

**DESCRIPTION OF THE CHAIRMAN'S MARK OF A PROPOSAL TO
PROVIDE AN EXCEPTION TO THE PRIVATE FOUNDATION
EXCESS BUSINESS HOLDINGS RULES FOR CERTAIN
PHILANTHROPIC BUSINESS HOLDINGS**

Scheduled for Markup
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Prepared by the Staff
of the
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INTRODUCTION

The Senate Committee on Finance has scheduled a committee markup on February 11, 2015, of a proposal to provide an exception to the private foundation excess business holdings rules for certain philanthropic business holdings. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Mark of a Proposal to Provide an Exception to the Private Foundation Excess Business Holdings Rules for Certain Philanthropic Business Holdings* (JCX-25-15), February 9, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

A. Provide an Exception to the Private Foundation Excess Business Holdings Rules for Certain Philanthropic Business Holdings

Present Law

Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.² Certain organizations are classified as public charities *per se*, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations (including medical research organizations), certain organizations providing assistance to colleges and universities, and governmental units.³ Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.⁴ Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (*e.g.*, fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.⁵ A supporting organization, *i.e.*, an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets certain other requirements of the Code, also is classified as a public charity.⁶

² The Code does not expressly define the term “public charity,” but rather provides exceptions to those entities that are treated as private foundations.

³ Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

⁴ Treas. Reg. sec. 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a “facts and circumstances” test. Treas. Reg. sec. 1.170A-9(f)(3).

⁵ To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization’s exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

⁶ Sec. 509(a)(3). Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (*e.g.*, an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities, as well as a tax on their net investment income.⁷

Excess business holdings of private foundations

Private foundations are subject to tax on excess business holdings.⁸ In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership (substituting “profits interest” for “voting stock” and “capital interest” for “nonvoting stock”) and to other unincorporated enterprises (by substituting “beneficial interest” for “voting stock”). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.⁹ This five-year period may be extended an additional five years in limited circumstances.¹⁰ The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.¹¹

⁷ Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). Sec. 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-dealing transactions (sec. 4941), are required to make a minimum amount of charitable distributions each year (sec. 4942), are limited in the extent to which they may control a business (sec. 4943), may not make speculative investments (sec. 4944), and may not make certain expenditures (sec. 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

⁸ Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

⁹ Sec. 4943(c)(6).

¹⁰ Sec. 4943(c)(7).

¹¹ Sec. 4943(d)(3).

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Description of Proposal

The proposal creates an exception to the excess business holdings rules for certain philanthropic business holdings. Specifically, the tax on excess business holdings does not apply with respect to the holdings of a private foundation in any business enterprise that, for the taxable year, satisfies: (1) the exclusive ownership requirements; (2) the "all profits to charity" requirement; and (3) the independent operation requirements.

The exclusive ownership requirements are satisfied if: (1) all ownership interests in the business enterprise are held by the private foundation at all times during the taxable year; and (2) all the private foundation's ownership interests in the business enterprise were acquired under the terms of a will or trust upon the death of the testator or settlor, as the case may be.

The "all profits to charity" requirement is satisfied if the business enterprise, not later than 120 days after the close of the taxable year, distributes an amount equal to its net operating income for such taxable year to the private foundation. For this purpose, the net operating income of any business enterprise for any taxable year is an amount equal to the gross income of the business enterprise for the taxable year, reduced by the sum of: (1) the deductions allowed by chapter 1 of the Code for the taxable year that are directly connected with the production of the income; (2) the tax imposed by chapter 1 on the business enterprise for the taxable year; and (3) an amount for a reasonable reserve for working capital and other business needs of the business enterprise.

The independent operation requirements are met if, at all times during the taxable year, the following three requirements are satisfied. First, no substantial contributor to the private foundation, or family member of such a contributor, is a director, officer, trustee, manager, employee, or contractor of the business enterprise (or an individual having powers or responsibilities similar to any of the foregoing). Second, at least a majority of the board of directors of the private foundation are not also directors or officers of the business enterprise or members of the family of a substantial contributor to the private foundation. Third, there is no loan outstanding from the business enterprise to a substantial contributor to the private foundation or a family member of such contributor. For purposes of the independent operation requirements, "substantial contributor" has the meaning given to the term under section 4958(c)(3)(C), and family members are determined under section 4958(f)(4).

The proposal does not apply to the following organizations: (1) donor advised funds or supporting organizations that are subject to the excess business holdings rules by reason of section 4943(e) or (f); (2) any trust described in section 4947(a)(1) (relating to charitable trusts); or (3) any trust described in section 4947(a)(2) (relating to split-interest trusts).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

B. Estimated Revenue Effects

The proposal is estimated to have a negligible effect on Federal fiscal year budget receipts for the period 2015-2025.