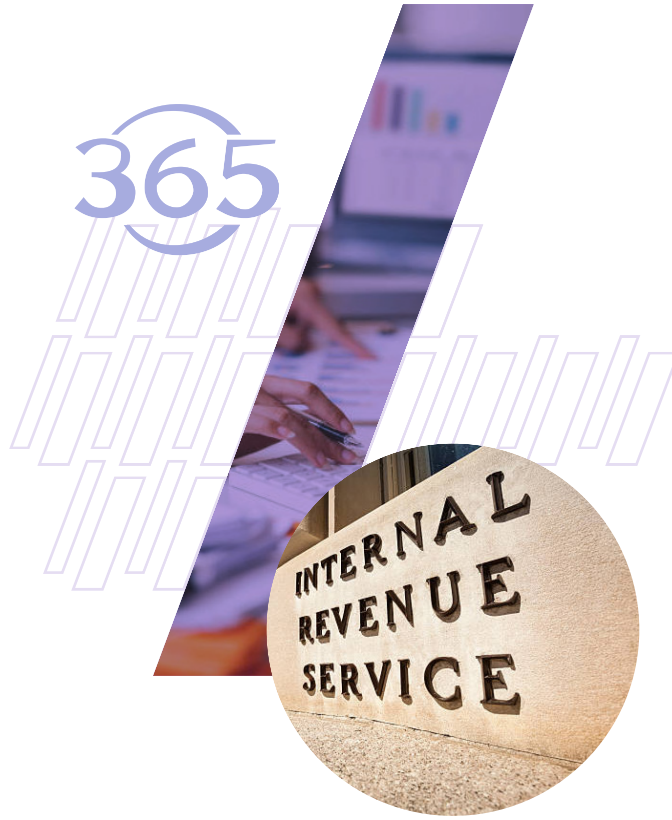
FOUNDATIONSOURCE

CALCULATING THE Minimum Distribution Requirement



A GUIDE FOR PRIVATE NON-OPERATING FOUNDATIONS

Private non-operating foundations are required by IRS regulations to make a minimum distribution each year for charitable purposes: roughly 5% of its assets, with certain adjustments, based on the previous year's assets. (There is no minimum distribution requirement in the founding year.)

Calculating this minimum distribution is complex and includes many components of the foundation's operations, such as grants, certain administrative expenses, grants repaid or returned to the foundation, cash reserves, tax liability, etc.

DEFINITION

For the purposes of this article, the **Minimum Distribution Requirement (MDR)** is the amount distributed before the end of the foundation's tax year to avoid the imposition of a penalty for failing to distribute the required amount. Technically, this is what the IRS tax rules call Undistributed Income (UI) for the previous year. For example, what the rules call the 2019 UI is referred to in this article as the 2020 MDR.

If calculated incorrectly, a foundation could inadvertently underpay its required minimum distribution. Should that happen, the foundation may be subject to a 30% penalty on the shortfall amount.

To avoid penalties, we strongly recommend that foundations seek out professionals who are intimately familiar with the calculations described here.

Here are the five steps detailed in this article:

1 Calculating the Total Average Annual Value of Foundation Assets

2 Calculating the Cash Reserve

3 Calculating the Adjusted Annual Average Value of Assets

4 Calculating the Minimum Investment Return (MIR)

5 Calculating the Minimum Distribution Requirement (MDR)

The examples used in this article reflect a foundation with a calendar tax year.

These principals apply equally to a fiscal year foundation.
Simply assume **365 days in a full fiscal year**, and substitute the last day of the fiscal year (example, November 30) in place of December 31.

1 Calculating the Total Average Annual Value of Foundation Assets

Annual Average of Cash + **Annual Average of Securities** + **Annual Average Value of Real Estate** + **Annual Average Value of Other Alternative Assets** = **TOTAL ANNUAL AVERAGE VALUE OF FOUNDATION ASSETS**

A. Calculating the Annual Average of Cash

Cash (money market funds) is valued on a monthly basis by averaging the amount of cash on hand on the first and last day of each month.

B. Calculating the Annual Average of Securities

Securities (including stocks, bonds, mutual funds, etc.) for which a market quotation is readily available must be valued monthly by reference to the foundation's portfolio report on a set day of each month, using any reasonable, consistent method, such as the last day of the month.

C. Valuation of Real Estate

Real estate may be valued once every five years, by reference to a written, certified, and independent appraisal, as described below. Real estate valuations should be done on approximately the same date every fifth year.

A certified, independent appraisal must be made in writing by a qualified person who is not a "disqualified person" (i.e., not an insider, substantial contributor, or a family member of such a person) with respect to the foundation. An appraisal is considered to be "certified" only if it includes a statement that, in the opinion of the appraiser, the values placed on the real estate appraised were determined in accordance with valuation principles regularly employed in making appraisals of such property using all reasonable valuation methods. Certified real estate appraisals can be made more frequently when real estate values have substantially declined; this would kick off a new five-year period.

One may also use non-certified appraisals. However, these must be based on industry appropriate valuation principles, and they must be done annually.

Valuing Real Estate Held for Only a Portion of a Full Tax Year. If real estate has not been held by the foundation for its entire taxable year, the fair market value is prorated to reflect the number of days that it has been held by the foundation in that year, as follows:

Real Estate's Value × **No. of Days Real Estate Held by Foundation** ÷ **365** = **PRORATED FAIR MARKET VALUE**

EXAMPLE: A contribution of real estate is made to the Foundation on September 22, 2019, and a qualified appraisal values the property at $200,000 as of December 31, 2019. The real estate's value would be prorated as follows:

$200,000 × **100** ÷ **365** = **$54,795 FAIR MARKET VALUE FOR THE CONTRIBUTION YEAR**

Valuing Real Estate Held for Only a Portion of a Short Tax Year. In a short tax year, such as the founding year, should the foundation hold real estate only a portion of that short tax year, the formula is slightly different, as follows:

Real Estate's Value × **No. of Days Real Estate Held by Foundation** ÷ **Number of Days in Short Tax Year** = **PRORATED FAIR MARKET VALUE**

EXAMPLE: **Same as above, except this example is a 200-day short tax year:**

$200,000 × **100** ÷ **200** = **$100,000 FAIR MARKET VALUE FOR THE CONTRIBUTION YEAR**

D. Valuation of Other Alternative Assets

All other asset types need to be valued once per year, generally by reference to estate tax rules. The valuation for such alternative assets should be done on approximately the same date every year. If an alternative asset has not been held by a foundation for the foundation's entire taxable year, the fair market value of such asset is prorated to reflect the number of days that it has been held by the foundation in that year. (See formulas above for real estate held only a portion of a full tax year and only a portion of a short tax year.)

E. Excluding Charitable (Non-Investment) Assets

Essentially, a charitable asset is any foundation asset that is directly tied to fulfilling that foundation's charitable mission. For example, suppose that a foundation purchases a computer, monitor, and printer for administrative purposes. Assume that an asset that helps a foundation accomplish its administrative duties is considered to be used to fulfill that foundation's charitable mission. Therefore, the computer, monitor, and printer would all be considered charitable assets. The average fair market value of this type of asset must be EXCLUDED from all Minimum Investment Return, and hence, all Minimum Distribution Requirement calculations (although such assets will be listed on the foundation's books as charitable assets).

2 Calculating the Cash Reserve (CR)

This is a straightforward calculation:

Total Annual Average Value of Foundation Assets (Step 1) × **1.50%** = **CASH RESERVE (CR)**

3 Calculating the Adjusted Annual Average Value of Assets

Total Annual Average Value of Foundation Assets − **Debt** − **CR** = **ADJUSTED ANNUAL AVERAGE VALUE OF ASSETS**

4 Calculating the Minimum Investment Return (MIR)

The **Minimum Investment Return** for any private foundation is 5% of the excess of the combined fair market value of all assets of the foundation, other than those used or held for use for exempt purposes, over the amount of indebtedness incurred to buy these assets.

Adjusted Annual Average Value of Assets × **MIR Percentage** = **MIR**

Except for the foundation's creation, termination or other short years (see following section), the MIR Percentage always will equal 5%.

Prorating the 5% MIR Percentage for a Short Taxable Year

The MIR percentage is reduced for a foundation with a short taxable year, for example, the first short year of a foundation's formation or the year of termination.

Number Of Days in the Short Taxable Year × **5%** ÷ **365** = **MIR % FOR A SHORT YEAR**

5 Calculating the Minimum Distribution Requirement (MDR)

MIR + **Repaid or Returned Grants** − **Excise and Income (UBIT) Taxes for the Year** = **TENTATIVE MDR**

The tentative MDR is determined by starting with the MIR, adding back any repaid or returned grants or expenses previously treated as qualified expenditures (see below), and then is reduced by the foundation's excise and incomes taxes for the year. The "tentative" MDR is only tentative because it is the starting point before any reductions due to excess grants made by the foundation exceeding its MDR in prior years.

EXAMPLE: Suppose a foundation's 2019 MDR was $100; now suppose that in 2019 the foundation made actual qualifying distributions of $120. Those excess qualifying distributions will carry forward and reduce the 2020 MDR. So if the foundation's tentative 2020 MDR is $200, after taking into account the $20 excess from 2019, the actual MDR would only be $180.

NOTE: Our tentative MDR is what the IRS calls the prior year's **Distributable Amount** or **DA**. For example, the 2020 tentative MDR for 2020 is what the IRS rules would refer to as the 2019 Distributive Amount or DA.

Qualifying Distributions that Count Toward a Foundation's MDR

A. Charitable Grants: Grants made for charitable purposes, typically to 501(c)(3) charitable organizations.

B. Operational Expenses: Administrative fees and other reasonable overhead/expenses paid out by the foundation in connection with the conduct of its charitable activities count as qualifying distributions, including legal, accounting, state registration and other fees and expenses paid in connection with the creation and ongoing qualification of a private foundation.

The portion of the foundation's administrative expenses allocable to management of properties held for the production of income, such as investment advisory or bank fees, are not considered allocable to the foundation's exempt activities. Such expenses would constitute investment expenses that may be applied to offset the foundation's gross investment income, potentially reducing the foundation's excise tax liability.

C. Amounts paid to acquire assets used directly for charitable purpose

D. Program-Related Investments.

E. Amounts (set aside) for specific charitable projects that satisfy IRS tax rules.

Ordering Rules: Applying Qualifying Distributions to Determine Excess Grants Carryforward

RS Rules and treasury regulations require that qualifying distributions are applied in the following order:

- Applied first to satisfy the current year's MDR (the prior year's Undistributed Income).
- Second, if an election is made, applied to reduce an MDR deficit from prior years.
- Third, if an election is made, it is treated as a "distribution out of corpus."
- Fourth, applied to reduce the next year's MDR.
- The balance, if any, becomes an excess grants carryforward.

ABOUT FOUNDATION SOURCE

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