UNDERSTANDING A POWERFUL PRIVATE FOUNDATION TOOL: THE CASH SET-ASIDE

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When used correctly, the cash distribution set-aside (when its technicalities are properly understood) is invaluable for foundations completing long-term charitable projects.

Generally, private foundations ("PFs") are required to expend at least 5 percent of their assets each year on grantmaking, charitable activities, and certain other qualifying expenditures. Regardless of their accounting method, a PF normally is required to satisfy its minimum distribution requirement ("MDR") to avoid penalties with funds that have actually been expended, not merely pledged or promised. However, PFs can avail themselves of a powerful tool, known as a set-aside, to treat amounts merely set aside for payment in a future year toward satisfying the current year's MDR. This can be especially helpful when a PF is engaged in a long-term charitable project because it enables a PF to save up amounts (that otherwise would need to be distributed to avoid penalties) for projects that will not be completed by the end of the set-aside year.

One type of set-aside, the cash distribution set-aside, allows PFs to defer their MDRs in their early years without IRS approval. Although PFs may be able to make cash distribution set-asides in their later years, it's rarely done because they typically would not have satisfied certain ongoing and burdensome reporting and special distribution requirements that would have applied since inception. (Another type of set-aside, the suitability set-aside, allows PFs to defer their MDRs at any time in their lifecycles, provided that they obtain approval from the IRS.)

While the cash set-aside can be advantageous, its technicalities are commonly misunderstood and must be approached carefully to avoid serious consequences.

Here are the most important points to understand about the cash distribution set-aside:

1. It doesn't replace the MDR; it postpones it. A set-aside doesn't excuse a PF from satisfying its MDR; rather, the obligation to pay the amount set aside is simply *postponed* to a later time (up to 60 months from the date of the set-aside). Bear in mind that the PF will still need to timely satisfy its MDR for the remaining years within that 60-month postponement period. For instance, suppose a PF has an MDR of $50,000 and makes a set-aside for that year in such amount to satisfy its entire MDR without disbursing any cash. Suppose further that its MDR for each of the following five years (the postponement period) is also $50,000. Therefore, the

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EXHIBIT 1
Private Foundation Startup Period

	Startup Period				
	Year 1	Year 2	Year 3	Year 4	Total
Distributable Amount	$100,000	$100,000	$100,000	$100,000	-
CDR percentage	20%	40%	60%	80%	-
CDR	$20,000	$40,000	$60,000	$80,000	$200,000

PF will be obligated to distribute a total of at least $300,000 ($50,000 in each year multiplied by 5 years, plus $50,000 postponed set-aside amount) by the end of the postponement period.

2. A PF can make more than one cash set-aside during its "startup period." During a PF's "startup period," which is the first four tax years after the tax year in which the PF was deemed created, a PF may make more than one set-aside. For instance, in the previously mentioned example, if the $50,000 set-aside was made during the startup period, the PF could have made more than one set-aside during that period.

3. Cash set-asides must satisfy a separate CDR. A PF making a cash set-aside must satisfy a separate minimum cash distribution requirement ("CDR") that is completely independent from the annual MDR. (The CDR does not apply when making a suitability set-aside, which requires IRS approval.) Generally, the CDR requires a PF to make aggregate qualifying distributions of a statutorily defined amount in the form of cash by the end of the startup period, even if the entire amount is distributed during the last year. The CDR is the aggregate of 20, 40, 60, and 80 percent of its "distributable amount," respectively, of its first, second, third, and fourth years of the startup period. The distributable amount for a given year is roughly 5 percent of the foundation's assets, with certain adjustments. While the CDR cannot be satisfied by making *another* set-aside, it can be satisfied by any amounts distributed in satisfaction of a set-aside before the end of the startup period.

Note: The more years in which a PF utilizes the cash set-aside during its startup period to satisfy all or part of a given year's MDR, the greater the risk that the PF may fail to satisfy the CDR and invalidate any cash set-asides made during such period. This could cause the PF to miss its MDR for any year a cash set-aside was taken and expose the PF to significant underdistribution penalties.

For instance, suppose that a PF has a distributable amount of $100,000 for each year of the four-year startup period and it makes a cash set-aside of $100,000 in Year 4. As shown in Exhibit 1, the PF's CDR will be $200,000, which must be distributed by the end of Year 4 of the startup period. However, the PF will have 60 months from the date of the set-aside (in Year 4) to distribute the amount set aside. Suppose further that if the PF made qualifying distributions in cash of $100,000 in each of Years 1 through 3, the PF would satisfy its CDR.

Suppose the same previously mentioned facts, except that the PF made cash set-asides in Years 3 and 4 totaling $200,000 which, as previously mentioned, must be distributed by the end of Year 4 of the startup period. If the PF made cash qualifying distributions of $200,000 in Years 1 and 2 of the startup period, it will satisfy its CDR of $200,000.

Finally, supposing the same facts from the previous example, except that the PF made cash set-asides in Years 1, 2, and 3, totaling $300,000, and made cash qualifying distributions of only $100,000 in Year 4 of the startup period. In this case, the PF would fail to satisfy its CDR. However, if the PF satisfied its $100,000 Year 1 set-aside by the end of the startup period (12 months earlier than required), in addition to the $100,000 it made in qualifying distributions in Year 4, the CDR would be fully satisfied because the satisfaction of the set-aside counts toward the satisfaction of the CDR.

[1] Treas. Reg. Section 53.4942(a)-3(b)(7)(ii)

4. Funds allocated to satisfy a CDR do not also satisfy the MDR for the same year. Although amounts distributed in a given year in satisfaction of a set-aside count toward meeting the CDR, such amounts do not count toward satisfying the MDR for that year. After all, the PF would be counted twice if it were permitted to count the amount set aside toward meeting its MDR for the set-aside year as well as for the year in which it is actually distributed.

5. Cash set-asides must be explained on tax returns via separate statements. In accordance with the Treasury Regulations,[1] the PF must attach a statement to the return for the set-aside year containing certain representations regarding the set-aside. Further, in the set-aside year and the five taxable years following such year, the PF must attach a statement to the return indicating the distributable amount for each year in the startup period and the amount of cash actually distributed during such period.

Conclusion

As illustrated in this article, it can be very easy for a PF to fail to meet the technical requirements needed to make a cash set-aside. However, if approached with caution, the set-aside can be a useful tool that enables a PF to save up amounts (that otherwise would need to be distributed to avoid penalties) for long-term charitable endeavors that extend beyond the end of the set-aside year.

About Foundation Source

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We work in concert with financial advisors, legal and accounting professionals, consultants, and family offices, as well as directly with individuals, families, and corporations to bring philanthropic visions to life. As we celebrate our 20th year of service, Foundation Source supports nearly 2,000 family, corporate, and professionally staffed foundations of all sizes and has enabled more than $7 billion in charitable grants. ■