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**WHAT FOUNDATION MANAGERS NEED TO KNOW ABOUT
THE QUALIFYING DISTRIBUTION RULES**

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**Celia Roady, Esq.
Morgan, Lewis & Bockius LLP
1111 Pennsylvania Avenue, NW
Washington, DC
202-739-5279
croady@morganlewis.com**

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Celia Roady
Morgan, Lewis & Bockius LLP
Washington, DC

I. Introduction

- A. History & Purpose. Congress enacted Section 4942 of the Internal Revenue Code out of concern that some private foundations were unreasonably accumulating income without making grants for charitable purposes, even though foundation donors had received immediate tax deductions for their contributions. Accordingly, Section 4942 imposes minimum income distribution requirements for both private foundations and private operating foundations.
- B. Basics. The amount that a foundation is required to distribute annually is called its “distributable amount.” Section 4942 requires that a foundation pay out its distributable amount for each tax year by the end of the following tax year. The required payout must be in the form of “qualifying distributions,” meaning any expenditure, grant or set-aside of funds for charitable purposes, as described below.
- C. Penalties. If a foundation fails to satisfy its payout requirements, a 15% excise tax is imposed on the shortfall between its distributable amount and qualifying distributions for the tax year. An additional excise tax equal to 100% of the undistributed income is imposed if the failure is not “corrected” within a certain time frame.

II. Calculating the Mandatory Distribution Requirements

- A. How to Calculate a Foundation’s Mandatory Distribution Requirements. To determine the distributable amount that a foundation must pay out to avoid tax under Section 4942:
1. First, determine the foundation’s “minimum investment return,” which is generally about 5% of its investment assets; and
 2. Second, adjust the minimum investment return by certain amounts that had previously been treated as qualifying charitable distributions but were subsequently put to other uses – including adding any amounts that the foundation had previously used to meet its distribution requirements and that were returned to the foundation, such as program-related investments that were repaid.¹
 - a. In this way, the foundation would be required to redistribute such amounts by the end of the year following the year in which the funds were repaid.

¹ Treas. Reg. § 53.4942(a)-2.

III. Step 1: Calculating a Foundation's "Minimum Investment Return"

- A. Definition of Minimum Investment Return. A foundation's minimum investment return is 5% of the excess of:
1. the fair market value of the foundation's investment assets (*i.e.*, not including assets used to carry out the foundation's exempt purposes), over
 2. the amount of its "acquisition indebtedness"² with respect to such assets.³
- B. Determining the Fair Market Value of a Foundation's Investment Assets in Calculating Its Minimum Investment Return. The fair market value of a foundation's investment assets includes:
1. for securities for which market quotations are readily available, the average of the fair market values of the securities on a monthly basis;
 2. the average of the foundation's monthly cash balances; and
 3. the fair market value of all other investment assets that the foundation held during the tax year, not including certain items described below.⁴
- C. Assets Not Included in Calculating a Foundation's Minimum Investment Return. The following items are excluded in calculating the fair market value of a foundation's investment assets:
1. future interests (*e.g.*, a vested or contingent remainder) in the income or corpus of real or personal property;
 2. the assets of an estate until the assets are distributed to the foundation or the estate is considered terminated;
 3. present interests in a trust created and funded by another person;⁵
 4. pledges to the foundation of money or property; and
 5. Exempt Purpose Assets – assets used directly (or held for use) in carrying out the foundation's exempt purposes, described below.⁶ This is the most important category of excluded assets.
 - a. Examples of Exempt Purpose Assets Excluded in Calculating a Foundation's Minimum Investment Return: assets used directly in carrying out the foundation's

² Determined under Section 514(c)(1), but without regard to the tax year in which the indebtedness was incurred.

³ Treas. Reg. § 53.4942(a)-2(c).

⁴ Treas. Reg. § 53.4942(a)-2(c)(2).

⁵ However, a foundation is required to increase its distributable amount to reflect certain income distributions from split-interest trusts. These rules are described in Treas. Reg. § 53.4942(a)-2(b)(2).

⁶ Treas. Reg. § 53.4942(a)-2(c)(3).

exempt purposes (*e.g.*, land held for conservation purposes); administrative assets (*e.g.*, office supplies); interests in a “functionally related business”⁷ or in a program-related investment; and a reasonable amount of cash to cover current routine expenses.

- (i) In Rev. Rul. 74-498, the IRS decided that a collection of paintings, owned by a private foundation formed to further the arts, that was loaned under an active loan program for exhibition in museums, universities and similar institutions was used directly in carrying out the foundation’s exempt purposes, and that the value of the paintings was excludable in computing the foundation’s minimum investment return.
- b. If the use of property for exempt purposes represents 95% or more of the property’s total use, then the property is considered to be used exclusively for exempt purposes. If the exempt use of the property is less than 95%, then the foundation must make a reasonable allocation.
 - (i) In Rev. Rul. 83-137, a private foundation owned a building, a portion of which was used directly in carrying out its exempt purposes, with the remainder leased to commercial tenants. The IRS determined that the percentage of exempt use of the building for purposes of calculating the foundation’s minimum investment return should be determined by dividing the fair rental value of that portion of the building used for exempt purposes by the fair rental value of the entire building.

D. Valuing Assets in Calculating a Foundation’s Minimum Investment Return. Special guidelines are used to determine the value of assets for purposes of calculating a foundation’s minimum investment return.⁸

1. Valuation Methods. Commonly accepted methods of valuation must be used in making an appraisal of property.
2. Valuation of Securities for which Market Quotations Are Readily Available. A foundation may use any reasonable method to determine the fair market value on a monthly basis of securities (*e.g.*, stocks, bonds, mutual funds) for which market quotations are readily available, provided that such method is used consistently.
 - a. Market quotations are readily available if a security is listed on a national, regional or local exchange that issues regular quotations (*e.g.*, the New York Stock Exchange).
 - b. A reduction to the value of securities – capped at 10% – is available to the extent that a foundation demonstrates that the market quotations do not reflect their actual fair market value because of the size of the block of securities, because of the fact that

⁷ Meaning either a trade or business that is not “unrelated” under the UBIT rules of Section 513 or an activity carried on within a larger aggregate of similar activities related to the foundation’s exempt purposes. See Treas. Reg. § 53.4942(a)-2(c)(3).

⁸ Treas. Reg. § 53.4942(a)-2(c)(4).

they are in a closely held corporation or because the sale of the securities would result in a forced or distress sale.

3. Valuation of Cash Balances. The amount of a foundation's cash balance is determined by valuing the cash on a monthly basis by taking the average of the amount of cash on hand as of the first and last days of the month.
4. Valuation of Real Property Interests. The fair market value of real property may be determined on a five-year basis (*i.e.*, the tax year of the valuation and the four previous years), provided that the foundation obtains a reasonable, certified and independent appraisal in writing from a person who is not a disqualified person to or an employee of the foundation.
5. Valuation of Other Assets. The fair market value of other assets (except for real property) is generally determined annually, and as of the same date each year.⁹

IV. Step 2: Calculating the "Distributable Amount" from the "Minimum Investment Return"

A. A foundation's distributable amount is calculated by adjusting its minimum investment return as follows:

1. Subtract any income taxes and the Section 4940 excise tax on investment income paid by the foundation, and
2. Add the following amounts treated by the foundation as charitable distributions in a previous year that were subsequently recovered (so that, as a result, the foundation must redistribute such amounts during the next year):
 - a. amounts received as repayments of amounts that were considered qualifying distributions in any tax year;
 - b. any amount received from the sale or other disposition of property to the extent that the acquisition of such property was considered a qualifying distribution in any tax year; and
 - c. any amount "set aside" under Section 4942(g)(2) (described below) to the extent that it was not necessary for the purposes for which it was set aside.¹⁰
3. Special rules apply if a foundation has income from distributions from a split-interest trust attributable to the income portion of amounts placed in trust after May 26, 1969.¹¹

⁹ Treas. Reg. § 53.4942(a)-2(c)(4)(iii). We also note that although Treas. Reg. § 53.4942(a)-2(b)(2) requires a foundation to include in its distributable amount for each year the full income portion of distributions from split-interest trusts, the courts have struck down this requirement, and the IRS has publicized its intent to codify the courts' holding in new regulations. See Notice 2004-36.

¹⁰ Treas. Reg. § 53.4942(a)-2(d)(2)(iii).

¹¹ Treas. Reg. § 53.4942(a)-2(b)(2).

V. Qualifying Distributions

A. Qualifying Distributions Requirements. To avoid penalties under Section 4942, a private foundation must make “qualifying distributions” in an amount equal to the distributable amount before the end of the succeeding tax year.

B. Amounts Treated as Qualifying Distributions. “Qualifying distributions” include:

1. Amounts paid to accomplish charitable, religious, educational or other exempt purposes and amounts contributed to a governmental unit for exclusively public purposes, such as:
 - a. grants to charitable organizations described in Sections 501(c)(3) and 509(a)(1) (other than controlled organizations);
 - b. grants to other kinds of organizations over which the foundation exercises expenditure responsibility (except private foundations that have not redistributed such grants);
 - c. program-related investments; and
 - d. “reasonable and necessary” administrative expenses of the foundation’s charitable programs, such as compensation and travel expenses of foundation staff, office supplies, equipment repair, fees paid to outside firms and individuals, and the cost of preparing Form 990-PF and making it available for public inspection.¹²
 - (i) Example. Rev. Rul. 75-495 explains that legal fees that are not excessive in amount and that were paid by an exempt charitable trust in a lawsuit to determine the proper beneficiary of a portion of its net income, count as qualifying distributions.
2. Amounts paid to acquire an asset used (or held for use) directly in carrying out one or more charitable or public purposes.
3. Amounts “set aside” for a specific project that furthers charitable or public purposes.¹³

C. Amounts Excluded from Qualifying Distributions. Qualifying distributions do not include:

1. payments of any Chapter 42 private foundation taxes,
2. contributions to non-operating private foundations (except where redistributed), or
3. contributions to other Section 501(c)(3) organizations (including public charities) that are directly or indirectly controlled by the grantor foundation or any of its “disqualified persons.”

¹² Treas. Reg. § 53.4942(a)-3(a)(8).

¹³ Sec. 4942(g); Treas. Reg. § 53.4942(a)-3.

- a. In order for a grant to a controlled organization to be considered a qualifying distribution, the grantee must demonstrate that it has redistributed the grant amount out of corpus prior to the end of the year after the year in which it received the grant.¹⁴
- D. Foreign Grantees. A grant to a foreign organization that has not received a ruling or determination letter affirming that it is a public charity or an operating foundation may nonetheless be considered a qualifying distribution if the grantor foundation either (1) exercises expenditure responsibility, or (2) follows the procedures for making a good faith determination that the donee organization qualifies as a public charity or an operating foundation.¹⁵
- E. Set-Asides. Foundations are permitted to treat as qualifying distributions certain amounts of income that they have not yet actually expended but have set aside for future use, within no more than 60 months, in a specific project – called “set-asides.”¹⁶ Set-asides are treated as qualifying distributions in the year in which they are set aside, not in the year in which they are actually paid out. To claim qualifying distribution treatment for a set-aside, a foundation must establish to the IRS’ satisfaction that:
- a. the amount will actually be paid for the “specific project” within five years of the date funds are set aside, and
 - b. the set-aside satisfies the “suitability test.”
2. Suitability Test for Set-Asides. Under the suitability test, a foundation is required to demonstrate to the IRS in writing, before the end of the tax year in which the amount is set aside, that the specific project can be better accomplished by the set-aside than by immediate payment of funds.¹⁷
- a. Such projects include those where relatively long-term grants or expenditures must be made to ensure the continuity of particular charitable projects or program-related investments or where grants are made as part of a matching-grant program.
 - b. Example. In PLR 200534024 (June 3, 2005), the IRS approved a foundation’s proposed set-aside of funds for a grant to another charitable organization for the purpose of restoring and renovating a historic site and creating a museum, under the suitability test. This grant was part of a matching-grant program intended to stimulate additional grants from the community at large. By providing the grantee with 29 months during which it could secure additional donations, the foundation hoped to give the grantee adequate time to raise additional funding. The foundation felt that it would best meet the goal of preserving this site by retaining a degree of control over the renovation process and making the disbursement of grant funds dependent upon approval of drawings, plans and specifications of the restoration project.

¹⁴ See Sec. 4942(g)(3); Treas. Reg. § 53.4942(a)-3(c)(1)(i).

¹⁵ Treas. Reg. § 53.4942(a)-3(a)(6).

¹⁶ Treas. Reg. § 53.4942(a)-3(b).

¹⁷ As described in Treas. Reg. § 53.4942(a)-3(b)(7)(i).

3. Minimum Distribution During Start-up Period. A minimum distribution requirement is imposed on private foundations during a foundation's "start-up period," which generally consists of the four tax years after the year in which the foundation was created.¹⁸
 - a. The "start-up period minimum amount" that a foundation must distribute in its start-up period cannot be less than the *sum* of 20% of its distributable amount for the first tax year of the start-up period, 40% of its distributable amount for the second tax year, 60% of its distributable amount for the third tax year and 80% of its distributable amount for the fourth tax year.
 - b. The total "start-up period minimum amount" must be distributed before the end of the period as a whole; how much a foundation distributes in any particular year is irrelevant.
4. Minimum Distribution Required During the Full-Payment Period. A foundation must begin distributing its "full-payment period minimum amount" – 100% of its distributable amount – each year during its "full-payment period," which begins after the end of its start-up period.¹⁹
5. Timing of Distributions. Foundations have until the end of the following tax year to complete the distributions required for a given year. For example, a foundation is not required to distribute its required payout based on the 2006 value of its assets until the end of 2007.²⁰
6. Distributing More Than the Minimum Amount. If a foundation distributes more than its minimum amount in a given tax year, it may carry forward the excess to reduce its minimum amount during the next five tax years.²¹

VI. Taxes for Failing to Satisfy the Payout Requirement

- A. Under Section 4942, a 15% excise tax is imposed on the shortfall between a foundation's distributable amount and qualifying distributions for a tax year – known as its "undistributed income" (this term is somewhat misleading; the foundation's actual income earned during that year is irrelevant).²²
 1. The 15% tax is imposed in addition to – not in lieu of – distributing the required amounts.
- B. No tax is imposed on a foundation for failing to satisfy its payout requirements due to an incorrect valuation of its assets, provided that the foundation corrects such failure and notifies the IRS.
 1. The tax is not imposed to the extent that the foundation failed to distribute any amount solely because of an incorrect valuation of assets, so long as such failure was not willful

¹⁸ Treas. Reg. § 53.4942(a)-3(b)(i)(4).

¹⁹ Treas. Reg. § 53.4942(a)-3(b)(i)(5).

²⁰ Treas. Reg. § 53.4942(a)-3(c)(2).

²¹ Treas. Reg. § 53.4942(a)-3(e).

²² Treas. Reg. § 53.4942(a)-1.

and was due to reasonable cause, and such amount is distributed as qualifying distributions.²³

- C. An additional excise tax equal to 100% of the undistributed income is imposed if the foundation's failure to satisfy its payout requirements is not "corrected" within a certain time.
- D. Unlike other private foundation excise taxes, no penalty is imposed on foundation managers for failing to satisfy a foundation's distribution requirements.

VII. Special Rules for Private Operating Foundations

- A. The Section 4942 excise tax for failure to make qualifying distributions does not apply to private "operating foundations."²⁴
- B. Private operating foundations are organizations that do not satisfy the public support test required for classification as a public charity but, unlike non-operating foundations, primarily conduct charitable activities on their own rather than making grants to other organizations.
 - 1. Private foundations may treat distributions not only to public charities but to operating foundations as qualifying distributions under Section 4942.²⁵ However, distributions to non-operating foundations do not count as qualifying distributions, unless the recipient foundation makes a qualifying distribution of the grant within a certain period.²⁶
- C. To qualify as an operating foundation, an organization must satisfy an "income" test and one of three alternative tests: the "assets," "endowment" or "support" test. These tests essentially require that operating foundations also distribute certain amounts annually, although such amounts are calculated differently than for non-operating foundations.
- D. The income test requires that a foundation make qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated equal to 85% or more of the *lesser* of its minimum investment return or its "adjusted net income."²⁷
 - 1. Minimum investment return is calculated in the same manner as it is for private non-operating foundations – *i.e.*, it is approximately 5% of the fair market value of the foundation's investment assets.
 - 2. Adjusted net income is defined as gross income less deductions allowed to taxable corporations, with certain modifications to both income and deductions.²⁸ Gross income includes all amounts derived from property held by the foundation, including property used directly in an exempt function and in unrelated trade or business activities. However, contributions received by the foundation are not included.

²³ Treas. Reg. § 53.4942(a)-1(b).

²⁴ Sec. 4942(a)(1).

²⁵ Sec. 4942(g)(1).

²⁶ Sec. 4942(g)(3).

²⁷ Sec. 4942(j)(3)(A); Treas. Reg. § 53.4942(b)-1(c).

²⁸ Sec. 4942(f); Treas. Reg. § 53.4942(a)-2(d).

- a. In computing gross income and deductions, the income tax principles under subtitle A of the Internal Revenue Code generally apply, but exclusions, deductions and credits are not allowed unless expressly provided under Section 4942.
 - b. Adjusted net income includes various amounts that represent repayments of amounts previously claimed as qualifying distributions, such as:
 - (i) amounts received as repayments of amounts that were previously treated as qualifying distributions,
 - (ii) amounts received from the disposition of property to the extent that the acquisition of such property was previously treated as a qualifying distribution, and
 - (iii) set-asides, to the extent the amount is determined not to be necessary for the purposes for which it was set aside.
 - c. Various modifications apply in calculating a foundation's income, including the following:
 - (i) interest from tax-exempt bonds is included in income,
 - (ii) capital gains and losses are excluded from the sale of property, except to the extent of net short-term capital gain,
 - (iii) income received from an estate during the period of administration (unless the estate is considered terminated for federal income tax purposes due to prolonged administration),
 - (iv) distributions from certain trusts are not included in income, and
 - (v) net Section 1231 gains are not included in income, but net Section 1231 losses are included if they would otherwise be allowable as incurred in connection with the production of gross income.
 - d. Modifications also apply to allowable deductions. Deductions generally do not include deductions other than ordinary and necessary expense of producing income and maintaining property held for producing income. Modifications include the following:
 - (i) deductions are allowed for operating expenses (*e.g.*, salaries, rent, taxes), although where property is held both to produce income and for exempt functions, deductions must be apportioned between such uses, and
 - (ii) deductions are not allowed for charitable contributions or net operating losses.
3. If an organization's qualifying distributions exceed its minimum investment return, but are less than its adjusted net income in a particular year, then substantially all of its

qualifying distributions must be made directly for the active conduct of activities constituting its charitable purpose.

4. However, if the foundation's minimum investment return is less than its adjusted net income and its qualifying distributions equal or exceed such adjusted net income, then only that portion of the qualifying distributions equal to substantially all of the foundation's adjusted net income must be made directly for the "active conduct of activities" relating to its charitable activities.²⁹
5. Specific rules apply in determining whether a particular distribution made by a foundation qualifies as a "direct exempt-function distribution," including the following:³⁰
 - a. In general, such distributions must be used by the foundation itself.
 - b. Scholarships, grants, program-related investments and other payments to individuals constitute direct exempt-function distributions only if the grantor foundation satisfies applicable requirements for maintaining "significant involvement" in the active programs involved.³¹
 - c. Amounts paid to acquire or maintain assets used directly in the conduct of the foundation's exempt activities, such as the operating assets of a museum, public park or historic site, are considered direct exempt-function distributions.
 - d. Reasonable administrative expenses necessary to conduct the foundation's exempt activities are treated as direct exempt-function distributions.
 - e. Expenses attributable to both direct exempt functions and other functions must be allocated between them on a reasonable and consistently applied basis.
 - f. A set-aside for a specific project is considered a direct exempt-function distribution if it satisfies the set-aside requirements described above.
 - g. Payment of the Section 4940 tax on net investment income is treated as a direct exempt-function distribution.

E. Operating foundations must also satisfy one of the following three alternative tests:

1. The assets test requires an operating foundation to devote at least 65% of its assets (calculated at fair market value) to the active conduct of charitable activities.³²
 - a. Assets devoted directly to the active conduct of charitable activities must (1) be devoted directly to exemption functions, (2) be devoted directly to functionally related businesses, (3) consist of stock in a corporation controlled by the foundation

²⁹ Treas. Reg. § 53.4942(b)-1(a)(1).

³⁰ Treas. Reg. § 53.4942(b)-1(b).

³¹ Treas. Reg. § 53.4942(b)-1(b)(2).

³² Treas. Reg. § 53.4942(b)-2(a).

- and substantially all of the assets of which are so devoted, or (4) consist of any combination of the above.
- b. Assets held for investment purposes do not count, even if the income generated by those assets is used for active charitable purposes.³³
 - c. Property is considered to be used exclusively for direct exempt functions if such use is 95% or more of the total use; otherwise, the use of the property must be allocated.
 - d. For purposes of this test, amounts that are set aside are not treated as used directly for exempt functions.
2. The endowment test requires a foundation to spend an amount equal to two-thirds of the minimum investment return (as defined above) for qualifying distributions directly for the active conduct of activities constituting the foundation's exempt purpose.³⁴
- a. In essence, this test requires a foundation to spend an amount equal to 3.33% of the value of its non-charitable use assets in qualifying distributions for active charitable purposes.
 - b. Many operating foundations find this to be the easiest alternative to meet.
 - c. A foundation that satisfies the income test will generally satisfy the endowment test as well, unless its minimum investment return is markedly higher than its adjusted net income.
3. The support test requires "substantially all" (85% or more) of the organization's support to come from the public or five or more exempt organizations. In addition, not more than 25% of the organization's support (other than gross investment income) may normally be received from any one such exempt organization and not more than half of its support may come from gross investment income.³⁵
- a. Support from an individual or non-exempt organization (other than a governmental unit) is treated as support from the general public only to the extent that it does not exceed 1% of the foundation's total support (other than gross investment income).
- F. In order to qualify as an operating foundation in any given year, an organization must meet the tests described above either on an aggregate basis over a four-year period or during three out of the previous four years.³⁶
1. A foundation must use the same calculation period for both the income test and the alternative test in its three- or four-year calculations on Form 990-PF for a given year, but may use the other calculation period for the two tests the following year.

³³ Treas. Reg. § 53.4942-2(a).

³⁴ Treas. Reg. § 53.4942(b)-2(b).

³⁵ Treas. Reg. § 53.4942(b)-2(c).

³⁶ Treas. Reg. § 53.4942(b)-3(a).

2. Failing to qualify as an operating foundation in one year does not retroactively disqualify the foundation's operating status in prior years.
- G. For new organizations, a procedure exists to obtain an advance ruling that the new organization qualifies as an operating foundation.³⁷
1. Before the end of its first tax year, an organization may be treated as an operating foundation if it has made a good faith determination that it is likely to meet the tests for its first year.
 2. A good faith determination may be based on an affidavit or opinion from counsel giving enough facts concerning the operations and support of the organization to enable the Internal Revenue Service to determine that the requirements are likely to be met.

VIII. Recent Legislative Developments

- A. On November 18, 2005, the Senate passed the Tax Relief Act of 2005 (S. 2020), which contains several significant modifications to the tax rules governing exempt organizations and charitable giving.
- B. The companion legislation in the House of Representatives (H.R. 4297) is smaller in scope and does not currently contain the charitable provisions in the Senate bill. The differences between the two bills are currently being reconciled in a conference committee. Thus, it remains unclear which provisions, if any, will be included in final legislation.
- C. The Tax Relief Act of 2005 (S. 2020) would affect the qualifying distribution rules applicable to private foundations. Specifically, it would:
1. prohibit private foundations from counting distributions to "supporting organizations" as qualifying distributions;³⁸
 2. impose payout requirements on Type III supporting organizations and on donor-advised funds;³⁹ and
 3. double the excise tax penalties for violations of most private foundation rules, including Section 4942.⁴⁰
- D. Other suggestions for legislative reform have included provisions to:
1. prohibit foundation grants to donor-advised funds,⁴¹
 2. limit the administrative expenses that count as payouts for private foundations,⁴² and

³⁷ Treas. Reg. § 53.4942(b)-3(b)(2).

³⁸ Sec. 345.

³⁹ Sec. 342; Sec. 331.

⁴⁰ Sec. 313.

⁴¹ See the Senate Finance Committee's Staff Discussion Draft, available at www.senate.gov/~finance/hearings/testimony/2004test/062204stfdis.pdf.

3. increase the payout requirement – this would be achieved as a result of reducing the Section 4940 tax on net investment income, which is subtracted from a foundation’s minimum investment return in calculating its mandatory distribution requirement.⁴³

⁴² See the Senate’s CARE Act of 2003 (S. 476, the Charity Aid, Recovery and Empowerment Act), which the Senate approved in 2003.

⁴³ See H.R. 7, Sec. 105.