

Qualifying Distributions: What About Admin Expenses?

02.20.18 | Linda J. Rosenthal, JD



From time to time, the U.S. Congress undertakes a major overhaul of the federal tax code. One of those years was 1969.

Before then, there was inadequate oversight of private foundations. The major changes that Congress authorized that year significantly tightened the regulatory structure that distinguished private foundations from public charities.

One of the pre-1969 problems was that many private foundations hoarded their charitable assets instead of making reasonable attempts to distribute at least some of it currently. The relevant statute then in effect was Internal Revenue Code section 504(a)(1); a private foundation could lose its tax-exempt status if its “aggregate accumulated income was unreasonable in amount or duration.” Experts argued, though, that “existing law, with its emphasis on the ‘reasonableness’ of accumulations, was inadequate, as well as difficult and expensive to administer. [Also, the] consequence of unreasonable accumulations – revocation of exemption – was viewed as being quite drastic, and hence infrequently invoked.” The “fatal flaw” of IRC 504(a)(1) was the “necessarily subjective nature of determinations made in connection with the reasonableness or unreasonableness of a private foundation’s accumulations.”

“Qualifying Distributions” Rule

Congress created a solution to the problem that charitable beneficiaries were not receiving enough of the money being held by private foundations: New Internal Revenue Code section 4942, which imposes an excise tax on the undistributed income of private foundations.

Section 4942 is one of a series of private foundation excise taxes designed to provide more control over private foundations which – unlike public charities – don’t get their support from the general public. Instead, private foundations generally are funded by one or just a few people.

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IRC Section 4942 requires private nonoperating foundations to make qualifying distributions, by the end of the following year, at least equal to five percent of the fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out the foundation’s exempt purpose (its minimum investment return), reduced by acquisition indebtedness, certain carryovers and taxes paid by the foundation.

If the private foundation fails to meet that requirement, section 4942(a) imposes a 15 percent tax on a private foundation’s undistributed income, which is described in subsection (c) as the amount by which the “distributable amount” exceeds “qualifying distributions.”

What, then, are “qualifying distributions” within the meaning of Section 4942(g)? They include:

- Direct expenditures to accomplish [an exempt] purpose;
- Certain set-asides for future charitable purchases or expenditures; or
- Grants to public charities or private operating foundations

Otherwise stated, a “qualifying distribution” is defined in section 4942(g)(1)(A) as “any amount ... paid to accomplish one or more [exempt] purposes....”

What About Admin Expenses?

Any organization will necessarily incur certain administrative expenses in carrying out its purposes and mission. What about those costs? Are they considered in the math calculations on “qualifying distributions”?

Generally, yes. “Qualifying distributions under IRC Section 4942 *include* that portion of reasonable and necessary administrative expenses paid to accomplish one or more exempt purposes....”

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Administrative expenses can be direct or indirect. Direct expenses are specifically identified with a particular activity, including compensation and travel expenses of employees and officers. Indirect, known as overhead expenses, aren’t specifically identifiable with a particular activity. Examples include most occupancy expenses, clerical compensation, repairs, equipment rental and maintenance, accounting fees, and personnel serving the department or function.

Neither section 4942 nor the treasury regulations issued to interpret that statute include any limits on the total of administrative expenses. The only restriction is that they be “reasonable and necessary for the accomplishment of the private foundation’s exempt purposes.” See Treasury Reg. subsections 53.4942(a)-3(a)(2)(i) and 3(a)(8).

See also, for example, Revenue Ruling 75-945, 1975-2 C.B. 449. There, the Internal Revenue Service ruled that legal fees paid by an exempt charitable trust to determine the proper beneficiary of a portion of the net income are “qualifying distributions” under section 4942(g)(1); they were reasonable and necessary for that purpose.

Conclusion

While there haven’t been any new or changed regulations on administrative expenses being treated as qualifying distributions, the IRS has released [helpful guidance](#) on January 11, 2017.