

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).

(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 re-

maining 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.

[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]

§ 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 chil-

dren, 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 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 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 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 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, 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