

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.

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§ 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 (with-

in 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, 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.

(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 founda-

tion 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 \times \$400,000 = \$24,000; $\frac{2}{3} \times$ \$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 percent \times \$375,000 = \$22,500; $\frac{2}{3} \times$ \$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 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