COMMITTEE REPORT:
PHILANTHROPY

By **Conrad Teitell**, **Heather J. Rhoades** & **Brianna L. Marquis**

Donors' Charitable Pledges

The ins and outs

Warning: An arcane federal estate tax rule can be dangerous to your client's wealth. Suppose your client wants a charity to get a cash gift on their death. What's the difference to the charity if it receives a bequest under your client's will or living trust *or* receives the gift by a binding pledge signed during your client's life and payable to the charity on their death? Assume no will contest. And forget about the possible different elapsed times after the client's death before the charity receives the dough. For the charity, there's no difference.

What's the difference to your client's estate, assuming it's subject to the federal estate tax? In most cases, there's no difference. But suppose your client's estate includes a closely held business, a farm or both; there could be a huge difference.

So what's the answer? Hint: Pledges are deductible from the gross estate (as a debt, as we shall see) to determine the adjusted gross estate (AGE). Bequests are deductible from the AGE. Both deductions reduce the taxable estate. So why are we wasting your time? After all, a deduction is a deduction is a deduction.

Not always, when you consider the percentage of the federal AGE tests to qualify for special estate tax benefits.

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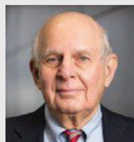

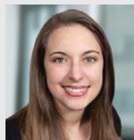

Estate Tax Deferral Issue

Internal Revenue Code Section 6166 allows the executor of some estates to defer the payment of estate taxes for up to five years after the return was originally due.[1] After the 5-year period, the deferred tax and interest can be paid in up to 10 annual installments.

Three requirements for an estate to be eligible to defer estate tax: (1) the estate must hold interests in a closely held business exceeding 35% of the decedent's AGE; (2) the decedent must have been a U.S. citizen or resident at the time of their death; and (3) the executor must make the IRC Section 6166 election on a timely filed Form 706 federal estate tax return.[2]

In determining its eligibility for the deferral, the estate calculates the 35% threshold by subtracting allowable deductions under IRC Sections 2053 and 2054 from the gross estate. These deductions include liens, funeral expenses, debts, mortgages and administration costs. As you'll see, pledges are deductible as debts. Charitable and marital deductions, however, aren't included in the items deductible from the gross estate to arrive at the AGE. They're deductible from the AGE.

Here are two examples:

Situation 1: A $2 million charitable gift is made by pledge payable on the donor's death.
Value of gross estate: $20 million
Value of closely held business: $6.5 million
Debts and estate expenses (including a $2 million pledge): $3 million
Value of AGE: $17 million
Value of a charitable bequest: $0

Here, the $6.5 million closely held business interest is about 38% of the decedent's AGE, which

exceeds the 35% threshold. This estate would qualify for the estate tax deferral provided that the other two requirements are also met.

Situation 2: A $2 million gift to charity is made by bequest.
Value of gross estate: $20 million
Value of closely held business: $6.5 million
Debts and estate expenses: $1 million (no $2 million pledge deduction)
Value of AGE: $19 million

In Situation 2, the charitable bequest doesn't factor in determining the AGE—so the AGE is $19 million. That makes the $6.5 million value of the closely held business interest only about 34% of the decedent's AGE, which fails the eligibility test.

As shown above, the pledge versus bequest distinction could mean the difference between having to pay the estate tax within nine months of the decedent's death and the ability to pay in installments over 15 years.

Estates that include significant interests in a closely held business might have a large value, but don't often have significant liquid assets available to pay the estate tax. The extra time is crucial to avoid selling off interests in the company.

The same estate tax deferral issue can apply to farmers' estates. Often, the largest asset is farm real estate. Surviving family members often don't want to sell the farm to raise cash to pay the estate tax.[3] Through a series of revenue rulings and private letter rulings, the Internal Revenue Service has stated that as long as requirements are met, farms can also be eligible for tax deferral.[4]

Not to ruin your day. Might an estate's executor be duty bound to seek recompense (damages) from the tax advisor who failed to consider the difference between a charitable pledge and a charitable bequest?

Pledges Defined

Charitable pledges are contracts**.** A donor commits to making a future charitable contribution. They can place stipulations on their pledge or make it unconditional. Pledges can be fulfilled with one payment or multiple payments over a set period. Unlike donations, which are immediate, pledges are promises to pay in the future.

Enforceability

The enforceability of charitable pledges depends on many factors. General contract law and applicable state laws govern. A binding contract generally has three requirements: offer, acceptance and consideration. But a review of case law from several states on the enforceability of charitable pledges shows it's not that simple. If one or more of the contract elements are missing or questionable, some courts rely on public policy to enforce pledges. Others look for varying degrees of reliance by the charity or whether the pledge induced others to contribute. Still others consider a combination of these factors.

On an implied bilaterality theory, one court held that a charity's acceptance of a pledge and carrying on its normal charitable activities might be enough to enforce it.

Landmark pledge case. *Allegheny College v. National Chautauqua County Bank of Jamestown* held that as a matter of public policy, charitable pledges are enforceable.[5] In that case, Mary Yates Johnston's will pledged $5,000 to Allegheny College. The will provision noted that the obligation would be due 30 days after her death. It also provided that the fund should include her name and be used to educate students preparing for the ministry. Two years after signing her will, she paid $1,000 to the college. The college created a scholarship fund in her name, as Mary had directed. The following year, she sent a notice to the college retracting her promise. The court stated that the college's acceptance of the first payment and creation of the scholarship fund in the donor's name established a bilateral agreement.

As soon as the payment was accepted, the college assumed a duty to maintain the memorial according to her wishes. It couldn't just hold the funds and not follow through with the scholarship. The promise was implied by conduct instead of by words. Thus, the pledge was enforced.[6]

Implied bilaterality. Similarly, on an implied bilaterality theory, the court in *I. & I. Holding Corporation v. Ginsberg* held that a charity's acceptance of a pledge and carrying on its normal charitable activities might be enough to enforce it.[7] The $5,000 pledge to the Beth Israel Hospital Association was payable in four yearly installments. After the agreement was executed, the hospital "proceeded in its humanitarian work, obtained similar 'subscriptions,' expended large sums of money and incurred large liabilities."[8] The court held the complaint stated enough facts to constitute a cause of action.[9]

Case law demonstrates that if a charity incurs liabilities based on its reliance on a pledge, courts are more likely to enforce it.

Public policy. Citing the above cases, the court in *Woodfern Academy v. Steinberg* upheld on public policy grounds a written $375,000 pledge.[10] Originally, the donor in that case promised to make payments over three years so that the school could build a library. In exchange, the school promised to name the library after the donor's wife. After making the first payment, the agreement was revised to extend the time to pay. The donor's attorney even assisted in drafting the amendment. The donor made the second payment but failed to make the final one. The court held that "as a matter of public policy, pledge agreements calculated to foster eleemosynary enterprises are enforceable" and struck each of the donor's defenses.[11]

Another New York case, *Estate of Parson*, involved a $5 million oral pledge by Joan Whitney Parson, former owner of the New York Mets.[12] In an "informal chat" with the Metropolitan Museum of Art's president, she promised to donate $5 million toward the construction of a new "American Wing" at the museum. She later donated about $3.5 million in appreciated securities to the museum. Based on her donation and pledge, the museum began construction of the new wing. Relying on the pledge, the museum also promised New York City that if the city would give $3.5 million to the project, the museum would come up with the rest. After Joan's death, her executors refused to pay the outstanding $1.5 million balance. The court held that the statute of frauds, which requires certain promises to be in writing, was satisfied because she signed a letter from her bank acknowledging the pledge. It went on to say that even if the statute of frauds wasn't satisfied, the pledge would be enforceable on public policy grounds.[13]

Reliance. Other case law demonstrates that if a charity incurs liabilities based on its reliance on a pledge, courts are more likely to enforce it. *In re Lipsky's Estate* is a case on point: The donor died before fulfilling his pledge.[14] Originally, he promised to pay $500 to the charity during a fundraising campaign. He paid $250 and subsequently pledged an additional $250, making the remaining balance $500. The pledge was memorialized in a letter from the charity acknowledging receipt of the pledge and expressing gratitude for the donor's support. The donor died, however, before making any additional payments. In its action to enforce the pledge against the donor's estate, the charity explained that it relied heavily on pledges. In fact, the charity borrowed a combined $60 million from seven different banks to carry out its charitable work. The banks, in turn, required the charity to provide a monthly certified list of its outstanding pledges as part of the loan agreements. Based on this reliance, the court held the charity entered into a contract with the donor, and the pledge was binding.[15]

Pledges from others. In addition to public policy and reliance, courts consider whether a pledge encouraged other pledges. *Paul & Irene Bogoni Foundation v. St. Bonaventure University* upheld a charitable pledge in which the "amount pledged was memorialized in an unambiguous gift commitment agreement, and defendants [the university] acted in

reliance thereon when securing additional pledges and constructing expansion."[16] In its early discussions with the donors (a foundation and its founders) the university submitted construction bids for a library expansion that were well above what the donors had planned to contribute. The university later raised an additional $700,000 in funding, and the donors stated by letter that they were satisfied with the progress and would release the remaining $900,000 when work began. However, the donors failed to pay the remaining balance and sued the university for breach of contract because they were dissatisfied with the disbursement of funds. The court held that because the university was in compliance with the agreement, the donors had to complete the pledge.[17] Similarly, the court in *Timko's Estate v. Oral Roberts Evangelistic Association* held the promise of a donor—who sat on the charity's Board of Trustees—to cover the unpaid balance on a building purchased by the charity at his suggestion would reasonably have caused the charity to move forward with the purchase of that building. Accordingly, the pledge was enforceable.[18]

Unenforceable Pledges

Not all cases favor the charities. The failure to show any affirmative reliance on the pledge and an agreement that didn't specify the purpose of the pledge were a charity's undoing in *Mount Sinai Hospital of Greater Miami, Inc. v. Jordan*.[19] The court cautioned against public policy arguments when the facts can't back them up.[20]

In 2016, the New York Court of Appeals (the state's highest court) departed from the trend of pledge enforceability to the tune of $1.8 million. As in *Mount Sinai Hosp. of Greater Miami, Inc.*, the holding in *In re Kramer* demonstrated that although charities don't have to do too much to show they depended on a pledge, they do have to take some steps to show acceptance and reliance.[21] The donor in this case executed both a pledge card *and* a promissory note in 2006, but the charity took no further steps to act on it. The court held there just wasn't enough to enforce the pledge.[22]

Income Tax Deductibility Rules

A donor's pledge is deductible on their income tax return in the year the pledge is fulfilled, not when it was made.[23] Typically, paying a debt with appreciated property is the same as selling that property and paying off the debt with the proceeds. That triggers capital gains tax on the appreciation. But there's no capital gains when satisfying a binding pledge with appreciated property.[24]

A charitable pledge satisfied by a donation of property that's depreciated in value doesn't entitle the donor to take a deductible loss.[25] Essentially, Revenue Ruling 55-410 holds that a charitable pledge isn't a legal obligation for purposes of IRC Section 677 and doesn't create a debt for federal income tax purposes.[26]

> The IRS has ruled that a gift was complete when a donor's promise to make a charitable contribution became binding under local law.

Gift Tax Deductibility Rules

A binding pledge is a gift, but no gift tax is payable because of the unlimited gift tax charitable deduction. In Private Letter Ruling 8230156 (April 30, 1982), the IRS examined when a pledge gift is deemed made for gift tax purposes. In that situation, the donor and the charity agreed that the donor would contribute $30,000 in installments as determined by the donor. If, however, the charity received specific contributions from other sources and the IRS issued a favorable ruling relating to the gift, the donor would become personally liable under local law to fulfill the promise. The IRS ruled the gift was complete when the donor's promise to make a charitable contribution became binding under local law. At that time, the donor was entitled to a gift tax charitable deduction. The income tax charitable deduction, however, wasn't available until the donor actually transferred cash or property to the charity.[27]

In Rev. Rul. 81-110, the IRS examined the gift and income tax consequences resulting when someone else (a friend, for example) satisfies a donor's pledge. The donor in the ruling pledged $10,000 to the

charity in January, and as part of the agreement, promised that it would be paid by June. The charity began making improvements to its property in reliance on the pledge. By May, the donor was unable to satisfy the pledge but his friend stepped in and paid it for him. The friend's payment to the charity was considered a gift from the friend to the donor. Accordingly, the friend's payment of the donor's pledge to the charity wasn't a charitable gift by the friend under IRC Section 2522 because the pledge was the donor's binding obligation.[28]

For income tax purposes, the donor couldn't deduct his charitable contribution until payment was actually made to the charity (May). For gift tax purposes though, the donor was deemed to have made a gift to the charity when the pledge became enforceable (March). It's important to note that had the friend owed money to the donor and paid the debt with appreciated property, the friend would have to report capital gains equal to the property's appreciation. Similarly, the friend would still have to report capital gains on the property's appreciation if the friend paid his debt to the donor by transferring appreciated property to the charity in satisfaction of the donor's pledge.[29]

When a pledge isn't binding, there's no estate tax deduction as a debt of the estate.

Estate Tax Deductibility Rules

When a pledge isn't binding, there's no estate tax deduction as a debt of the estate. However, if the donor made a non-binding pledge during life and provided in their will that their estate should satisfy any unpaid pledges, the donor is deemed to have made a charitable bequest qualifying for the estate tax charitable deduction. As stated earlier, enforceable pledges that aren't fulfilled during a donor's life are treated as a debt of the donor's estate and deducible as a debt instead of a charitable deduction, if: (1) the donor's promise was enforceable against the donor's estate; (2) the amount of the unfulfilled pledge was paid to the charity; and (3) an estate tax deduction would have been allowed if the gift had been made by the donor's will.[30]

In PLR 9718031 (May 2, 1997), the donor signed a memo pledging $250,000 to a university to help construct a new building. Construction began, but the donor died before making any payments. The IRS ruled that the pledge was deductible as a debt of the estate instead of as a charitable deduction. According to the IRS, the pledge was enforceable because the charity showed substantial reliance on the pledge, and the document containing the pledge stated the specific purpose for which the funds had to be used.[31]

How PFs Fit In (or Don't)

Private foundations (PFs) are subject to special self-dealing rules. Those rules don't allow for dealings between PFs and individuals known as "disqualified persons." They're the foundation's directors, major contributors, officers, their families and certain business entities these individuals control. If a PF pays an individual's pledge, IRC Section 4941 imposes excise taxes on self-dealing because the individual is receiving a benefit. There's a 10% tax on the amount paid, and the pledge will likely have to be returned. The IRS considers a pledge to be the individual's personal legal obligation.

In Technical Advice Memorandum 8723001, the donor was a substantial contributor to a PF. That made him a disqualified person. The donor made several pledges to the PF and promised to transfer cash or marketable assets. The District Director of the PF requested technical advice from the IRS when, on several occasions, the donor substituted larger pledge amounts due at later dates. The IRS ruled that swapping smaller pledges for larger ones didn't create a problem provided they were still due at the same time. A new pledge with a later date could potentially provide a benefit to the disqualified person because the PF may not be compensated for the delays in payment. In this case, however, the substituted pledges created a 20% larger annual return, so there was no concern over compensation to the PF. If the new pledges had a later due date but weren't for a larger amount, the IRS would consider it an act of self-dealing.[32]

To Sue or Not to Sue

An enforceable pledge and favorable tax treatment doesn't mean an automatic win for the charity. If a donor refuses to pay and further negotiations fall flat, the charity has to sue the donor if it wants the unpaid balance. By the same token, if a donor dies before paying the pledge and the executor won't honor it, the charity would have to make a claim against the estate for the funds. While the process for recouping the promised assets seems straightforward, a charity's decision to move forward with the claims or litigation isn't.

Charities might not want to sue a donor even if the claim is justified. Foremost, that's because suing could have a chilling effect on other supporters. Patrons don't want to end up in court if they aren't able to continue their support. It would be counterproductive if pursuing pledged funding causes the organization to lose out on future donations.

Another reason not to sue is bad press. Some charities aren't intimidated by the potential for negative publicity and will sue to collect pledges. They believe it's their duty to their other donors who do follow through on their promises. Other charities, though, have been hesitant. After the University of Oregon's president supported a workers' rights group that took issue with Nike's operation in Asia, the founder of Nike, Phil Knight, withdrew his $30 million pledge to expand Autzen Stadium. Instead of suing him, the school decided to end its relationship with the workers' rights group. Not long after, Knight resumed donating.[33]

Duke University in Durham, N.C. faced a problem when it filed a claim against the estate of wealthy alumnus, Aubrey McClendon. He died suddenly, leaving an unfulfilled $9.9 million pledge to Duke along with hundreds of millions of dollars in other liabilities. In the probate process, Duke responded to a notice from the court asking creditors to submit their claims. Soon thereafter, Duke faced backlash from other members of the community and withdrew its claim. While the exact reason for the withdrawal wasn't clear, it likely wasn't for lack of a solid claim as Duke clearly relied on McClendon's pledges over the years and had every expectation that they would be fulfilled.[34]

Potential Pitfalls

A charity's board of directors may not be under any legal obligation to sue for unfulfilled pledges. But the board does have a fiduciary duty to the charity. After taking a close look at each individual circumstance, that duty could compel a board to bring a claim against a donor. In deciding whether to move forward with litigation, a board should consider that their duty to the charity includes managing and safeguarding its assets. A pledge is considered the charity's asset as soon as it's made. So litigation against a donor to recover pledged assets may be reasonable.[35]

> Charities should have written policies that help them decide whether to enforce a pledge.

Charities should also be sensitive to any potential conflicts of interest. Board members who have outstanding pledges should disclose that fact to the board and shouldn't be involved in votes or discussions on the policies for pledge enforcement. Taken a step further, it goes without saying (but we'll say it) that any board member who defaults on a pledge shouldn't vote when the charity decides whether to litigate that particular claim.[36]

If a donor doesn't pay, the state's Attorney General (AG) may also get involved. AGs are responsible for assuring that charitable assets are protected and used lawfully for their intended purpose in the public interest. AGs have the ability not only to investigate but also to bring legal action against charities that act improperly. In *Carl J. Herzog Foundation, Inc. v. University of Bridgeport,* the donor pledged funds to the university so that it could provide need-based merit scholarships to disadvantaged students in the medical field.[37] For a while, the school provided scholarships honoring its agreement. But a few years later, it closed its nursing program. When the funds were moved to the general endowment, the donor argued that moving it defeated the purpose of the donation. The court held that only the AG, or a

donor who expressly reserved a property interest in the donation, could maintain a suit. The donor didn't have standing.[38] It's still unclear why the Connecticut AG decided not to act in this case.

Put It In Writing

Charities should have written policies that help them decide whether to enforce a pledge. Charities should consider potential donor-relations issues. It's important to also look at the economics behind the transaction. If the donor simply doesn't have the means to fulfill the pledge, why bother?

Charitable pledges and other donor contracts are important to many charities' works. We only hear about the outliers in court cases and in the news. The vast majority of pledges work as they should. The donor makes an important charitable gift and receives favorable tax treatment, and the charity can continue its good work.

Endnotes

1. 26 U.S.C.A. Section 6166 (West).
2. *Ibid.*
3. Roger A. McEowen, "What Is a 'Trade or Business' For Purposes of Installment Payment of Federal Estate Tax?" *Agricultural Law and Taxation Blog* (March 11, 2020), *https://lawprofessors.typepad.com/agriculturallaw/2020/03/what-is-a-trade-or-business-for-purposes-of-installment-payment-of-federal-estate-tax.html.*
4. *See* Revenue Ruling 75-366 (holding that decedent's active involvement in trade or business of farming was sufficient to constitute an interest in closely held business for purposes of Internal Revenue Code Section 6166); Private Letter Ruling 8515010 (Jan. 8, 1985) (ruling that cash rental of pasture and barn didn't constitute trade or business of farming and didn't qualify as interests in closely held business); Rev. Rul. 2006-34 (concluding that the following non-exclusive factors can be used to determine whether decedent's interest is active trade or business: (1) amount of time decedent (or agents or employees) spent in farming business; (2) whether an office was maintained from which activities were conducted or coordinated and whether regular office hours are maintained; (3) extent to which decedent was actively involved in finding new tenants and negotiating and executing leases; (4) extent to which decedent provided landscaping, grounds care or other services beyond furnishing of leased premises; (5) extent to which decedent personally made, arranged for or supervised repairs and maintenance on property; and (6) extent to which decedent handled tenant requests for repairs and complaints).
5. *Allegheny Coll. v. Nat'l Chautauqua Cty. Bank of Jamestown,* 246 N.Y. 369, 369 (1927).
6. *Ibid.*, at p. 379.
7. *I. & I. Holding Corp. v. Gainsburg*, 276 N.Y. 427, 431 (1938).
8. *Ibid.*
9. *Ibid.,* at p. 434.
10. *Woodmere Academy v. Steinberg*, 41 N.Y.2d 746 (1977).
11. *Ibid.*, at p. 749. *See also Jewish Fed'n of Cent. New Jersey v. Barondess*, 234 N.J. Super. 526 (Law. Div. 1989) (involving a $2,000 pledge and holding that while reliance is a questionable basis for enforcing charitable pledges, the real basis for enforcing them is one of public policy).
12. *Estate of Payson*, Surrogate's Court, Nassau County (1978).
13. *Ibid.*
14. *In re Lipsky's Est.,* 45 Misc.2d 320 (Sur. 1965).
15. *Ibid.,* at p. 322.
16. *Paul & Irene Bogoni Found. v. St. Bonaventure Univ.,* 78 A.D.3d 616 (2010).
17. *Ibid.*
18. *Timko's Est. v. Oral Roberts Evangelistic Ass'n*, 51 Mich. App. 662 (1974).
19. *Mount Sinai Hosp. of Greater Miami, Inc. v. Jordan*, 290 So.2d 484 (Fla. 1974).
20. *Ibid.*
21. *In re Kramer,* 140 A.D.3d 768 (2016).
22. *Ibid.*
23. 26 U.S.C.A. Section 170.
24. Rev. Rul. 55-410 (1955).
25. *Ibid.*
26. Rev. Rul. 64-240 (1964).
27. PLR 8230156 (April 30, 1982).
28. Rev. Rul. 81-110 (1981).
29. *Ibid.*
30. 26 C.F.R. Section 20.2053-5.
31. PLR 9718031 (May 2, 1997).
32. Technical Advice Memorandum 8723001 (Feb. 5, 1987) (donor's satisfaction of pledge of cash or securities with real property wasn't sale or exchange and wasn't self-dealing).
33. Frank Monti, "When Donors Back Out: Are Charitable Pledges Legally Enforceable?" *Inside Philanthropy: The Gift Adviser* (Nov. 4, 2015), *www.insidephilanthropy.com/the-gift-adviser/2015/11/4/when-donors-back-out-are-charitable-pledges-legally-enforcea.html#:~:text=A%20charitable%20pledge%20is%20enforceable,in%20exchange%20for%20the%20pledge.*
34. Frank Monti, "Forget the Critics. If a Donor Owes You, Collect—Even If They're Dead," *Inside Philanthropy: The Gift Adviser* (Sept. 7, 2016), *www.insidephilanthropy.com/the-gift-adviser/2016/9/7/forget-the-critics-if-a-donor-owes-you-collecteven-if-theyre.html.*
35. Perlman & Perlman, LLP, "Legal Issues Related to Unfulfilled Charitable Pledges" (2008).
36. *Ibid.*
37. *Carl J. Herzog Found., Inc. v. Univ. of Bridgeport*, 699 A.2d 995, 996 (1997).
38. *Ibid.*

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Form 990-PF Revisions Are Long Overdue

Many of the sections are inapplicable to transitioning organizations

Some public charities lose their tax-exempt status for failure to meet ongoing public support tests over a moving 5-year window.[1] If such a public charity fails to meet the applicable support test for two consecutive years, Treasury regulations provide that it be treated as a private foundation (PF)—*but only for certain purposes*—as of the beginning of that second consecutive year (the "transition year"). Of course, a public charity may not know if it will fail the public support test for a second consecutive year until that year is over. Given the uncertainty regarding its tax classification at the beginning of the transition year, it's understandable why the regulations provide relief from the immediate application of nearly all the PF rules until the following year.

Presently, Form 990-PF, the annual information return a PF must file, treats transitioning organizations no differently than established PFs, and the instructions to such form provide very little guidance. As a result, transitioning organizations are required to fill out sections of the return that are inapplicable to them, unnecessarily subjecting themselves to a distribution requirement for the following year.

Inapplicable Questions

As mentioned above, the regulations provide that a transitioning organization is treated as a PF in the transition year only for purposes of Internal Revenue Code Sections 507, 4940 and 6033.[2] Generally, IRC Section 507 relates to termination of PF status, Section 4940 subjects the organization to a 1.39% excise tax on its net investment income and Section 6033 requires a PF to provide certain information on IRS Form 990-PF.

Section 6033 requires a transitioning organization to file Form 990-PF, beginning with the transition year, and the instructions to such form explicitly acknowledge that only Sections 507, 4940 and 6033 apply to the organization in that year. As an information return, Form 990-PF requires a PF to provide information addressing Chapter 42 compliance rules, such as self-dealing (IRC Section 4941), minimum annual distributions (IRC Section 4942), excess business holdings (IRC Section 4943), jeopardizing investments (IRC Section 4944) and taxable expenditures (IRC Section 4945)—*none of which apply to a transitioning organization in its transition year*. Unfortunately, neither the return nor its instructions direct a transitioning organization to skip inapplicable sections of the transition year return. In fact, a transitioning organization filing its transition year return would be expected to complete Form 990-PF in its entirety. By contrast, operating and foreign foundations are instructed to skip the sections of the return that don't apply to them, evidencing the fact that Treasury is willing and able to customize the instructions under certain circumstances.

Specifically, it seems that a transitioning organization would be required to complete five sections (Part VII-B, and Parts X through XIII), spanning four pages of the transition year return, to report its compliance with the Chapter 42 rules and to calculate its minimum distribution requirement (MDR) for the following year.[3] However, a

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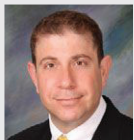


transitioning organization shouldn't be required to complete sections of the return that are geared towards compliance with Sections 4941, et. seq., which are generally inapplicable to the transitioning organization in the transition year.[4]

For instance, most of the questions posed in Part VII-B are aimed at unearthing PF-oriented compliance lapses, such as self-dealing. These questions are typically coupled with follow-up questions asking whether the organization qualified for an exception specifically pertaining to PFs. As we noted above, these sections are inapplicable to a transitioning organization in its transition year. Therefore, the transitioning organization should be excused from completing the PF compliance questions in Part VII-B. At the very least, the section should be revised to indicate that the organization either qualified for a special exception to the rule or that the rule didn't apply to the organization because the return year was its transition year.

Why Satisfy an MDR?

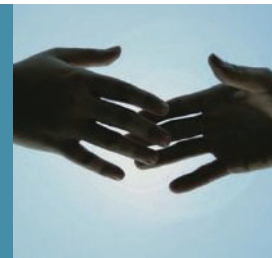
Aside from the administrative burden of preparing inapplicable sections of the return, why should the organization be expected to satisfy an MDR arising from its transition year when Section 4942 doesn't apply in such year? After all, an organization that has insufficient liquid assets may need to sell assets that it would otherwise retain to satisfy an artificial MDR. To add insult to injury, if the organization fails to satisfy this artificial MDR, it could be subject to underdistribution penalties. A less obvious, but potentially more serious, problem is what happens on the flipside—when the transitioning organization makes substantial enough qualifying distributions (QDs) in the transition year to generate excess grant carryover (EGC), which can be carried forward for up to five years to satisfy its MDR. In fact, having spoken with a number of practitioners in the sector, transitioning organizations often find themselves in this situation. Because EGC, like MDR, is governed by Section 4942, it stands to reason that just as transition year MDR is artificial, so too are any transition year QDs and resulting EGCs.

The concern here is that any such EGCs could be invalid and, therefore, unavailable for application towards the transitioning organization's MDR for any future tax years.[5] For instance, suppose that an organization generates EGCs in the transition year—*and relies on them in good faith* to satisfy its MDR for one or more future years.[6] Doing so could subject the organization to an underdistribution penalty in each such future year if the EGCs are, in fact, determined to be invalid. To make matters worse, even though the organization likely would be unaware of any underdistribution, any such penalty could be reassessed each year until the underdistribution has been corrected.[7]

> Form 990-PF and its instructions need to do much more than merely acknowledge the limited application of the PF rules to an organization in its transition year.

Essentially, tracking transition year QDs and calculating the next year's MDR are two sides of the same coin, as they're both governed by different provisions of Section 4942. Therefore, if the IRS were to expect a transition year organization to calculate its MDR for the following year, the PF, in all fairness, should be entitled to count its transition year QDs towards generating valid ECGs that may be used to satisfy its MDR in future years without fear of lurking underdistribution penalties.

Form 990-PF and its instructions need to do much more than merely acknowledge the limited application of the PF rules to an organization in its transition year. The suspension of these rules must be incorporated into the instructions and the form itself. Currently, the form and instructions create the expectation that certain transitioning organizations must meet an MDR they shouldn't have to satisfy, while others may rely on transition year ECGs that are invalid. In the absence of such long overdue revisions, transitioning organizations—and the IRS—are in the unenviable position of wasting time and resources.



Endnotes

1. The moving 5-year window is composed of the return year and the immediately preceding four years.
2. *See* Internal Revenue Code Sections 170(b)(1)(A)(vi) and 509(a)(2).
3. As used in this article, the term "minimum distribution requirement" (MDR) means the minimum amount of qualifying distributions (QDs) that must be distributed before the end of a private foundation's (PF) current tax year to avoid an underdistribution penalty. The Internal Revenue Service, however, uses a different term—"undistributed income"—which means the amount of QDs that must be distributed before the end of the PF's next tax year to avoid a penalty. Therefore, a PF's undistributed income for a given year is its next year's MDR.
4. The only Chapter 42 provision that would apply to a transitioning organization in its transition year is IRC Section 4940, which imposes a tax on a PF's net investment income.
5. Applying transition year QDs to the next year's MDR shouldn't expose the organization to a penalty because the organization would be applying artificial QDs toward an artificial MDR. The real danger would be in applying artificial transition year QDs toward a "real" (post-transition year) MDR.
6. Because current year QDs are always applied before excess grant carryovers (EGCs), a transitioning organization that draws on EGCs to satisfy its MDR necessarily would suffer an underdistribution penalty if the EGCs were determined to be invalid because it wouldn't have enough current year QDs to satisfy its MDR.
7. An underdistribution isn't automatically corrected by making additional QDs in the following year; instead, the organization must make an election pursuant to IRC Section 4942(h)(2) and Treasury Regulations Section 53.4942(a)-3(d)(2) to avoid having the penalty reassessed for multiple years.

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