86 FR 6219, Jan. 19, 2021]

§ 53.4961–1 Abatement of second tier taxes for correction within correction period.

If any taxable event is corrected during the correction period for the event, then any second tier tax imposed with respect to the event shall not be assessed. If the tax has been assessed, it shall be abated. If the tax has been collected, it shall be credited or refunded as an overpayment. For purposes of this section, the tax imposed includes interest, additions to the tax and additional amounts. For definitions of the terms *second tier tax, taxable event, correct,* and *correction period,* see § 53.4963–1.

§ 53.4961–2 Court proceedings to determine liability for second tier tax.

(a) *Introduction.* Under section 4961 (b) and (c), the period of limitations on collection may be suspended and assessment or collection of first or second tier tax may be prohibited during the pendency of administrative and judicial proceedings conducted to determine a taxpayer's liability for second tier tax. This section provides rules relating to the suspension of the limitations period and the prohibitions on assessment and collection. In addition, this section describes the administrative and judicial proceedings to which these rules apply.

(b) *Initial proceeding*—(1) *Defined.* For purposes of subpart K, an initial proceeding means a proceeding described in subparagraph (2) or (3).

(2) *Tax Court proceeding before assessment.* A proceeding is described in this subparagraph (2) if it is a proceeding with respect to the taxpayer's liability for second tier tax and is commenced in accordance with section 6213 (a).

(3) *Refund proceeding commenced before correction period ends.* A proceeding is described in this subparagraph (3) if it is a proceeding commenced under section 7422, in accordance with the provisions of § 53.4963–1(e) (4) and (5) (relating to prerequisites to extension of the correction period during certain refund proceedings), and with respect

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00303 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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to the taxpayer's liability for second tier tax.

(c) *Supplemental proceeding*—(1) *Jurisdiction*. If a determination in an initial proceeding that a taxpayer is liable for a second tier tax has become final, the court in which the initial proceeding was commenced shall have jurisdiction to conduct any necessary supplemental proceeding to determine whether the taxable event was corrected during the correction period.

(2) *Time for beginning proceeding*. The time for beginning a supplemental proceeding begins on the day after a determination in an initial proceeding becomes final and ends on the 90th day after the last day of the correction period.

(d) *Restriction on assessment during Tax Court proceeding*. If a supplemental proceeding described in section 4961 (b) and § 53.4961–2(c) is commenced in the Tax Court, the provisions of the second and third sentences of section 6213(a) and the first and third sentences of § 301.6213–1(a)(2) apply with respect to a deficiency in second tier tax until the decision of the Tax Court in the supplemental proceeding is final.

(e) *Suspension of period of collection for second tier tax*—(1) *Scope*. Except as provided in subparagraph (6), this paragraph (e) applies to the second tier tax assessed with respect to a taxable event if a claim described in subparagraph (2) is filed.

(2) *Claim for refund*. A claim for refund is described in this subparagraph (2) if, no later than 90 days after the day on which the second tier tax is assessed with respect to a taxable event, the taxpayer—

(i) Pays the full amount of first tier tax for the taxable period, and

(ii) Files a claim for refund of the amount paid.

(3) *Collection prohibited*. No levy or proceeding in court for the collection of the second tier tax shall be made, begun, or prosecuted until the end of the collection prohibition period described in subparagraph (5). Notwithstanding section 7421(a), the collection by levy or proceeding may be enjoined during the collection prohibition period by a proceeding in the proper court.

(4) *Suspension of running of period of limitations on collection*. With respect to a second tier tax to which this paragraph (e) applies, the running of the period of limitations provided in section 6502 (relating to collection of tax by levy or by a proceeding in court) shall be suspended for the collection prohibition period described in subparagraph (5).

(5) *Collection prohibition period*. The collection prohibition period begins on the day the second tier tax is assessed and ends on the latest of:

(i) The day a decision in a refund proceeding commenced before the 91st day after denial of the claim described in subparagraph (2) of this paragraph (including any supplemental proceeding under § 53.4961–2(c)) becomes final;

(ii) The 90th day after the claim referred to in subparagraph (2) is denied; or

(iii) The 90th day after the second tier tax is assessed.

(6) *Jeopardy collection*. If the Secretary makes a finding that the collection of the second tier tax is in jeopardy, nothing in this paragraph (e) shall prevent the immediate collection of such tax.

(f) *Finality*—(1) *Tax Court proceeding*. For purposes of this subpart K, section 7481 applies in determining when a decision in a Tax Court proceeding becomes final.

(2) *Refund proceeding*. For purposes of this subpart K, § 301.7422–1 applies in determining when a decision in a refund proceeding becomes final.

§ 53.4963–1 Definitions.

(a) *First tier tax*. For purposes of this subpart K, the term *first tier tax* means any tax imposed by subsection (a) of section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4955, 4958, 4966, 4967, 4971, or 4975. A first tier tax may also be referred to as an ''initial tax'' in parts 53 and 54.

(b) *Second tier tax*. For purposes of this subpart K, the term *second tier tax* means any tax imposed by subsection (b) of section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4955, 4958, 4971, or 4975. A second tier tax may also be referred to as an ''additional tax'' in parts 53 and 54.

(c) *Taxable event*. For purposes of this subpart K, the term *taxable event* means any act, or failure to act, giving

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00304 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

rise to liability for tax under section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4955, 4958, 4966, 4967, 4971, or 4975.

(d) *Correct*—(1) *In general*. Except as provided in subparagraph (2), the term *correct* has the same meaning for purposes of this subpart K as in the section which imposes the second tier tax or the regulations thereunder.

(2) *Special rules*. The term *correct* means—

(i) For a second tier tax imposed by section 4942(b), reducing the amount of the undistributed income to zero,

(ii) For a second tier tax imposed by section 4943(b), reducing the amount of the excess business holdings to zero, and

(iii) For a second tier tax imposed by section 4944(b), removing the investment from jeopardy.

(e) *Correction period*—(1) *In general*. The correction period with respect to any taxable event shall begin with the date on which the taxable event occurs and shall end 90 days after the date of mailing of a notice of deficiency under section 6212 with respect to the second tier tax imposed with respect to the taxable event.

(2) *Extensions of correction period*. The correction period referred to in subparagraph (1) of this paragraph shall be extended by any period in which a deficiency cannot be assessed under section 6213(a). In addition, the correction period referred to in subparagraph (1) of this paragraph (e) shall be extended in accordance with subparagraph (3), (4), and (5) of this paragraph except that subparagraph (4), or (5) shall not operate to extend a correction period with respect to which a taxpayer has filed a petition with the United States Tax Court for redetermination of a deficiency within the time prescribed by section 6213(a).

(3) *Extensions by Commissioner*. The correction period referred to in subparagraph (1) of this paragraph may be extended by any period which the Commissioner determines is reasonable and necessary to bring about correction (including, for taxes imposed by section 4975, equitable relief sought by the Secretary of Labor) of the taxable event. The Commissioner ordinarily will not extend the correction period unless the following factors are present.

(i) The taxpayer on whom the second tier tax is imposed, the Secretary of Labor (for taxes imposed by section 4975), or an appropriate State officer (as defined in section 6104(c)(2)) is actively seeking in good faith to correct the taxable event;

(ii) Adequate corrective action cannot reasonably be expected to result during the unextended correction period;

(iii) For taxes imposed by section 4975, the Secretary of Labor requests the extension because subdivision (ii) applies; and

(iv) For taxes imposed by chapter 42 (other than taxes imposed by section 4940), the taxable event appears to have been an isolated occurrence so that it appears unlikely that similar taxable events will occur in the future.

(4) *Extension for payment of first tier tax*. If, within the unexpected correction period, the taxpayer pays the full amount of the first tier tax imposed with respect to the taxable event the Commissioner shall extend the correction period to the later of—

(i) Ninety days after the payment of the first tier tax, or

(ii) The last day of the correction period determined without regard to this paragraph.

(5) *Extensions for filing claim for refund or refund suit*. If prior to the expiration of the correction period (including extensions) a claim for refund is filed with respect to payment of the full amount of the first tier tax imposed with respect to the taxable event, the Commissioner shall extend the correction period during the pendency of the claim plus an additional 90 days. If within that time a suit or proceeding referred to in section 7422(g) with respect to the claim is filed, the Commissioner shall extend the correction period until the determination in the suit for refund (determined without regard to a supplemental proceeding under section 4861(b)) is final, determined under § 301.7422–2(a).

(6) *End of correction period if waiver accepted*. If the notice of deficiency referred to in paragraph (1) is not mailed because there is a waiver of the restrictions on assessment and collection of

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00305 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

the deficiency or because the deficiency is paid, the correction period will end with the end of the collection prohibition period described in § 53.4961–2(e)(5).

(7) *Date on which taxable event occurs.* For purposes of subparagraph (1), the taxable event shall be treated as occurring—

(i) Under section 4942, on the first day of the taxable year for which there is undistributed income,

(ii) Under section 4943, on the first day on which there are excess business holdings,

(iii) Under section 4971, on the last day of the plan year in which there is an accumulated funding deficiency, and

(iv) In all other cases, the date on which the event occurred.

(f) *Effective date.* The provisions of this subpart K are effective with respect to second tier taxes assessed after December 24, 1980. The preceding sentence shall not be construed to permit the assessment of a tax in a case to which, on December 24, 1980, the doctrine of res judicata applied.

[T.D. 8084, 51 FR 16303, May 2, 1986; 51 FR 17732, May 15, 1986, as amended by T.D. 8628, 60 FR 62212, Dec. 5, 1995; T.D. 8920, 66 FR 2171, Jan. 10, 2001; T.D. 9855, 84 FR 14009, Apr. 9, 2019]

§ 53.4965–1 Overview.

(a) *Entity-level excise tax.* Section 4965 imposes two excise taxes with respect to certain tax shelter transactions to which tax-exempt entities are parties. Section 4965(a)(1) imposes an entity-level excise tax on certain tax-exempt entities that are parties to ''prohibited tax shelter transactions,'' as defined in section 4965(e). *See* § 53.4965–2 for the discussion of covered tax-exempt entities. *See* § 53.4965–3 for the definition of prohibited tax shelter transactions. *See* § 53.4965–4 for the definition of tax-exempt party to a prohibited tax shelter transaction. The entity-level excise tax under section 4965(a)(1) is imposed on a specified percentage of the entity's net income or proceeds that are attributable to the transaction for the relevant tax year (or a period within that tax year). The rate of tax depends on whether the entity knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time the entity became a party to the transaction. *See* § 53.4965–7(a) for the discussion of the entity-level excise tax under section 4965(a)(1). *See* § 53.4965–6 for the discussion of ''knowing or having reason to know.'' *See* § 53.4965–8 for the definition of net income and proceeds and the standard for allocating net income and proceeds that are attributable to a prohibited tax shelter transaction to various periods.

(b) *Manager-level excise tax.* Section 4965(a)(2) imposes a manager-level excise tax on ''entity managers,'' as defined in section 4965(d), of tax-exempt entities who approve the entity as a party (or otherwise cause the entity to be a party) to a prohibited tax shelter transaction and know or have reason to know, at the time the tax-exempt entity enters into the transaction, that the transaction is a prohibited tax shelter transaction. *See* § 53.4965–5 for the definition of entity manager and the meaning of ''approving or otherwise causing,'' and § 53.4965–6 for the discussion of ''knowing or having reason to know.'' *See* § 53.4965–7(b) for the discussion of the manager-level excise tax under section 4965(a)(2).

(c) *Effective/applicability dates. See* § 53.4965–9 for the discussion of the relevant effective and applicability dates.

[T.D. 9492, 75 FR 38702, July 6, 2010]

§ 53.4965–2 Covered tax-exempt entities.

(a) *In general.* Under section 4965(c), the term ''tax-exempt entity'' refers to entities that are described in sections 501(c), 501(d), or 170(c) (other than the United States), Indian tribal governments (within the meaning of section 7701(a)(40)), and tax-qualified pension plans, individual retirement arrangements and similar tax-favored savings arrangements that are described in sections 4979(e)(1), (2) or (3), 529, 457(b), or 4973(a). The tax-exempt entities referred to in section 4965(c) are divided into two broad categories, non-plan entities and plan entities.

(b) *Non-plan entities.* Non-plan entities are—

(1) Entities described in section 501(c);

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(2) Religious or apostolic associations or corporations described in section 501(d);

(3) Entities described in section 170(c), including states, possessions of the United States, the District of Columbia, political subdivisions of states and political subdivisions of possessions of the United States (but not including the United States); and

(4) Indian tribal governments within the meaning of section 7701(a)(40).

(c) *Plan entities.* Plan entities are—

(1) Entities described in section 4979(e)(1) (qualified plans under section 401(a), including qualified cash or deferred arrangements under section 401(k) (including a section 401(k) plan that allows designated Roth contributions));

(2) Entities described in section 4979(e)(2) (annuity plans described in section 403(a));

(3) Entities described in section 4979(e)(3) (annuity contracts described in section 403(b), including a section 403(b) arrangement that allows Roth contributions);

(4) Qualified tuition programs described in section 529;

(5) Eligible deferred compensation plans under section 457(b) that are maintained by a governmental employer as defined in section 457(e)(1)(A);

(6) Arrangements described in section 4973(a) which include—

(i) Individual retirement plans defined in section 408(a) and (b), including—

(A) Simplified employee pensions (SEPs) under section 408(k);

(B) Simple individual retirement accounts (SIMPLEs) under section 408(p);

(C) Deemed individual retirement accounts or annuities (IRAs) qualified under a qualified plan (deemed IRAs) under section 408(q); and

(D) Roth IRAs under section 408A.

(ii) Arrangements described in section 220(d) (Archer Medical Savings Accounts (MSAs));

(iii) Arrangements described in section 403(b)(7) (custodial accounts treated as annuity contracts);

(iv) Arrangements described in section 530 (Coverdell education savings accounts); and

(v) Arrangements described in section 223(d) (health savings accounts (HSAs)).

(d) *Effective/applicability dates.* See §53.4965–9 for the discussion of the relevant effective and applicability dates.

[T.D. 9492, 75 FR 38702, July 6, 2010; 75 FR 46844, Aug. 4, 2010]

§ 53.4965–3 Prohibited tax shelter transactions.

(a) *In general.* Under section 4965(e), the term *prohibited tax shelter transaction* means—

(1) Listed transactions within the meaning of section 6707A(c)(2), including subsequently listed transactions described in paragraph (b) of this section; and

(2) Prohibited reportable transactions, which consist of the following reportable transactions within the meaning of section 6707A(c)(1)—

(i) Confidential transactions, as described in §1.6011–4(b)(3) of this chapter; or

(ii) Transactions with contractual protection, as described in §1.6011–4(b)(4) of this chapter.

(b) *Subsequently listed transactions.* A subsequently listed transaction for purposes of section 4965 is a transaction that is identified by the Secretary as a listed transaction after the tax-exempt entity has entered into the transaction and that was not a prohibited reportable transaction (within the meaning of section 4965(e)(1)(C) and paragraph (a)(2) of this section) at the time the entity entered into the transaction.

(c) *Cross-reference.* The determination of whether a transaction is a listed transaction or a prohibited reportable transaction for section 4965 purposes shall be made under the law applicable to section 6707A(c)(1) and (c)(2).

(d) *Effective/applicability dates.* See §53.4965–9 for the discussion of the relevant effective and applicability dates.

[T.D. 9492, 75 FR 38702, July 6, 2010]

§ 53.4965–4 Definition of tax-exempt party to a prohibited tax shelter transaction.

(a) *In general.* For purposes of sections 4965 and 6033(a)(2), a tax-exempt entity is a party to a prohibited tax shelter transaction if the entity—

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(1) Facilitates a prohibited tax shelter transaction by reason of its tax-exempt, tax indifferent or tax-favored status; or

(2) Is identified in published guidance, by type, class or role, as a party to a prohibited tax shelter transaction.

(b) Published guidance may identify which tax-exempt entities, by type, class or role, will not be treated as a party to a prohibited tax shelter transaction.

(c) *Example.* The following example illustrates the principle of paragraph (a)(1) of this section:

Example. A tax-exempt entity enters into a transaction (Transaction A) with an S corporation. Transaction A is the same as or substantially similar to the transaction identified by the Secretary as a listed transaction in Notice 2004–30 (2004–1 CB 828). The tax-exempt entity's role in Transaction A is similar to the role of the tax-exempt party, as described in Notice 2004–30. Under the terms of the transaction, as described in Notice 2004–30, the tax-exempt entity receives the S corporation stock and purports to aid the S corporation and its shareholders in avoiding taxable income. The tax-exempt entity facilitates Transaction A by reason of its tax-exempt, tax indifferent or tax-favored status. Accordingly, the tax-exempt entity is a party to Transaction A for purposes of sections 4965 and 6033(a)(2). *See* § 601.601(d)(2)(ii)(*b*) of this chapter.

(d) *Effective/applicability dates.* See § 53.4965–9 for the discussion of the relevant effective and applicability dates.

[T.D. 9492, 75 FR 38702, July 6, 2010]

§ 53.4965–5 Entity managers and related definitions.

(a) *Entity manager of a non-plan entity*—(1) *In general.* Under section 4965(d)(1), an *entity manager of a non-plan entity* is—

(i) A person with the authority or responsibility similar to that exercised by an officer, director, or trustee of an organization (that is, the non-plan entity); and

(ii) With respect to any act, the person who has final authority or responsibility (either individually or as a member of a collective body) with respect to such act.

(2) *Definition of officer.* For purposes of paragraph (a)(1)(i) of this section, a person is considered to be an officer of the non-plan entity (or to have similar authority or responsibility) if the person—

(i) Is specifically designated as such under the certificate of incorporation, by-laws, or other constitutive documents of the non-plan entity; or

(ii) Regularly exercises general authority to make administrative or policy decisions on behalf of the non-plan entity.

(3) *Exception for acts requiring approval by a superior.* With respect to any act, any person is not described in paragraph (a)(2)(ii) of this section if the person has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior.

(4) *Delegation of authority.* A person is an entity manager of a non-plan entity within the meaning of paragraph (a)(1)(ii) of this section if, with respect to any prohibited tax shelter transaction, such person has been delegated final authority or responsibility with respect to such transaction (including by transaction type or dollar amount) by a person described in paragraph (a)(1)(i) of this section or the governing board of the entity. For example, an investment manager is an entity manager with respect to a prohibited tax shelter transaction if the non-plan entity's governing body delegated to the investment manager the final authority to make certain investment decisions and, in the exercise of that authority, the manager committed the entity to the transaction. To be considered an entity manager of a non-plan entity within the meaning of paragraph (a)(1)(ii) of this section, a person need not be an employee of the entity. A person is not described in paragraph (a)(1)(ii) of this section if the person is merely implementing a decision made by a superior.

(b) *Entity manager of a plan entity*—(1) *In general.* Under section 4965(d)(2), an *entity manager of a plan entity* is the person who approves or otherwise causes the entity to be a party to the prohibited tax shelter transaction.

(2) *Special rule for plan participants and beneficiaries who have investment elections*—(i) *Fully self-directed plans or arrangements.* In the case of a fully self-directed qualified plan, IRA, or other savings arrangement (including a case

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where a plan participant or beneficiary is given a list of prohibited investments, such as collectibles), if the plan participant or beneficiary selected a certain investment and, therefore, approved the plan entity to become a party to a prohibited tax shelter transaction, the plan participant or the beneficiary is an entity manager.

(ii) *Plans or arrangements with limited investment options.* In the case of a qualified plan, IRA, or other savings arrangement where a plan participant or beneficiary is offered a limited number of investment options from which to choose, the person responsible for determining the pre-selected investment options is an entity manager and the plan participant or the beneficiary generally is not an entity manager.

(c) *Meaning of ''approves or otherwise causes''*—(1) *In general.* A person is treated as approving or otherwise causing a tax-exempt entity to become a party to a prohibited tax shelter transaction if the person has the authority to commit the entity to the transaction, either individually or as a member of a collective body, and the person exercises that authority.

(2) *Collective bodies.* If a person shares the authority described in paragraph (c)(1) of this section as a member of a collective body (for example, board of trustees or committee), the person will be considered to have exercised such authority if the person voted in favor of the entity becoming a party to the transaction. However, a member of the collective body will not be treated as having exercised the authority described in paragraph (c)(1) of this section if he or she voted against a resolution that constituted approval or an act that caused the tax-exempt entity to be a party to a prohibited tax shelter transaction, abstained from voting for such approval, or otherwise failed to vote in favor of such approval.

(3) *Exceptions*—(i) *Successor in interest.* If a tax-exempt entity that is a party to a prohibited tax shelter transaction is dissolved, liquidated, or merged into a successor entity, an entity manager of the successor entity will not, solely by reason of the reorganization, be treated as approving or otherwise causing the successor entity to become a party to a prohibited tax shelter transaction, provided that the reorganization of the tax-exempt entity does not result in a material change to the terms of the transaction. For purposes of this paragraph (c)(3)(i), a material change includes an extension or renewal of the agreement (other than an extension or renewal that results from another party to the transaction unilaterally exercising an option granted by the agreement) or a more than incidental change to any payment under the agreement. A change for the sole purpose of substituting the successor entity for the original tax-exempt party is not a material change.

(ii) *Exercise or nonexercise of options.* Nonexercise of an option pursuant to a transaction involving the tax-exempt entity generally will not constitute an act of approving or causing the entity to be a party to the transaction. If, pursuant to a transaction involving the tax-exempt entity, the entity manager exercises an option (such as a repurchase option), the entity manager will not be subject to the entity manager-level tax if the exercise of the option does not result in the tax-exempt entity becoming a party to a second transaction that is a prohibited tax shelter transaction.

(4) *Example.* The following example illustrates the principles of paragraph (c)(3)(ii) of this section:

Example. In a sale-in, lease-out (SILO) transaction described in Notice 2005–13 (2005–1 CB 630), X, which is a non-plan entity, has purported to sell property to Y, a taxable entity and lease it back for a term of years. At the end of the basic lease term, X has the option of ''repurchasing'' the property from Y for a predetermined purchase price, with funds that have been set aside at the inception of the transaction for that purpose. The entity manager, by deciding to exercise or not exercise the ''repurchase'' option is not approving or otherwise causing the non-plan entity to become a party to a second prohibited tax shelter transaction. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(5) *Coordination with the reason-to-know standard.* The determination that an entity manager approved or caused a tax-exempt entity to be a party to a prohibited tax shelter transaction, by itself, does not establish liability for the section 4965(a)(2) tax. For rules on determining whether an entity manager knew or had reason to know that

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the transaction was a prohibited tax shelter transaction, *see* § 53.4965–6(b).

(d) *Effective/applicability dates. See* § 53.4965–9 for the discussion of the relevant effective and applicability dates.

[T.D. 9492, 75 FR 38702, July 6, 2010; 75 FR 46844, Aug. 4, 2010]

§ 53.4965–6 Meaning of "knows or has reason to know".

(a) *Attribution to the entity.* An entity will be treated as knowing or having reason to know for section 4965 purposes if one or more of its entity managers knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time the entity manager(s) approved the entity as (or otherwise caused the entity to be) a party to the transaction. The entity shall be attributed the knowledge or reason to know of any entity manager described in § 53.4965–5(a)(1)(i) even if that entity manager does not approve the entity as (or otherwise cause the entity to be) a party to the transaction.

(b) *Determining whether an entity manager knew or had reason to know*—(1) *In general.* Whether an entity manager knew or had reason to know that a transaction is a prohibited tax shelter transaction is based on all facts and circumstances. In order for an entity manager to know or have reason to know that a transaction is a prohibited tax shelter transaction, the entity manager must have knowledge of sufficient facts that would lead a reasonable person to conclude that the transaction is a prohibited tax shelter transaction. An entity manager will be considered to have ''reason to know'' if a reasonable person in the entity manager's circumstances would conclude that the transaction was a prohibited tax shelter transaction based on all the facts reasonably available to the manager at the time of approving the entity as (or otherwise causing the entity to be) a party to the transaction. Factors that will be considered in determining whether a reasonable person in the entity manager's circumstances would conclude that the transaction was a prohibited tax shelter transaction include, but are not limited to—

(i) The presence of tax shelter indicia (see paragraph (b)(2) of this section);

(ii) Whether the entity manager received a disclosure statement prior to the consummation of the transaction indicating that the transaction may be a prohibited tax shelter transaction (see paragraph (b)(3) of this section); and

(iii) Whether the entity manager made appropriate inquiries into the transaction (see paragraph (b)(4) of this section).

(2) *Tax-shelter indicia.* The presence of indicia that a transaction is a tax shelter will be treated as an indication that the entity manager knew or had reason to know that the transaction was a prohibited tax shelter transaction. Tax shelter indicia include but are not limited to—

(i) The transaction is extraordinary for the entity considering prior investment activity;

(ii) The transaction promises an economic return for the organization that is exceptional considering the amount invested by, the participation of, or the absence of risk to the organization; or

(iii) The transaction is of significant size relative to the receipts of the entity.

(3) *Effect of disclosure statements.* Receipt by an entity manager of a statement, including a statement described in section 6011(g), in advance of a transaction that the transaction may be a prohibited tax shelter transaction (or a statement that a partnership, hedge fund or other investment conduit may engage in a prohibited tax shelter transaction in the future) is a factor relevant in the determination of whether the entity manager knew or had reason to know that the transaction is a prohibited transaction. However, an entity manager will not be treated as knowing or having reason to know that the transaction was a prohibited tax shelter transaction solely because the entity manager receives such a disclosure.

(4) *Appropriate inquiries.* What inquiries are appropriate will be determined from the facts and circumstances of each case. For example, if one or more tax shelter indicia are present or if an entity manager receives a disclosure statement described in paragraph (b)(3) of this section, an entity manager has a responsibility to inquire further

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whether the transaction is a prohibited tax shelter transaction.

(c) *Reliance on professional advice*—(1) *In general*. An entity manager is not required to obtain the advice of a professional tax advisor to establish that the entity manager made appropriate inquiries. Moreover, not seeking professional advice, by itself, shall not give rise to an inference that the entity manager had reason to know that a transaction is a prohibited tax shelter transaction.

(2) *Reliance on written opinion of professional tax advisor*. An entity manager may establish that he or she did not have a reason to know that a transaction was a prohibited tax shelter transaction at the time the tax-exempt entity entered into the transaction if the entity manager reasonably, and in good faith, relied on the written opinion of a professional tax advisor. Reliance on the written opinion of a professional tax advisor establishes that the entity manager did not have reason to know if, taking into account all the facts and circumstances, the reliance was reasonable and the entity manager acted in good faith. For example, the entity manager's education, sophistication, and business experience will be relevant in determining whether the reliance was reasonable and made in good faith. In no event will an entity manager be considered to have reasonably relied in good faith on an opinion unless the requirements of this paragraph (c)(2) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the entity manager reasonably relied on the opinion in good faith. For example, reliance may not be reasonable or in good faith if the entity manager knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) *All facts and circumstances considered*. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. The requirements of this paragraph (c)(2) are not satisfied if the entity manager fails to disclose a fact that it knows, or reasonably should know, is relevant to determining whether the transaction is a prohibited tax shelter transaction.

(ii) *No unreasonable assumptions*. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the entity manager or any other person (including another party to the transaction or a material advisor within the meaning of sections 6111 and 6112).

(iii) *''More likely than not'' opinion*. The written opinion of the professional tax advisor must apply the appropriate law to the facts and, based on this analysis, must conclude that the transaction was not a prohibited tax shelter transaction at a ''more likely than not'' level of certainty at the time the entity manager approved the entity (or otherwise caused the entity) to be a party to the transaction.

(3) *Special rule*. An entity manager's reliance on a written opinion of a professional tax advisor will not be considered reasonable if the advisor is, or is related to a person who is, a material advisor with respect to the transaction within the meaning of sections 6111 and 6112.

(d) *Subsequently listed transactions*. An entity manager will not be treated as knowing or having reason to know that a transaction (other than a prohibited reportable transaction as defined in section 4965(e)(1)(C) and § 53.4965–3(a)(2)) is a prohibited tax shelter transaction if the entity enters into the transaction before the date on which the transaction is identified by the Secretary as a listed transaction.

(e) *Effective/applicability dates*. See § 53.4965–9 for the discussion of the relevant effective and applicability dates.

[T.D. 9492, 75 FR 38702, July 6, 2010]

§ 53.4965–7 Taxes on prohibited tax shelter transactions.

(a) *Entity-level taxes*—(1) *In general*. Entity-level excise taxes apply to non-plan entities (as defined in § 53.4965–2(b)) that are parties to prohibited tax shelter transactions.

(i) *Prohibited tax shelter transactions other than subsequently listed transactions*—(A) *Amount of tax if the entity did not know and did not have reason to*

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know. If the tax-exempt entity did not know and did not have reason to know that the transaction was a prohibited tax shelter transaction at the time the entity entered into the transaction, the tax is the highest rate of tax under section 11 multiplied by the greater of—

(*1*) The entity's net income with respect to the prohibited tax shelter transaction (after taking into account any tax imposed by Subtitle D, other than by this section, with respect to such transaction) for the taxable year; or

(*2*) 75 percent of the proceeds received by the entity for the taxable year that are attributable to such transaction.

(B) *Amount of tax if the entity knew or had reason to know*. If the tax-exempt entity knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time the entity entered into the transaction, the tax is the greater of—

(*1*) 100 percent of the entity's net income with respect to the transaction (after taking into account any tax imposed by Subtitle D, other than by this section, with respect to such transaction) for the taxable year; or

(*2*) 75 percent of the proceeds received by the entity for the taxable year that are attributable to such transaction.

(ii) *Subsequently listed transactions*—(A) *In general*. In the case of a subsequently listed transaction (as defined in section 4965(e)(2) and § 53.4965–3(b)), the tax-exempt entity's income and proceeds attributable to the transaction are allocated between the period before the transaction became listed and the period beginning on the date the transaction became listed. See § 53.4965–8 for the standard for allocating net income or proceeds to various periods. The tax for each taxable year is the highest rate of tax under section 11 multiplied by the greater of—

(*1*) The entity's net income with respect to the subsequently listed transaction (after taking into account any tax imposed by Subtitle D, other than by this section, with respect to such transaction) for the taxable year that is allocable to the period beginning on the later of the date such transaction is identified by the Secretary as a listed transaction or the first day of the taxable year; or

(*2*) 75 percent of the proceeds received by the entity for the taxable year that are attributable to such transaction and allocable to the period beginning on the later of the date such transaction is identified by the Secretary as a listed transaction or the first day of the taxable year.

(B) *No increase in tax*. The 100 percent tax under section 4965(b)(1)(B) and § 53.4965–7(a)(1)(i)(B) does not apply to any subsequently listed transaction (as defined in section 4965(e)(2) and § 53.4965–3(b)) entered into by a tax-exempt entity before the date on which the transaction is identified by the Secretary as a listed transaction.

(2) *Taxable year*. The excise tax imposed under section 4965(a)(1) applies for the taxable year in which the entity becomes a party to the prohibited tax shelter transaction and any subsequent taxable year for which the entity has net income or proceeds attributable to the transaction. A taxable year for tax-exempt entities is the calendar year or fiscal year, as applicable, depending on the basis on which the tax-exempt entity keeps its books for Federal income tax purposes. If a tax-exempt entity has not established a taxable year for Federal income tax purposes, the entity's taxable year for the purpose of determining the amount and timing of net income and proceeds attributable to a prohibited tax shelter transaction will be deemed to be the annual period the entity uses in keeping its books and records.

(b) *Manager-level taxes*—(1) *Amount of tax*. If any entity manager approved or otherwise caused the tax-exempt entity to become a party to a prohibited tax shelter transaction and knew or had reason to know that the transaction was a prohibited tax shelter transaction, such entity manager is liable for the $20,000 tax. See § 53.4965–5(d) for the meaning of approved or otherwise caused. See § 53.4965–6 for the meaning of knew or had reason to know.

(2) *Timing of the entity manager tax*. If a tax-exempt entity enters into a prohibited tax shelter transaction during a taxable year of an entity manager, then the entity manager that approved

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or otherwise caused the tax-exempt entity to become a party to the transaction is liable for the entity manager tax for that taxable year if the entity manager knew or had reason to know that the transaction was a prohibited tax shelter transaction.

(3) *Example*. The application of paragraph (b)(2) of this section is illustrated by the following example:

Example. The entity manager's taxable year is the calendar year. On December 1, 2006, the entity manager approved or otherwise caused the tax-exempt entity to become a party to a transaction that the entity manager knew or had reason to know was a prohibited tax shelter transaction. The tax-exempt entity entered into the transaction on January 31, 2007. The entity manager is liable for the entity manager level tax for the entity manager's 2007 taxable year, during which the tax-exempt entity entered into the prohibited tax shelter transaction.

(4) *Separate liability*. If more than one entity manager approved or caused a tax-exempt entity to become a party to a prohibited tax shelter transaction while knowing (or having reason to know) that the transaction was a prohibited tax shelter transaction, then each such entity manager is separately (that is, not jointly and severally) liable for the entity manager-level tax with respect to the transaction.

(c) *Effective/applicability dates*. *See* §53.4965–9 for the discussion of the relevant effective and applicability dates.

[T.D. 9492, 75 FR 38702, July 6, 2010]

§ 53.4965–8 Definition of net income and proceeds and standard for allocating net income or proceeds to various periods.

(a) *In general*. For purposes of section 4965(a), the amount and the timing of the net income and proceeds attributable to the prohibited tax shelter transaction will be computed in a manner consistent with the substance of the transaction. In determining the substance of listed transactions, the IRS will look to, among other items, the listing guidance and any subsequent guidance published in the Internal Revenue Bulletin relating to the transaction.

(b) *Definition of net income and proceeds*—(1) *Net income*. A tax-exempt entity's net income attributable to a prohibited tax shelter transaction is its gross income derived from the transaction reduced by those deductions that are attributable to the transaction and that would be allowed by chapter 1 of the Internal Revenue Code if the tax-exempt entity were treated as a taxable entity for this purpose, and further reduced by taxes imposed by Subtitle D, other than by this section, with respect to the transaction.

(2) *Proceeds*—(i) *Tax-exempt entities that facilitate the transaction by reason of their tax-exempt, tax indifferent or tax-favored status*. Solely for purposes of section 4965, in the case of a tax-exempt entity that is a party to the transaction by reason of §53.4965–4(a)(1) of this chapter, the term *proceeds* means the gross amount of the tax-exempt entity's consideration for facilitating the transaction, not reduced for any costs or expenses attributable to the transaction. Published guidance with respect to a particular prohibited tax shelter transaction may designate additional amounts as proceeds from the transaction for section 4965 purposes.

(ii) *Treatment of gifts and contributions*. To the extent not otherwise included in the definition of proceeds in paragraph (b)(2)(i) of this section, any amount that is a gift or a contribution to a tax-exempt entity and is attributable to a prohibited tax shelter transaction will be treated as proceeds for section 4965 purposes, unreduced by any associated expenses.

(c) *Allocation of net income and proceeds*—(1) *In general*. For purposes of section 4965(a), the net income and proceeds attributable to a prohibited tax shelter transaction must be allocated in a manner consistent with the tax-exempt entity's established method of accounting for Federal income tax purposes. If the tax-exempt entity has not established a method of accounting for Federal income tax purposes, solely for purposes of section 4965(a) the tax-exempt entity must use the cash receipts and disbursements method of accounting (cash method) provided for in section 446 of the Internal Revenue Code to determine the amount and timing of net income and proceeds attributable to a prohibited tax shelter transaction.

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(2) *Special rule.* If a tax-exempt entity has established a method of accounting other than the cash method, the tax-exempt entity may nevertheless use the cash method of accounting to determine the amount of the net income and proceeds—

(i) Attributable to a prohibited tax shelter transaction entered into prior to the effective date of section 4965(a) tax and allocable to pre- and post-effective date periods; or

(ii) Attributable to a subsequently listed transaction and allocable to pre- and post-listing periods.

(d) *Transition year rules.* In the case of the taxable year that includes August 16, 2006 (the transition year), the IRS will treat the period beginning on the first day of the transition year and ending on August 15, 2006, and the period beginning on August 16, 2006, and ending on the last day of the transition year as short taxable years. This treatment is solely for purposes of allocating net income or proceeds under section 4965. The tax-exempt entity continues to file tax returns for the full taxable year, does not file tax returns with respect to these deemed short taxable years and does not otherwise take the short taxable years into account for Federal tax purposes. Accordingly, the net income or proceeds that are properly allocated to the transition year in accordance with this section will be treated as allocable to the period—

(1) Ending on or before August 15, 2006 (and accordingly not subject to tax under section 4965(a)) to the extent such net income or proceeds would have been properly taken into account in accordance with this section by the tax-exempt entity in the deemed short year ending on August 15, 2006; and

(2) Beginning after August 15, 2006 (and accordingly subject to tax under section 4965(a)) to the extent such income or proceeds would have been properly taken into account in accordance with this section by the tax-exempt entity in the short year beginning August 16, 2006.

(e) *Allocation to pre- and post-listing periods.* If a transaction other than a prohibited reportable transaction (as defined in section 4965(e)(1)(C) and § 53.4965–3(a)(2)) to which the tax-exempt entity is a party is subsequently identified in published guidance as a listed transaction during a taxable year of the entity (the listing year) in which it has net income or proceeds attributable to the transaction, the net income or proceeds are allocated between the pre- and post-listing periods. The IRS will treat the period beginning on the first day of the listing year and ending on the day immediately preceding the date of the listing, and the period beginning on the date of the listing and ending on the last day of the listing year as short taxable years. This treatment is solely for purposes of allocating net income or proceeds under section 4965. The tax-exempt entity continues to file tax returns for the full taxable year, does not file tax returns with respect to these deemed short taxable years and does not otherwise take the short taxable years into account for Federal tax purposes. Accordingly, the net income or proceeds that are properly allocated to the listing year in accordance with this section will be treated as allocable to the period—

(1) Ending before the date of the listing (and accordingly not subject to tax under section 4965(a)) to the extent such net income or proceeds would have been properly taken into account in accordance with this section by the tax-exempt entity in the deemed short year ending on the day immediately preceding the date of the listing; and

(2) Beginning on the date of the listing (and accordingly subject to tax under section 4965(a)) to the extent such income or proceeds would have been properly taken into account in accordance with this section by the tax-exempt entity in the short year beginning on the date of the listing.

(f) *Examples.* The following examples illustrate the allocation rules of this section:

Example 1. (i) In 1999, X, a calendar year non-plan entity using the cash method of accounting, entered into a lease-in/lease-out transaction (LILO) substantially similar to the transaction described in Notice 2000–15 (2000–1 CB 826) (describing Rev. Rul. 99–14 (1999–1 CB 835), superseded by Rev. Rul. 2002–69 (2002–2 CB 760)). In 1999, X purported to lease property to Y pursuant to a ''head lease,'' and Y purported to lease the property back to X pursuant to a ''sublease'' of a

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shorter term. In form, X received $268M as an advance payment of head lease rent. Of this amount, $200M had been, in form, financed by a nonrecourse loan obtained by Y. X deposited the $200M with a ''debt payment undertaker.'' This served to defease both a portion of X's rent obligation under its sublease and Y's repayment obligation under the nonrecourse loan. Of the remainder of the $268M advance head lease rent payment, X deposited $54M with an ''equity payment undertaker.'' This served to defease the remainder of X's rent obligation under the sublease as well as the exercise price of X's end-of-sublease term purchase option. This amount inures to the benefit of Y and enables Y to recover its investment in the transaction and a return on that investment. In substance, the $54M is a loan from Y to X. X retained the remaining $14M of the advance head lease rent payment. In substance, this represents a fee for X's participation in the transaction. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(ii) According to the substance of the transaction, the head lease, sublease and nonrecourse debt will be ignored for Federal income tax purposes. Therefore, any net income or proceeds resulting from these elements of the transaction will not be considered net income or proceeds attributable to the LILO transaction for purposes of section 4965(a). The $54M deemed loan from Y to X and the $14M fee are not ignored for Federal income tax purposes.

(iii) Under X's established cash basis method of accounting, any net income received in 1999 and attributable to the LILO transaction is allocated to X's December 31, 1999, tax year for purposes of section 4965. The $14M fee received in 1999, which constitutes proceeds of the transaction, is likewise allocated to that tax year. Because the 1999 tax year is before the effective date of the section 4965 tax, X will not be subject to any excise tax under section 4965 for the amounts received in 1999.

(iv) Any earnings on the amount deposited with the equity payment undertaker that constitute gross income to X will be reduced by X's original issue discount deductions with respect to the deemed loan from Y, in determining X's net income from the transaction.

Example 2. B, a non-plan entity using the cash method of accounting, has an annual accounting period that ends on December 31, 2006. B entered into a prohibited tax shelter transaction on March 15, 2006. On that date, B received a payment of $600,000 as a fee for its involvement in the transaction. B received no other proceeds or income attributable to this transaction in 2006. Under B's method of accounting, the payment received by B on March 15, 2006, is taken into account in the deemed short year ending on August 15, 2006. Accordingly, solely for purposes of section 4965, the payment is treated as allocable solely to the period ending on or before August 15, 2006, and is not subject to the excise tax imposed by section 4965(a).

Example 3. The facts are the same as in *Example 2*, except that B received an additional payment of $400,000 on September 30, 2006. Under B's method of accounting, the payment received by B on September 30, 2006, is taken into account in the deemed short year beginning on August 16, 2006. Accordingly, solely for purposes of section 4965, the $400,000 payment is treated as allocable to the period beginning after August 15, 2006, and is subject to the excise tax imposed by section 4965(a).

Example 4. C, a non-plan entity using the cash method of accounting, has an annual accounting period that ends on December 31. C entered into a prohibited tax shelter transaction on May 1, 2005. On March 15, 2007, C received a payment of $580,000 attributable to the transaction. On June 1, 2007, the transaction is identified by the IRS in published guidance as a listed transaction. On June 15, 2007, C received an additional payment of $400,000 attributable to the transaction. Under C's method of accounting, the payments received on March 15, 2007, and June 15, 2007, are taken into account in 2007. The IRS will treat the period beginning on January 1, 2007, and ending on May 31, 2007, and the period beginning on June 1, 2007, and ending on December 31, 2007, as short taxable years. The payment received by C on March 15, 2007, is taken into account in the deemed short year ending on May 31, 2007. Accordingly, solely for purposes of section 4965, the payment is treated as allocable solely to the pre-listing period, and is not subject to the excise tax imposed by section 4965(a). The payment received by C on June 15, 2007, is taken into account in the deemed short year beginning on June 1, 2007. Accordingly, solely for purposes of section 4965, the payment is treated as allocable to the post-listing period, and is subject to the excise tax imposed by section 4965(a).

(g) *Effective/applicability dates*. See § 53.4965–9 for the discussion of the relevant effective and applicability dates.

[T.D. 9492, 75 FR 38702, July 6, 2010; 75 FR 46844, Aug. 4, 2010]

§ 53.4965–9 Effective/applicability dates.

(a) *In general*. The taxes under section 4965(a) and § 53.4965–7 are effective for taxable years ending after May 17, 2006, with respect to transactions entered into before, on or after that date, except that no tax under section 4965(a) applies with respect to income or proceeds that are properly allocable to

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any period ending on or before August 15, 2006.

(b) *Applicability of the regulations.* As of July 6, 2010, except as provided in paragraph (c) of this section, §§ 53.4965–1 through 53.4965–8 of this chapter will apply to taxable years ending after July 6, 2007. A tax-exempt entity may rely on the provisions of §§ 53.4965–1 through 53.4965–8 for taxable years ending on or before July 6, 2007.

(c) *Effective/applicability date with respect to certain knowing transactions*—(1) *Entity-level tax.* The 100 percent tax under section 4965(b)(1)(B) and § 53.4965–7(a)(1)(i)(B) does not apply to prohibited tax shelter transactions entered into by a tax-exempt entity on or before May 17, 2006.

(2) *Manager-level tax.* The IRS will not assert that an entity manager who approved or caused a tax-exempt entity to become a party to a prohibited tax shelter transaction is liable for the entity manager tax under section 4965(b)(2) and § 53.4965–7(b)(1) with respect to the transaction if the tax-exempt entity entered into such transaction prior to May 17, 2006.

[T.D. 9492, 75 FR 38702, July 6, 2010]

§ 53.4968–1 Excise tax based on investment income of certain private colleges and universities.

(a) *Excise tax on the investment income of certain private colleges and universities.* For taxable years beginning after December 31, 2017, section 4968 of the Internal Revenue Code (Code) imposes a tax equal to 1.4 percent of the net investment income (as defined in section 4968(c) and § 53.4968–2) of an applicable educational institution (as defined in section 4968(b)(1) and paragraph (b)(1) of this section).

(b) *Definitions.* The definitions in this paragraph (b) apply for purposes of section 4968 and §§ 53.4968–1 through 53.4968–4.

(1) *Applicable educational institution.* The term *applicable educational institution* means any eligible educational institution (as defined in section 25A(f)(2) of the Code and § 1.25A–2(b) of this chapter)—

(i) That had at least 500 tuition-paying students during the preceding taxable year;

(ii) More than 50 percent of whose tuition-paying students are located in the United States;

(iii) That is not described in the first sentence of section 511(a)(2)(B) of the Code (relating to state colleges and universities); and

(iv) The aggregate fair market value of the assets of which at the end of such preceding taxable year (other than those assets that are used directly in carrying out the institution's exempt purpose) is at least $500,000 per student.

(2) *Student.* The term *student* means a person who is enrolled and attending a course for academic credit from the institution and who is being charged tuition at a rate that is commensurate with the tuition rate charged to students enrolled for a degree. The number of students of an educational institution (including for purposes of determining the number of students at a particular location) is based on the daily average number of full-time students (with part-time students taken into account on a full-time student equivalent basis). The standards for determining part-time students, full-time students, full-time equivalents, and daily average are determined by each educational institution. However, the standards may not be lower than the minimum applicable standards established by the Department of Education under the Higher Education Act of 1965 (20 U.S.C. 1088), as amended.

(3) *Tuition-paying*—(i) *In general.* The term *tuition-paying* means the payment of any tuition or fees required for the enrollment or attendance of a student for a course of instruction at an educational institution. Tuition and fees do not include payment for supplies or equipment required during a specific course once a student is enrolled in and attending the course, or payment for room and board or other personal living expenses.

(ii) *Treatment of a comprehensive or bundled fee.* If a student is required to pay a fee (such as a comprehensive fee or a bundled fee) to an educational institution that combines charges for tuition with charges for personal expenses such as room and board, the student is a tuition-paying student.

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(iii) *Scholarships, grants, and work study programs*. Whether a student is tuition-paying is determined after taking into account any scholarships and grants provided directly by the educational institution or by the Federal government or any state or local government, and after application of any work study programs operated directly by the institution. Scholarships and grants provided by non-governmental third parties, even if administered by the institution, are considered payments of tuition on behalf of the student. Accordingly, a student will be considered a tuition-paying student if payment of tuition or a fee is required for the enrollment or attendance of the student for courses of instruction after the application of any scholarships offered directly by the institution, any work study program operated directly by the institution, and any grants and scholarships provided by the Federal government or any state or local government.

(4) *Located in the United States*. A student is *located in the United States* if the student resided in the United States for at least a portion of the time the student attended the educational institution during the institution's preceding taxable year. Whether a student resided in the United States in any given year can be determined using any reasonable method, as long as that method is consistently applied.

(5) *Assets used directly in carrying out an institution's exempt purpose*—(i) *In general*. Except as provided in paragraph (b)(5)(iv) of this section, an asset is *used directly in carrying out an educational institution's exempt purpose* only if the asset is actually used directly by the institution in carrying out its exempt purpose. Whether an asset is used directly by the institution to carry out its exempt purpose is determined based on all the facts and circumstances. If property is used for an exempt purpose and for other purposes, and the exempt use represents 95 percent or more of the total use, the property is considered to be used exclusively for an exempt purpose. If the exempt use of such property represents less than 95 percent of the total use, the institution must make a reasonable allocation between such exempt and nonexempt uses.

(ii) *Illustrations*. Examples of assets that are used directly in carrying out an institution's exempt purpose include, but are not limited to, the following—

(A) Administrative assets, such as office equipment and supplies used by the institution directly in the administration of its exempt activities;

(B) Real estate or the portion of any building used by the institution directly in its exempt activities;

(C) Physical property such as paintings or other works of art owned by the institution that are on public display (or held for public display), fixtures and equipment in classrooms, research facilities and related equipment that under the facts and circumstances serve a useful purpose in the conduct of the institution's exempt activities;

(D) The reasonable cash balance, determined using any reasonable method, necessary to cover current operating and administrative expenses and other normal and current disbursements directly connected with the educational institution's exempt activities. For this purpose, a reasonable method would include calculating an amount equal to three months of operating expenses allocable to program services, calculated by dividing annual functional expenses allocable to program services by four. A larger amount may be a reasonable cash balance for this purpose if, under the facts and circumstances, a larger amount is established to be necessary to cover administrative expenses and other normal disbursements directly connected with the institution's exempt activity.

(E) Any property the educational institution leases to other persons at no cost (or at a nominal rent) to the lessee in furtherance of the institution's exempt purposes; and

(F) Patents, copyrights, and other intellectual property and intangible property to the extent that income from those assets is excluded from net investment income by § 53.4968–2(b)(2)(iii).

(iii) *Assets not used directly*. The following assets are examples of assets not used directly in carrying out an institution's exempt purpose—

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(A) Assets that are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or leased real estate not described in paragraph (b)(5)(ii)(E) of this section), even if the income from such assets is used to carry out such exempt purpose; and

(B) Property (such as offices and equipment) used for the purpose of managing the institution's endowment funds.

(iv) *Assets of related organizations.* An asset of a related organization that is treated as an asset of an educational institution by section 4968(d) and § 53.4968–3(c) and that is used directly in carrying out an educational institution's exempt purpose, or that is used directly in carrying out the exempt purpose of a related organization that is described in section 501(c)(3), is considered used directly by the educational institution in carrying out its exempt purpose.

(v) *Valuation of assets not used directly in carrying out an institution's exempt purpose*—(A) *In general.* The values of assets not used directly in carrying out an educational institution's exempt purpose are determined under the rules of section 4942(e) and § 53.4942(a)–2(c)(4), as modified by paragraph (b)(5)(v)(B) of this section.

(B) *Modifications.* In applying the rules of § 53.4942(a)–2(c)(4), an educational institution must—

(*1*) Substitute ''educational institution'' for ''private foundation'' or ''foundation'' every place they appear; and

(*2*) Make such adjustments as are reasonable and necessary to obtain the fair market value of any and all assets as of the last day of the preceding taxable year, rather than as of any other times permitted or required by § 53.4942(a)–2(c)(4).

[T.D 9917, 85 FR 65557, Oct. 15, 2020]

§ 53.4968–2 Net investment income.

(a) *Net investment income*—(1) *In general.* For taxable years beginning after December 31, 2017, section 4968(a) of the Internal Revenue Code (Code) imposes a 1.4 percent excise tax on the net investment income (as defined in section 4968(c) and this section) of an applicable educational institution and on certain amounts of net investment income of certain related organizations, as described in section 4968(d) and § 53.4968–3. For purposes of this section, net investment income is determined under rules similar to the rules of section 4940(c) of the Code. Thus, net investment income generally is the amount by which the sum of the gross investment income (as defined in paragraph (b) of this section) and the capital gain net income (as defined in paragraph (d) of this section) exceeds the deductions allowed by paragraph (c) of this section. Except to the extent inconsistent with the provisions of this section, net investment income is determined under the principles of subtitle A of the Code.

(2) *Tax-exempt income.* For purposes of this section, net investment income is determined by applying section 103 of the Code (relating to State and local bonds) and section 265 of the Code (relating to expenses and interest relating to tax-exempt income).

(b) *Gross investment income*—(1) *In general.* For purposes of this section and except as provided in paragraph (b)(2) of this section, the term *gross investment income* means the gross amounts of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5) of the Code), and royalties, but not including any such income to the extent included in computing the tax imposed by section 511 of the Code. Such term also includes income from sources similar to those in the preceding sentence. In general, gross investment income includes the items of investment income described in § 1.512(b)–1(a) of this chapter.

(2) *Exceptions.* The following items of income are excluded from the definition of gross investment income:

(i) Interest income from a student loan that was made by the applicable educational institution or a related organization to a student of the applicable educational institution in connection with the student's attendance at the institution;

(ii) Rental income from the provision of housing by the applicable educational institution or a related organization to students of the applicable

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educational institution and from housing for faculty and staff if the housing is provided contingent on their roles as faculty or staff of the applicable educational institution; and

(iii) Royalty income that is derived from patents, copyrights, and other intellectual property and intangible property to the extent those assets resulted from the work of student(s) or faculty member(s) in their capacities as such with the applicable educational institution. However, neither royalty income from trademarks on the institution's logo or name nor royalty income from intellectual property donated or sold to the institution is excluded from gross investment income under this rule.

(c) *Deductions*—(1) *In general*. For purposes of computing net investment income—

(i) There is allowed as a deduction from gross investment income all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income, determined with the modifications set forth in paragraph (c)(2) of this section. Taxes paid or incurred under section 4968 are not paid or incurred for the production or collection of gross investment income. Allowable expenses include that portion of an applicable educational institution's operating expenses that is paid or incurred for the production or collection of gross investment income. An applicable educational institution's operating expenses include compensation of officers, other salaries and wages of employees, outside professional fees, interest, and rent and taxes on property used in the applicable educational institution's operations. Where an applicable educational institution's officers or employees engage in activities on behalf of the institution for both activities that generate net investment income and for activities that do not generate net investment income, compensation and salaries paid to such officers or employees must be allocated between the activities that generate net investment income and for activities that do not generate net investment income.

(ii) Where only a portion of property produces, or is held for the production of, income subject to the section 4968 excise tax, and the remainder of the property is used for other purposes, the deductions allowed by this paragraph must be apportioned between the taxable and other uses.

(iii) No amount is allowable as a deduction under this section to the extent it is paid or incurred for purposes other than those described in paragraph (c)(1)(i) of this section. Thus, for example, the charitable deductions prescribed under sections 170 and 642(c) of the Code; the net operating loss deduction prescribed under section 172; and the special deductions prescribed under part VIII of subchapter B of chapter 1 of the Code are not allowable.

(2) *Deduction modifications*. The following modifications must be made in determining deductions otherwise allowable under this paragraph (c):

(i) The depreciation deduction is allowed, but only on the basis of the straight-line method provided in section 168(b)(3) and without regard to section 168(b)(1) and (2).

(ii) The depletion deduction is allowed, but such deduction is determined without regard to sections 613 and 613A of the Code, relating to percentage depletion.

(iii) The basis to be used for purposes of the deduction allowed for depreciation or depletion is the basis determined under the rules of part II of subchapter O of chapter 1 of the Code (part II of subchapter O), subject to the modifications found in paragraphs (c)(2)(i) and (ii) of this section (relating to depreciation and depletion), and without regard to §53.4968–2(d)(2) (relating to the basis for determining gain for property held on December 31, 2017, and continuously thereafter to the date of disposition), or section 362(c) of the Code (relating to certain special basis rules regarding contributions of capital to corporations). Thus, an applicable educational institution must reduce the cost or other substituted or transferred basis by an amount equal to the straight-line depreciation or cost depletion, without regard to whether the applicable educational institution deducted such depreciation or depletion

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during the period prior to its first taxable year beginning after December 31, 2017. However, where an applicable educational institution has previously taken depreciation or depletion deductions in excess of the amount which would have been taken had the straight-line or cost method been employed, such excess depreciation or depletion also is taken into account to reduce basis. If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to the applicable educational institution, then the original basis to the applicable educational institution of such property is determined under the rules of § 1.1015–1(a)(3) of this chapter.

(iv) The deduction for expenses paid or incurred in any taxable year for the production of gross investment income earned as an incident to a charitable function can be no greater than the income earned from such function which is includible as gross investment income for such year. For example, where rental income incidentally is realized in a year from historic buildings held open to the public, deductions for amounts paid or incurred in that year for the production of such income is limited to the amount of rental income includible as gross investment income for the year.

(d) *Capital gains and losses*—(1) *In general.* In determining capital gain net income for purposes of the tax imposed by section 4968—

(i) *Interaction with section 511.* No gain or loss from the sale or other disposition of property is taken into account to the extent that such gain or loss is taken into account for purposes of computing the tax imposed by section 511.

(ii) *Sales or other dispositions of exempt use property.* To the extent that property is used by the educational institution for its exempt purposes, capital gain from the sale or exchange of the portion of that property that is used by the educational institution for its exempt purposes is disregarded;

(iii) *Sales of donated property*—(A) *In general.* Any appreciation in the value of donated property that occurred prior to the date of its donation to the institution is disregarded.

(B) *Date of donation.* The date of donation is determined under the timing rules of § 1.170A–1(b) of this chapter.

(C) *Value on the date of donation.* The value of the donated property on the date of donation is determined under the valuation rules of § 1.170A–1(c) of this chapter; and

(iv) *Capital losses.* Net losses from sales or other dispositions of property by one related organization (or by the applicable educational institution) reduce (but not below zero) net gains from such sales or other dispositions by other related organizations (or by the applicable educational institution). Should overall net losses from sales or other dispositions of property exceed gains from sales or other dispositions of such property during the same taxable year, such excess may not be deducted from gross investment income in any taxable year, nor may such excess be used to reduce gains in prior taxable years. However, capital loss carryovers are allowed and may be deducted from capital gains in a future year.

(2) *Basis*—(i) *For purposes of calculating gain from the sale or other disposition of property other than a partnership interest.* Subject to the modifications of paragraphs (c)(2)(i) and (ii) of this section (referring to the modifications relating to deductions against gross investment income) and without regard to section 362(c), the basis for purposes of determining gain from the sale or other disposition of property (other than a partnership interest) for purposes of determining capital gain net income for purposes of the tax imposed by section 4968 is the greater of—

(A) Fair market value on December 31, 2017, plus or minus all adjustments after December 31, 2017, and before the date of disposition under the rules of part II of subchapter O, provided that the property was held by the applicable educational institution on December 31, 2017, and continuously thereafter to the date of disposition, or

(B) Basis as determined under the rules of part II of subchapter O.

(ii) *For purposes of determining a distributive share of gain from the sale or other disposition of a partnership asset.*

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For purposes of determining an applicable educational institution's share of gain upon the sale or other disposition of a partnership asset, the applicable educational institution's basis in each such partnership asset generally is determined under the rules of subchapter K of chapter 1 of the Code (subchapter K). However, see paragraph (d)(3) of this section.

(iii) *For purposes of determining gain on the sale or other disposition of a partnership interest.* For purposes of determining an applicable educational institution's gain upon the sale or other disposition of all or a portion of a partnership interest, the applicable educational institution's basis in such partnership interest is generally determined under the rules of subchapter K, subject to the special rules in paragraph (d)(3) of this section.

(iv) *For purposes of calculating loss.* Subject to the modifications of paragraphs (c)(2)(i) and (ii) of this section (referring to the modifications relating to deductions against gross investment income) and without regard to section 362(c), basis as determined in paragraph (d)(2)(i)(B) of this section applies for purposes of determining loss. For purposes of determining loss from the sale or other disposition of a partnership interest, basis is determined under the rules of subchapter K.

(3) *Special rules regarding partnership interests and partnership assets*—(i) *Reduction of distributive share of capital gain net income from a partnership.* For purposes of computing net investment income, an applicable educational institution reduces the amount of its distributive share of capital gain net income from a partnership by the least of—

(A) The applicable educational institution's share of applicable capital gain (as defined in paragraph (d)(3)(iii)(A) of this section) from such partnership;

(B) One-third of the applicable educational institution's unadjusted step-up (as defined in paragraph (d)(3)(iii)(B) of this section) for such partnership; or

(C) The applicable educational institution's adjusted step-up (as defined in paragraph (d)(3)(iii)(C) of this section) for such partnership.

(ii) *Reduction of capital gain net income from a sale or other disposition of all or a portion of a partnership interest.* For purposes of computing net investment income, an applicable educational institution reduces the amount of its capital gain net income upon the sale or other disposition of all or a portion of a partnership interest by an amount that bears the same relation to the applicable educational institution's adjusted step-up (as defined in paragraph (d)(3)(iii)(C) of this section) for such partnership as the fair market value of the transferred portion of the interest bears to the fair market value of the applicable educational institution's entire interest in such partnership before the sale or other disposition.

(iii) *Definitions.* For purposes of this section—

(A) *Applicable capital gain.* For an applicable educational institution's first taxable year beginning after December 31, 2017, the term *applicable capital gain* means an applicable educational institution's share of both short-term and long-term capital gains and losses subject to section 4968 from a partnership. For subsequent taxable years, applicable capital gain does not include an applicable educational institution's share of short-term capital gains and losses subject to section 4968 from a partnership. For purposes of this paragraph, applicable capital gain is not less than zero.

(B) *Unadjusted step-up.* An applicable educational institution computes an *unadjusted step-up* for each partnership interest it held on December 31, 2017. The unadjusted step-up for a partnership interest equals the excess, if any, of the fair market value of such partnership interest on December 31, 2017, over the adjusted basis of such partnership interest on December 31, 2017.

(C) *Adjusted step-up.* An applicable educational institution computes an *adjusted step-up* for each partnership interest it held on December 31, 2017. The adjusted step-up for a partnership interest equals the unadjusted step-up for such partnership, reduced by the amount of any capital gain net income reduction pursuant to paragraphs (d)(3)(i) and (ii) of this section for such partnership.

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(4) *Examples*. The following examples illustrate paragraph (d)(3) of this section. Unless stated otherwise in the examples, partners have no tax items other than those listed in the example. With respect to partnerships, all allocations are in accordance with section 704(b) and the regulations under section 704(b) in part 1 of this chapter (Income Tax Regulations).

(i) *Example 1*—(A) *Facts*. University (U), an applicable educational institution, is a partner in partnership PRS. On December 31, 2017, U's PRS interest had a fair market value of $130 and tax basis of $100. In 2018, U's share of capital gain net income from PRS is $5, which is comprised of $20 of gain from the sale of capital asset X and ($15) of loss from the sale of capital asset Y. Further, such $5 of capital gain net income is applicable capital gain (as defined in paragraph (d)(3)(iii)(A) of this section).

(B) *Analysis*. U has an unadjusted step-up (as defined in paragraph (d)(3)(iii)(B) of this section) for PRS of $30 ($130 fair market value − $100 tax basis on December 31, 2017). Pursuant to paragraph (d)(3)(i) of this section, for purposes of computing its net investment income, U reduces the amount of its capital gain net income from PRS by $5, which is the least of: U's share of applicable capital gain from PRS ($5); or one-third of U's unadjusted step-up for PRS ($10); or U's adjusted step-up for PRS ($30). Thus, U reduces its $5 of capital gain net income allocated from PRS by $5, resulting in U having $0 of capital gain net income in 2018 for purposes of section 4968. As a result, U's adjusted step-up for PRS for subsequent taxable years is reduced to $25 ($30 − $5) pursuant to paragraph (d)(4)(iii)(C) of this section. Pursuant to section 705, the $5 of gain allocated to U increases U's tax basis in its PRS interest to $105.

(ii) *Example 2*—(A) *Facts*. The facts are the same as in paragraph (d)(4)(i)(A) of this section (Example 1). In 2019, U sells its entire interest in PRS for $130, which, immediately prior to the sale, had a tax basis of $105. As a result, U has $25 of capital gain from the sale of its PRS interest.

(B) *Analysis*. Pursuant to paragraph (d)(3)(iii) of this section, for purposes of computing its net investment income, U reduces its capital gain net income resulting from the sale of its entire PRS interest by $25, which is the amount that bears the same relation to U's adjusted step-up for PRS ($25) as the fair market value of the transferred portion of PRS ($130) bears to the fair market value of the U's entire interest in PRS before the sale or other disposition ($130). Thus, U reduces its $25 of capital gain net income from the sale of its PRS interest by $25, resulting in U having $0 of capital gain net income in 2019 for purposes of section 4968.

(iii) *Example 3*—(A) *Facts*. The facts are the same as in paragraph (d)(4)(i)(A) of this section (Example 1). In 2019, U's share of capital gain net income from PRS is $15, which is comprised of $15 of gain from the sale of capital asset Z. Further, such $15 of capital gain net income is applicable capital gain (as defined in paragraph (d)(3)(iii)(A) of this section).

(B) *Analysis*. Pursuant to paragraph (d)(3)(i) of this section, for purposes of computing its net investment income, U reduces the amount of its capital gain net income from PRS by $10, which is the least of: U's share of applicable capital gain from PRS ($15); or one-third of U's unadjusted step-up for PRS ($10); or U's adjusted step-up for PRS ($25, computed as $30 of unadjusted step-up, less $5 of capital gain net income reduced in 2018 pursuant to paragraph (d)(3)(i) of this section). Thus, U reduces its $15 of capital gain net income allocated from PRS by $10, resulting in U having $5 of capital gain net income in 2019 for purposes of section 4968. As a result, U's adjusted step-up for PRS is reduced for subsequent taxable years to $15 ($25 − $10) pursuant to paragraph (d)(3)(iii)(C) of this section. Pursuant to section 705, the $15 of gain allocated to U increases U's tax basis in its PRS interest to $120.

[T.D 9917, 85 FR 65557, Oct. 15, 2020]

§ 53.4968–3 Related organizations.

(a) *Definition of related organization*—(1) *In general*. For purposes of section 4968(d) of the Internal Revenue Code (Code) and §§ 53.4968–1 through 53.4968–4, except as provided in paragraph (a)(2)

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of this section, the term *related organization* means, with respect to an educational institution, any organization that—

(i) Controls such institution;

(ii) Is controlled by such institution;

(iii) Is controlled by one or more persons that also control such institution;

(iv) Is a supported organization (as defined in section 509(f)(3) of the Code) with respect to such institution during the taxable year; or

(v) Is a supporting organization (as described in section 509(a)(3)) with respect to such institution during the taxable year.

(2) *Organizations not considered related organizations.* For purposes of section 4968(d) and §§ 53.4968–1 through 53.4968–4, the term *related organization* does not include any organization that is—

(i) A taxable corporation;

(ii) A taxable trust, including a nongrantor charitable lead trust (except to the extent the trust is controlled by the educational institution as described in paragraph (b)(2)(ii) of this section);

(iii) A grantor charitable lead trust;

(iv) A charitable remainder trust;

(v) A partnership, S corporation (as defined in section 1361(a)(1) of the Code), or other pass-through entity that is generally not subject to Federal income tax, the income of which is taxable to its partners or other interest holders; or

(vi) A decedent's estate.

(3) *Employee benefit plans or arrangements.* A trust or similar funding vehicle of an employee benefit plan or arrangement, such as a section 501(a) trust funding a section 401(a) qualified retirement plan, or an annuity contract funding a section 403(b) plan, or a section 419(e) welfare benefit fund (including a voluntary employees' beneficiary association under section 501(c)(9)) funding a welfare benefit plan, will not be treated as a related organization and its assets will not be treated as the assets of the educational institution or of a related organization. A trust or other funding vehicle of an unfunded employee benefit plan of an educational institution or a related organization, such as a grantor trust described in section 671 *et seq.*, used in connection with a section 457(b) plan or an arrangement subject to section 457(f), will be treated as a related organization for purposes of section 4968(d) and its assets will be treated as the assets of the educational institution or of a related organization, but the assets are not considered ''used directly in carrying out the institution's exempt purpose'' for purposes of section 4968(b)(1)(D). For purposes of determining whether the employee benefit plan of an educational institution is funded or unfunded, the educational institution and all of its related organizations are treated as a single sponsor and payor of the benefits.

(b) *Control*—(1) *Controls such institution.* For purposes of section 4968(d) and §§ 53.4968–1 through 53.4968–4, an organization controls an educational institution if—

(i) The organization owns (by vote or value) more than 50 percent of the voting and non-voting stock or membership interest of the educational institution; or

(ii) The organization (or one or more of its managers, directors, officers, trustees, or employees, acting only in those capacities) can—

(A) Appoint or elect (which must include the power to remove and replace) more than 50 percent of the members of the educational institution's governing body (such as directors, officers, or trustees), or otherwise has the ongoing power to appoint or elect more than 50 percent of such members with reasonable frequency;

(B) Require the educational institution to make an expenditure (or prevent the educational institution from making an expenditure); or

(C) Require the educational institution to perform any act that significantly affects its operations (or prevent it from performing such an act).

(2) *Is controlled by such institution.* For purposes of section 4968(d) and §§ 53.4968–1 through 53.4968–4, an organization is controlled by an educational institution:

(i) *Tax-exempt corporation.* In the case of a corporation recognized as exempt from income tax under section 501(a), if the educational institution owns (by vote or value) more than 50 percent of the voting and nonvoting stock or

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membership interest of the corporation.

(ii) *Trust*—(A) *In general*. In the case of a trust—

(*1*) If the educational institution is substantially the sole permissible trust beneficiary or appointee of both income and principal, whether or not the timing of the distribution is subject to the trustee's discretion;

(*2*) If the trust is a pooled income fund described in sections 642(c)(3) and 642(c)(5);

(*3*) If, but only to the extent that, the assets of the trust were contributed to the trust by the educational institution (or by a person controlled by the educational institution); or

(*4*) If, but only to the extent that, the educational institution (or person controlled by the educational institution) has the right to demand (or can otherwise cause) a distribution of principal from the trust to the educational institution (or a person controlled by the educational institution).

(B) *Person controlled by the educational organization*. For purposes of this paragraph (b)(2)(ii), a person is controlled by an educational institution if the educational institution has the power to remove and replace such person or otherwise controls the person under one of the tests described in § 53.4968–3(b)(2)(i), (ii), or (iii), with similar principles applying for purposes of determining control of any other form of entity.

(iii) *Nonstock organization*. In the case of a nonstock organization, if the educational institution (or one or more of its managers, directors, officers, trustees, or employees, acting only in those capacities) can—

(A) Appoint or elect (which must include the power to remove and replace) more than 50 percent of the members of the organization's governing body (such as directors, officers, or trustees), or otherwise has an ongoing power to appoint or elect more than 50 percent of such members with reasonable frequency);

(B) Require the organization to make an expenditure (or prevent the organization from making an expenditure); or

(C) Require the organization to perform any act that significantly affects its operations (or prevent it from performing such an act).

(3) *Is controlled by one or more persons that also control such institution*. For purposes of section 4968(d) and this section, an organization (other than one described in paragraph (a)(2) of this section) is controlled by one or more persons that also control the educational institution if more than 50 percent of the members of the governing body of the other organization are directly or indirectly controlled by persons that comprise more than 50 percent of the members of the governing body of the educational institution.

(4) *Constructive ownership*. The principles of section 318(a)(2) (relating to ownership attribution from partnerships, estates, trusts, and corporations) apply for purposes of determining ownership of stock in a corporation, and similar principles apply for purposes of determining ownership of an interest in any other entity.

(5) *Method of control*. Control includes control by aggregating votes or positions of authority (including by veto power), but applies regardless of the method by which the control is exercised or exercisable.

(c) *Organization described in section 509(a)(3) during the taxable year with respect to the educational institution*. A section 509(a)(3) organization is a supporting organization with respect to an educational institution only if the supporting organization meets the organizational, operational, and relationship tests of section 509(a)(3)(B) and § 1.509(a)–4 of this chapter with respect to the educational institution.

(d) *Assets and net investment income of related organizations*—(1) *In general*. A related organization's assets and net investment income are taken into account both in determining whether an institution is an applicable educational institution and in computing the net investment income of an applicable educational institution. For purposes of determining the aggregate fair market value of the assets and net investment income of an educational institution, the assets and net investment income of all related organizations are

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treated as the assets and net investment income, respectively, of the institution, unless an exception provided in paragraph (d)(2) of this section or the exception provided in §53.4968–1(b)(5)(iv) (relating to assets used directly in carrying out an exempt purpose) applies. In cases in which an organization is a related organization with respect to an educational institution under more than one definition of this §53.4968–3, then the rule that attributes the largest amount of assets and net investment income of the related organization to the educational institution must be applied.

(2) *Exceptions*. For purposes of section 4968 and this paragraph (d)(2)—

(i) *No amount is taken into account with respect to more than one educational institution*. In determining the aggregate fair market value of the assets and net investment income of an educational institution, assets and net investment income of a related organization are not taken into account with respect to more than one educational institution. Thus, in any case in which an organization is a related organization with respect to more than one educational institution, the assets and net investment income of the related organization must be allocated between or among the educational institutions as to which the organization is a related organization, subject to paragraph (d)(2)(ii) of this section. The educational institution must make such allocation in a reasonable manner, taking into account all facts and circumstances, that is consistent across all related organizations.

(ii) *Assets and net investment income that are not intended or available for the use or benefit of the educational institution*—(A) *In general*. Unless a related organization is controlled by the educational institution or is a supporting organization described in section 509(a)(3) with respect to such institution for the taxable year, assets and net investment income of a related organization that are not intended or available for the use or benefit of the educational institution are not taken into account by that educational institution.

(B) *Determining whether assets and net investment income of a related organization are intended or available for the use or benefit of an educational institution*. If a related organization controls the educational institution, is controlled by one or more persons that also control such institution (but is not described in section 509(a)(3) with respect to the educational institution for the taxable year), or is a supported organization (as defined in section 509(f)(3)) during the taxable year with respect to the educational institution, then the related organization's assets and net investment income are taken into account as assets and net investment income of the educational institution only to the extent the assets and net investment income are intended or available for the use or benefit of that educational institution. Assets and net investment income of a related organization are intended or available for the use or benefit of an educational institution if such assets and net investment income are specifically earmarked or restricted for the benefit of, or otherwise are fairly attributable to, the educational institution. For example, assets are fairly attributable to the educational institution if they have been affirmatively designated or appropriated for the educational institution or made available for the educational institution to draw upon at will. Conversely, assets and net investment income of a related organization are not intended or available for the use or benefit of an educational institution if such assets and net investment income are specifically earmarked or restricted for another entity or for unrelated purposes or otherwise are not fairly attributable to the educational institution. The assets and net investment income of a related organization must be allocated between those intended or available for the use or benefit of an educational institution and those not intended or not available for the use or benefit of that same educational institution. The educational institution must make such allocation in a reasonable manner, taking into account all facts and circumstances, that is consistent across all related organizations.

(C) *Related organizations that are controlled by the educational institution or*

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that are supporting organizations (as described in section 509(a)(3)) with respect to the educational institution during the taxable year—(*1*) *In general.* If a related organization is controlled, as defined in paragraph (b)(2) of this section, by an educational institution, or is a supporting organization with respect to the educational institution during the taxable year, as defined in paragraph (c) of this section, the assets and net investment income of the related organization are taken into account as assets and net investment income of the educational institution regardless of whether those assets and net investment income are earmarked or restricted for the benefit of, or otherwise are fairly attributable to, the educational institution and even if they are specifically earmarked or restricted for another entity or for unrelated purposes or otherwise are not fairly attributable to the educational institution, subject to paragraph (d)(2)(ii)(C)(*2*) of this section. However, see §§ 53.4968–1(b)(2)(ii)(A)(*3*) and (*4*) regarding trusts that are controlled related organizations only to the extent assets of the trust were contributed to the trust by the educational institution (or by a person controlled by the educational institution), or only to the extent the educational institution (or person controlled by the educational institution) has the right to demand (or can otherwise cause) a distribution of principal from the trust to the educational institution (or a person controlled by the educational institution). *See also* § 53.4968–1(b)(5)(iv) for rules relating to when assets of a related organization are deemed to be used directly in carrying out the institution's exempt purpose.

(*2*) *Special rule for Type III supporting organizations with respect to an educational institution as of December 31, 2017.* An educational institution with a related organization that was a Type III supporting organization with respect to the educational institution on December 31, 2017, takes into account only the assets and net investment income of such Type III supporting organization that are intended or available for the use or benefit of, or otherwise are fairly attributable to, the educational institution, as described in paragraph (d)(2)(ii)(B) of this section. An educational institution may determine whether the assets and net investment income of such a Type III supporting organization are intended or available for the use or benefit of, or otherwise are fairly attributable to, the educational institution using any reasonable method. A method that attributes to an educational institution assets and net investment income of a supporting organization that specifically are earmarked for the educational institution, are restricted for the benefit of the educational institution, or otherwise are fairly attributable to the educational institution (such as those that have been affirmatively designated or appropriated for the educational institution or made available for the educational institution to draw upon at will) will be deemed to be reasonable.

(3) *Determining assets of related organizations.* To determine which assets of a related organization are included by an educational institution under section 4968(b)(1)(D) for a particular year, an educational institution determines which organizations are related organizations, as defined in section 4968(d)(2) and § 53.4968–3, as of the end of the educational institution's preceding taxable year, and values the relevant assets on that date.

(4) *Determining net investment income of related organizations.* To determine the amount of net investment income of a related organization that is included by the applicable educational institution in calculating the tax imposed by section 4968(a) for a particular taxable year, an applicable educational institution determines which organizations are related organizations, as defined in section 4968(d)(2) and § 53.4968–3, as of the end of that taxable year of the applicable educational institution and includes the net investment income from each related organization's taxable year that ends with or within that same taxable year of the applicable educational institution. If an organization became a related organization after the beginning of the applicable educational institution's taxable year, then the applicable educational institution includes the organization's net investment income for the portion of

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the year that the organization was a related organization, using any reasonable method.

[T.D 9917, 85 FR 65557, Oct. 15, 2020]

§53.4968–4 Applicability date.

The rules of §§53.4968–1 through 53.4968–3 apply to taxable years of an educational institution beginning after October 15, 2020.

[T.D 9917, 85 FR 65557, Oct. 15, 2020]

Subpart L—Procedure and Administration

SOURCE: T.D. 7368, 40 FR 29843, July 16, 1975, unless otherwise noted. Redesignated by T.D. 8084, 51 FR 16303, May 2, 1986.

§53.6001–1 Notice or regulations requiring records, statements, and special returns.

(a) *In general.* Any person subject to tax under Chapter 42, Subtitle D, of the Code shall keep such complete and detailed records as are sufficient to enable the district director to determine accurately the amount of liability under Chapter 42.

(b) *Notice by district director requiring returns, statements, or the keeping of records.* The district director may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not such person is liable for tax under Chapter 42.

(c) *Retention of records.* The records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

§53.6011–1 General requirement of return, statement or list.

(a) Every private foundation liable for tax under section 4940 or 4948(a) shall file an annual return with respect to such tax on the form prescribed by the Internal Revenue Service for such purpose and shall include therein the information required by such form and the instructions issued with respect thereto.

(b) Every person (including a governmental entity) liable for tax imposed by sections 4941(a), 4942(a), 4943(a), 4944(a), 4945(a), 4955(a), 4958(a), 4959, 4960(a), 4965(a), 4966(a), 4967(a), or 4968(a), and every private foundation and every trust described in section 4947(a)(2) which has engaged in an act of self-dealing (as defined in section 4941(d)) (other than an act giving rise to no tax under section 4941(a)) shall file an annual return on Form 4720,''Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code,'' and shall include therein the information required by such form and the instructions issued with respect thereto. In the case of any tax imposed by sections 4941(a), 4942(a), 4943(a), and 4944(a), the annual return shall be filed with respect to each act (or failure to act) for each year (or part thereof) in the taxable period (as defined in sections 4941 (e)(1), 4942(j)(1), 4943(d)(2), and 4944(e)(1)). In the case of a tax imposed by section 4945(a), 4955(a), 4958(a), 4960(a), 4965(a), 4966(a), or 4967(a), the annual return shall be filed with respect to each act for the year in which such act giving rise to liability occurred. In the case of a tax imposed by section 4959 on a hospital organization (as defined in §1.501(r)–1(b)(18)), the annual return must include the required information for each of the organization's hospital facilities that failed to meet the requirements of section 501(r)(3) for the taxable year.

(c) For taxable years ending on or after December 31, 1975, every trust described in section 4947(a)(2) which is subject to any of the provisions of Chapter 42 as if it were a private foundation shall file an annual return on Form 5227. For taxable years beginning after December 31, 1980, every trust described in section 4947(a)(1) which is a private foundation shall file an annual return on Form 990–PF.

(d) For taxable years beginning after December 31, 1977, every person liable for tax under section 4951, 4952, or 4953 (relating to taxes on self-dealing, taxable expenditures, and excess contributions involving black lung benefit trusts) shall file an annual return with

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respect to the tax on the form prescribed by the Internal Revenue Service for that purpose. The person liable for the tax shall include the information required by the form and its related instructions.

(e) The rules of this section apply to any returns required to be filed under this section on or after January 11, 2021.

[T.D. 7368, 40 FR 29843, July 16, 1975, as amended by T.D. 7838, 47 FR 44249, Oct. 7, 1982; T.D. 8026, 50 FR 20757, May 20, 1985; T.D. 8628, 60 FR 62212, Dec. 5, 1995; T.D. 8705, 62 FR 26, Jan. 2, 1997; T.D. 9334, 72 FR 36872, July 6, 2007; T.D. 9629, 78 FR 49682, Aug. 15, 2013; T.D. 9708, 79 FR 79015, Dec. 31, 2014; T.D. 9855, 84 FR 14009, Apr. 9, 2019; T.D. 9972, 88 FR 11766, Feb. 23, 2023]

§ 53.6011–4 Requirement of statement disclosing participation in certain transactions by taxpayers.

(a) *In general.* If a transaction is identified as a *listed transaction* or a *transaction of interest* as defined in § 1.6011–4 of this chapter by the Commissioner in published guidance (see § 601.601(d)(2)(ii)(*b*) of this chapter), and the listed transaction or transaction of interest involves an excise tax under chapter 42 of subtitle D of the Internal Revenue Code (relating to private foundations and certain other tax-exempt organizations), the transaction must be disclosed in the manner stated in such published guidance.

(b) *Effective/applicability date.* This section applies to listed transactions entered into on or after January 1, 2003. This section applies to transactions of interest entered into on or after November 2, 2006.

[T.D. 9350, 72 FR 43154, Aug. 3, 2007]

§ 53.6060–1 Reporting requirements for tax return preparers.

(a) *In general.* A person that employs one or more tax return preparers to prepare a return or claim for refund of tax under Chapter 42 of the Internal Revenue Code, other than for the person, at any time during a return period, shall satisfy the record keeping and inspection requirements in the manner stated in § 1.6060–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6061–1 Signing of returns and other documents.

Any return, statement, or other document required to be made with respect to a tax imposed by Chapter 42 or the regulations thereunder shall be signed by the person required to file such return, statement or document, or by such other persons required or duly authorized to sign in accordance with the regulations, forms or instructions prescribed with respect to such return, statement or other document. The person required or duly authorized to make the return may incur liability for penalties provided for erroneous, false or fraudulent returns. For criminal penalties see sections 7201, 7203, 7206, and 7207.

§ 53.6065–1 Verification of returns.

(a) *Penalties of perjury.* If a return, statement, or other document made under the provisions of Chapter 42 or Subtitle F of the Code or the regulations thereunder with respect to any tax imposed by Chapter 42 of the Code, or the form and instructions issued with respect to such return, statement, or other document, requires that it shall contain or be verified by a written declaration that it is made under the penalties of perjury, it must be so verified by the person or persons required to sign such return, statement, or other document. In addition, any other statement or document submitted under any provision of Chapter 42 or Subtitle F of the Code or regulations thereunder with respect to any tax imposed by Chapter 42 of the Code may be required to contain or be verified by a written declaration that it is made under the penalties of perjury.

(b) *Oath.* Any return, statement, or other document required to be submitted under Chapter 42 or Subtitle F of the Code or regulations prescribed thereunder with respect to any tax imposed by Chapter 42 of the Code may be required to be verified by an oath.

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§53.6071–1 Time for filing returns.

(a) *General rule.* Except as otherwise provided in this section, a return required by §53.6011–1 shall be filed at the time the private foundation or trust described in section 4947(a)(2) is required to file its annual information or tax return under section 6033 or 6012 (as may be applicable).

(b) *Exception.* The Form 4720 of a person whose taxable year ends on a date other than that on which the taxable year of the foundation or trust ends shall be filed on or before the 15th day of the fifth month following the close of such person's taxable year.

(c) *Form 5227.* A Form 5227 required to be filed by paragraph (d) of §53.6011–1 for a trust described in section 4947(a) shall be filed on or before the 15th day of the fourth month following the close of the trust's taxable year.

(d) *Taxes related to black lung benefit trusts.* Forms 990–BL and 6069 shall be filed on or before the 15th day of the fifth month following the close of the filer's taxable year.

(e) *Taxes related to political expenditures of organizations described in section 501(c)(3) of the Internal Revenue Code.* A Form 4720 required to be filed by §53.6011–1(b) for an organization liable for tax imposed by section 4955(a) must be filed by the unextended due date for filing its annual information return under section 6033 or, if the organization is exempt from filing, the date the organization would be required to file an annual information return if it was not exempt from filing. The Form 4720 of a person whose taxable year ends on a date other than that on which the taxable year of the organization described in section 501(c)(3) ends must be filed on or before the 15th day of the fifth month following the close of the person's taxable year.

(f) *Taxes imposed on excess benefit transactions engaged in by organizations described in sections 501(c)(3) (except private foundations) and 501(c)(4)*—(1) *General rule.* A Form 4720 required by §53.6011–1(b) for a disqualified person or organization manager liable for tax imposed by section 4958(a) shall be filed by that person on or before the 15th day of the fifth month following the close of such person's taxable year.

(2) *Special rule for taxable years ending after September 13, 1995, and on or before July 30, 1996.* A Form 4720 required by §53.6011–1(b) for a disqualified person or organization manager liable for tax imposed by section 4958(a) on an excess benefit transaction occurring in such person's taxable year ending after September 13, 1995, and on or before July 30, 1996, is due on or before December 15, 1996.

(g) *Taxes imposed with respect to prohibited tax shelter transactions to which tax-exempt entities are parties*—(1) *Returns by certain tax-exempt entities.* A Form 4720, "Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code," required by §53.6011–1(b) for a tax-exempt entity described in section 4965(c)(1), (c)(2) or (c)(3) that is a party to a prohibited tax shelter transaction and is liable for tax imposed by section 4965(a)(1) shall be filed on or before the due date (not including extensions) for filing the tax-exempt entity's annual information return under section 6033(a)(1). If the tax-exempt entity is not required to file an annual information return under section 6033(a)(1), the Form 4720 shall be filed on or before the 15th day of the fifth month after the end of the tax-exempt entity's taxable year or, if the entity has not established a taxable year for Federal income tax purposes, the entity's annual accounting period.

(2) *Returns by entity managers of tax-exempt entities described in section 4965(c)(1), (c)(2) or (c)(3).* A Form 4720, required by §53.6011–1(b) for an entity manager of a tax-exempt entity described in section 4965(c)(1), (c)(2) or (c)(3) who is liable for tax imposed by section 4965(a)(2) shall be filed on or before the 15th day of the fifth month following the close of the entity manager's taxable year during which the entity entered into the prohibited tax shelter transaction.

(3) *Transition rule.* A Form 4720, for a section 4965 tax that was due on or before October 4, 2007, will be deemed to have been filed on the due date if it was filed by October 4, 2007, and if all section 4965 taxes required to be reported on that Form 4720 were paid by October 4, 2007.

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00329 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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(h) *Taxes on failures by charitable hospital organizations to satisfy the community health needs assessment requirements of section 501(r)(3).* A hospital organization (as defined in § 1.501(r)–1(b)(18)) liable for tax imposed by section 4959 must file a Form 4720 as required by § 53.6011–1(b), on or before the 15th day of the fifth month after the end of the hospital organization's taxable year for which it failed to meet the requirements of section 501(r)(3).

(i) *Taxes under section 4960, 4966, 4967, or 4968.* A person (including a governmental entity) required by § 53.6011–1(b) to file a return for a tax imposed by section 4960(a), 4966(a), 4967(a), or 4968(a) in a taxable year must file the Form 4720 on or before the 15th day of the fifth month after the end of the person's taxable year (or, if the person has not established a taxable year for Federal income tax purposes, the person's annual accounting period).

(j) *Effective/applicability date*—(1) Paragraph (g) of this section applies on and after July 6, 2007.

(2) Paragraph (h) of this section applies on and after August 15, 2013.

(3) Paragraph (i) of this section applies on and after April 9, 2019.

[T.D. 7368, 40 FR 29843, July 16, 1975, as amended by T.D. 7407, 41 FR 9322, Mar. 4, 1976; T.D. 7838, 47 FR 44249, Oct. 7, 1982; T.D. 8628, 60 FR 62212, Dec. 5, 1995; T.D. 8736, 62 FR 52257, Oct. 7, 1997; T.D. 9334, 72 FR 36872, July 6, 2007; T.D. 9492, 75 FR 38708, July 6, 2010; 75 FR 46845, Aug. 4, 2010; T.D. 9629, 78 FR 49682, Aug. 15, 2013; T.D. 9708, 79 FR 79015, Dec. 31, 2014; T.D. 9855, 84 FR 14009, Apr. 9, 2019]

§ 53.6081–1 Automatic extension of time for filing the return to report taxes due under section 4951 for self-dealing with a nuclear decommissioning fund.

(a) *In general.* A ''disqualified person'' for purposes of section 4951(e)(4) who engaged in self-dealing with a Nuclear Decommissioning Fund, and must report tax due under section 4951 on Form 1120-ND, ''Return for Nuclear Decommissioning Funds and Certain Related Persons,'' will be allowed an automatic 6-month extension of time to file the return after the date prescribed for filing the return if the disqualified person files an application under this section in accordance with paragraph (b) of this section. For guidance on requesting an extension of time to file Form 1120-ND for purposes of reporting contributions received, income earned, administrative expenses of operating the fund, and the tax on modified gross income, see § 1.6081–3 of this chapter.

(b) *Requirements.* To satisfy this paragraph (b), a disqualified person must—

(1) Submit a complete application on Form 7004, ''Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns,'' or in any other manner prescribed by the Commissioner;

(2) File the application on or before the date prescribed for filing the return with the Internal Revenue Service office designated in the application's instructions; and

(3) Remit the amount of the properly estimated unpaid tax liability on or before the date prescribed for payment.

(c) *No extension of time for the payment of tax.* An automatic extension of time for filing a return granted under paragraph (a) of this section will not extend the time for payment of any tax due on such return.

(d) *Termination of automatic extension.* The Commissioner may terminate an automatic extension at any time by mailing to the disqualified person a notice of termination at least 10 days prior to the termination date designated in such notice. The Commissioner must mail the notice of termination to the address shown on the Form 7004 or to the disqualified person's last known address. For further guidance regarding the definition of last known address, see § 301.6212–2 of this chapter.

(e) *Penalties.* See section 6651 for failure to file or failure to pay the amount shown as tax on the return.

(f) *Effective/applicability dates.* This section is applicable for applications for an automatic extension of time to file a return to report taxes due under section 4951 for self-dealing with a Nuclear Decommissioning Fund filed after July 1, 2008.

[T.D. 9407, 73 FR 37369, July 1, 2008]

§ 53.6091–1 Place for filing chapter 42 tax returns.

Except as provided in § 53.6091–2 (relating to exceptional cases):

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00330 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

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(a) *Persons other than corporations.* Chapter 42 tax returns of persons other than corporations shall be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office that serves the legal residence or principal place of business of the person required to make the return.

(b) *Corporations.* Chapter 42 tax returns of corporations shall be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office that serves the principal place of business or principal office or agency of the corporation.

(c) *Returns filed with service centers.* Notwithstanding paragraphs (a) and (b) of this section, unless a return is filed by hand carrying, whenever instructions applicable to Chapter 42 tax returns provide that the returns be filed with a service center, the returns must be so filed in accordance with the instructions. Returns which are filed by hand carrying shall be filed with any person assigned the responsibility to receive hand-carried returns in the local Internal Revenue Service office in accordance with paragraphs (a) or (b) of this section, whichever is applicable.

(d) *Returns of persons subject to a termination assessment.* Notwithstanding paragraph (c) of this section, income tax returns of persons with respect to whom a chapter 42 tax assessment was made under section 6852(a) with respect to the taxable year must be filed with any person assigned the responsibility to receive returns in the local Internal Revenue Service office as provided in paragraphs (a) and (b) of this section.

[T.D. 7368, 40 FR 29843, July 16, 1975, as amended by T.D. 7495, 42 FR 33727, July 1, 1977; T.D. 8628, 60 FR 62212, Dec. 5, 1995; T.D. 9156, 69 FR 55746, Sept. 16, 2004]

§ 53.6091–2 Exceptional cases.

Notwithstanding the provisions of §53.6091–1, the Commissioner may permit the filing of any Chapter 42 tax return in any local Internal Revenue Service office.

[T.D. 7368, 40 FR 29843, July 16, 1975. Redesignated by T.D. 8084, 51 FR 16303, May 2, 1986, as amended by T.D. 9156, 69 FR 55746, Sept. 16, 2004]

§ 53.6107–1 Tax return preparer must furnish copy of return or claim for refund to taxpayer and must retain a copy or record.

(a) *In general.* A person who is a signing tax return preparer of any return or claim for refund of tax under Chapter 42 of the Internal Revenue Code shall furnish a completed copy of the return or claim for refund to the taxpayer and retain a completed copy or record in the manner stated in §1.6107–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6109–1 Tax return preparers furnishing identifying numbers for returns or claims for refund filed.

(a) *In general.* Each tax return or claim for refund under Chapter 42 of the Internal Revenue Code prepared by one or more signing tax return preparers must include the identifying number of the preparer required by §1.6695–1(b) of this chapter to sign the return or claim for refund in the manner stated in §1.6109–2 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6151–1 Time and place for paying tax shown on returns.

The Chapter 42 tax shown on any return shall, without assessment or notice and demand, be paid to the internal revenue officer with whom the return is filed at the time and place for filing such return (determined without regard to any extension of time for filing the return). For provisions relating to the time and place for filing such return, see §§53.6071–1 and 53.6091–1. For provisions relating to the extension of time for paying the tax, see §53.6161–1.

§ 53.6161–1 Extension of time for paying tax or deficiency.

(a) *In general*—(1) *Tax shown or required to be shown on return.* A reasonable extension of the time for payment of the amount of any tax imposed by

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00331 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

Chapter 42 and shown or required to be shown on any return, may be granted by the district directors and directors of the service centers at the request of the taxpayer. The period of such extension shall not be in excess of 6 months from the date fixed for payment of such tax, except that if the taxpayer is abroad the period of the extension may be in excess of 6 months.

(2) *Deficiency*. The time for payment of any amount determined as a deficiency in respect of tax imposed by Chapter 42 may, at the request of the taxpayer, be extended by the internal revenue officer to whom the tax is required to be paid for a period not to exceed 18 months from the date fixed for payment of the deficiency, as shown on the notice and demand, and, in exceptional cases for a further period not in excess of 12 months. No extension of the time for payment of a deficiency shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(3) *Extension of time for filing distinguished*. The granting of an extension of time for filing a return does not operate to extend the time for the payment of the tax or any part thereof unless so specified in the extension.

(b) *Undue hardship required for extension*. An extension of the time for payment shall be granted only upon a satisfactory showing that payment on the due date of the amount with respect to which the extension is desired will result in an undue hardship. The extension will not be granted upon a general statement of hardship. The term ''undue hardship'' means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, loss due to the sale of property at a sacrifice price, will result to the taxpayer from making payment on the due date of the amount with respect to which the extension is desired. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

(c) *Application for extension*. An application for an extension of the time for payment of the tax shown or required to be shown on any return, or for the payment of any amount determined as a deficiency shall be made on Form 1127 and shall be accompanied by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. Such application shall also be accompanied by a statement of the assets and liabilities of the taxpayer and an itemized statement showing all receipts and disbursements for each of the three months immediately preceding the due date of the amount to which the application relates. The application, with supporting documents, must be filed on or before the date prescribed for payment of the amount with respect to which the extension is desired with the internal revenue officer to whom the tax is to be paid. The application will be examined, and within 30 days, if possible, will be denied, granted, or tentatively granted subject to certain conditions of which the taxpayer will be notified. If an additional extension is desired, the request therefor must be made on or before the expiration of the period for which the prior extension is granted.

(d) *Payment pursuant to extension*. If an extension of time for payment is granted, the amount the time for payment of which is so extended shall be paid on or before the expiration of the period of the extension without the necessity of notice and demand. The granting of an extension of the time for payment of the tax or deficiency does not relieve the taxpayer from liability for the payment of interest thereon during the period of the extension. See section 6601 and § 301.6601–1 of this chapter (Regulations on Procedure and Administration).

§ 53.6165–1 Bonds where time to pay tax or deficiency has been extended.

If an extension of time for payment of tax or deficiency is granted under section 6161, the district director or the director of the service center may, if he deems it necessary, require a bond for the payment of the amount in respect of which the extension is granted in accordance with the terms of the extension. However, such bond shall not exceed double the amount with respect to which the extension is granted. For provisions relating to form of bonds, see the regulations under section 7101

VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00332 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31
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contained in part 301 of this chapter (Regulations on Procedure and Administration).

§ 53.6601–1 Interest on underpayment, nonpayment, or extensions of time for payment, of tax.

For regulations concerning interest on underpayment, nonpayment, or extensions of time for payment of tax, see § 301.6601–1 of this chapter (Regulations on Procedure and Administration).

§ 53.6651–1 Failure to file tax return or to pay tax.

(a) *General rules.* For general rules relating to the failure to file tax return or to pay tax, see the regulations under section 6651 contained in part 301 of this chapter (Regulations on Procedure and Administration).

(b) *Special rule where foundation files return.* (1) Except as provided in paragraph (b)(2) of this section, in the case of tax imposed by section 4941(a)(1) on any disqualified person, reasonable cause shall be presumed, for purposes of section 6651(a)(1), where the private foundation or trust described in section 4947(a)(2) files a return in good faith and such return indicates no tax liability with respect to such tax on the part of such disqualified person.

(2) Paragraph (b)(1) of this section shall not apply where the disqualified person knew of facts which, if known by the foundation, would have precluded the foundation from making the return, as filed, in good faith.

§ 53.6694–1 Section 6694 penalties applicable to tax return preparer.

(a) *In general.* For general definitions regarding section 6694 penalties applicable to preparers of tax returns or claims for refund under Chapter 42 of the Internal Revenue Code, see § 1.6694–1 of this chapter.

(b) *Effective/applicability date.* Paragraph (a) of this section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6694–2 Penalties for understatement due to an unreasonable position.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under Chapter 42 of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(a) of the Code in the manner stated in § 1.6694–2 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under Chapter 42 of the Internal Revenue Code (Code) shall be subject to penalties under section 6694(b) of the Code in the manner stated in § 1.6694–3 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78457, Dec. 22, 2008]

§ 53.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general.* For rules relating to the extension of period of collection when a tax return preparer who prepared a return or claim for refund of tax under Chapter 42 of the Internal Revenue Code pays 15 percent of a penalty for understatement of taxpayer's liability and procedural matters relating to the investigation, assessment and collection of the penalties under section 6694(a) and (b), the rules under § 1.6694–4 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

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VerDate Sep<11>2014 14:03 May 18, 2023 Jkt 259108 PO 00000 Frm 00333 Fmt 8010 Sfmt 8010 Q:\26\26V19.TXT PC31

§ 53.6695–1 Other assessable penalties with respect to the preparation of tax returns or claims for refund for other persons.

(a) *In general.* A person who is a tax return preparer of any return or claim for refund of tax under Chapter 42 of the Internal Revenue Code (Code) shall be subject to penalties for failure to furnish a copy to the taxpayer under section 6695(a) of the Code, failure to sign the return under section 6695(b) of the Code, failure to furnish an identification number under section 6695(c) of the Code, failure to retain a copy or list under section 6695(d) of the Code, failure to file a correct information return under section 6695(e) of the Code, and negotiation of a check under section 6695(f) of the Code, in the manner stated in § 1.6695–1 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 53.6696–1 Claims for credit or refund by tax return preparers.

(a) *In general.* For rules for claims for credit or refund by a tax return preparer who prepared a return or claim for refund for tax under Chapter 42 of the Internal Revenue Code, the rules under § 1.6696–1 of this chapter will apply.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

§ 53.7101–1 Form of bonds.

For provisions relating to form of bonds, see the regulations under section 7101 contained in part 301 of this chapter (Regulations on Procedure and Administration).

§ 53.7701–1 Tax return preparer.

(a) *In general.* For the definition of a tax return preparer, see § 301.7701–15 of this chapter.

(b) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78458, Dec. 22, 2008]

PART 54—PENSION EXCISE TAXES

Sec.

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