

(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:

(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.

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#### § 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

(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 ac-

tually 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:

(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 es-

tablishes 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 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.

(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 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 (i)(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)(i)), 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 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 4½ percent,

(c) Beginning in 1973, apply with an applicable percentage of 4¾ 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 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 § 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*—(1) *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 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 non-exempt 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 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 vivos 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 terms of its governing instrument to accumulate 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 accumulate \$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.

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### § 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, or

(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;

(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