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- **Legal Matters for Community Foundations**  
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- **CFE Fundamentals**  
Jacksonville, FL— **OCT 24-25**
- **Racial Equity Forum**  
Washington, DC— **OCT 26**
- **Racial Equity Forum**  
Los Angeles, CA— **NOV 7**
- **Leading Together Conference**  
Miami, FL— **APR 30-MAY 1**

## UPCOMING WEBINARS

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## Lunch with Legal Counsel: Private Foundations

### ER CAUSING YOU TRAUMA?

Diagnosing the Rules and Regulations for Expenditure Responsibility



Source: Freerangestock.com



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Staff Counsel  
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This presentation does not provide legal, tax or financial advice. Consequently we urge you to seek the advice of your own legal, tax or financial professionals in connection with exemption organization matters. This communication (including any attachments or handouts) is not intended or written to be used and cannot be used, for the purpose of avoiding tax-related penalties.



# Agenda

- Congressional History & Intent of ER
- ER & the Law
- What is Expenditure Responsibility?
- X-Raying ER: The Guts of Expenditure Responsibility
- An Invasive Look at Statute & Regulations
- Complications
- 2017 Update
- Questions

First, let's talk about history





## **Legal Requirements for Certain Grants to Organizations that are not U.S. Public Charities**

### Goals:

- Ensure grant money is used for charitable purpose
- Ensure organization is capable of applying grant money for charitable purpose

\*Applies to private charities and donor advised funds held at public charities\*

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## Legal Risk to Private Foundations (Why are we talking about this?)

### IRC Sec. 4945: Taxes on Taxable Expenditures

- Imposes penalty tax of 20% on “taxable expenditure” and possible 5% tax on private foundation manager
- “Taxable expenditure” includes grants to organizations not described in certain Code sections as public charities or exempt operating foundations UNLESS the private foundation exercises expenditure responsibility



## Grantees that do **NOT** require ER

- Public Charities
  - Units of Government
  - International organizations designated by Executive Order
  - Exempt Operating Foundations
-



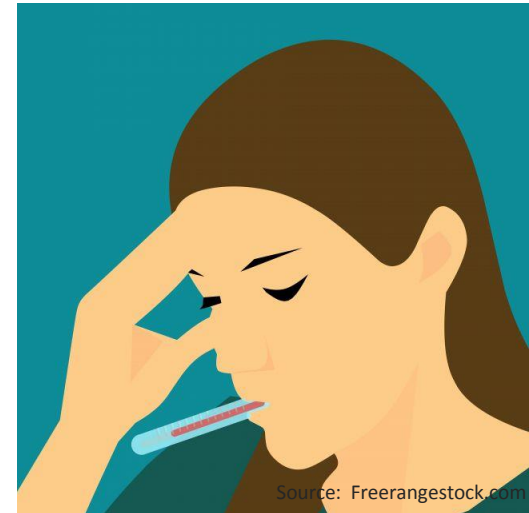
## Grantees that **DO** require ER

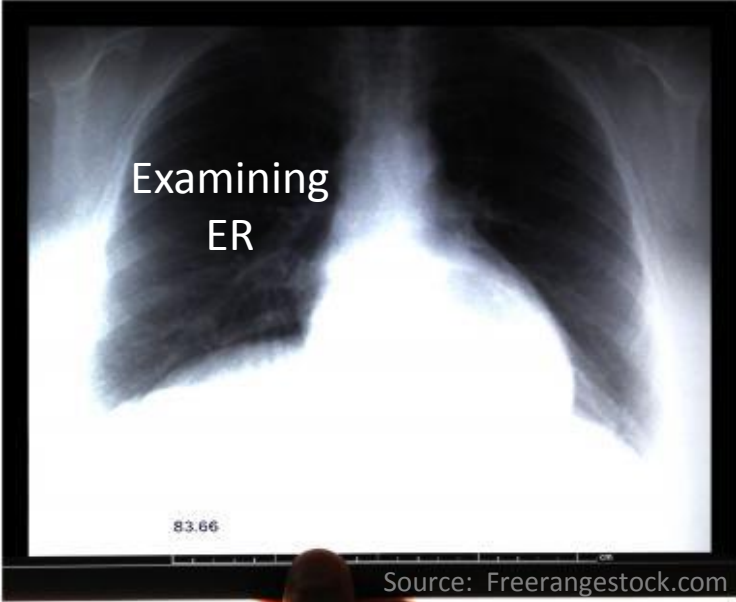
- Tax-exempt organizations not classified under 501(C)(3)
- Private Non-Operating Foundations
- Private Operating Foundations
- For-Profit Companies
- Organizations formed outside U.S.



## What is Expenditure Responsibility?

- Mandated procedure to ensure grant is used for charitable purposes
- Five basic steps:
  1. Pre-grant inquiry
  2. Written agreement
  3. Separate account
  4. Regular reports
  5. 990-PF reporting
- Requires *reasonable oversight* and *adequate procedures*





Examining  
ER

83.66

Source: Freerangestock.com



**26 U.S.C.A. § 4945, I.R.C. § 4945**  
**§ 4945. Taxes on taxable expenditures**

**(a) Initial taxes.--**

**(1) On the foundation.--**There is hereby imposed on each taxable expenditure (as defined in subsection (d)) a tax equal to 20 percent of the amount thereof. The tax imposed by this paragraph shall be paid by the **private foundation**.

**(2) On the management.--**There is hereby imposed on the agreement of any foundation manager to the making of an expenditure, knowing that it is a taxable expenditure, a tax equal to 5 percent of the amount thereof, unless such agreement is not willful and is due to reasonable cause. The tax imposed by this paragraph shall be paid by any foundation manager who agreed to the making of the expenditure.

...

**(h) Expenditure responsibility.--**The expenditure responsibility referred to in subsection (d)(4) means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures--

**(1)** to see that the grant is spent solely for the purpose for which made,

**(2)** to obtain full and complete reports from the grantee on how the funds are spent, and

**(3)** to make full and detailed reports with respect to such expenditures to the Secretary.

**26 U.S.C.A. § 4966, I.R.C. § 4966**  
**§ 4966. Taxes on taxable distributions**

**(a) Imposition of taxes.--**

**(1) On the sponsoring organization.--**There is hereby imposed on each taxable distribution a tax equal to 20 percent of the amount thereof. The tax imposed by this paragraph shall be paid by the sponsoring organization with respect to the **donor advised fund**.

**(2) On the fund management.--**There is hereby imposed on the agreement of any fund manager to the making of a distribution, knowing that it is a taxable distribution, a tax equal to 5 percent of the amount thereof. The tax imposed by this paragraph shall be paid by any fund manager who agreed to the making of the distribution.

...

**(c) Taxable distribution.--**For purposes of this section--

**(1) In general.--**The term “taxable distribution” means any distribution from a donor advised fund--

**(A)** to any natural person, or

**(B)** to any other person if--

**(i)** such distribution is for any purpose other than one specified in section 170(c)(2)(B), or

**(ii)** the sponsoring organization does not exercise expenditure responsibility with respect to such distribution in accordance with section 4945(h).



## Examining What's Behind ER







## 26 U.S.C.A. § 4945, I.R.C. § 4945

### § 4945. Taxes on taxable expenditures

...

**(h) Expenditure responsibility.**--The expenditure responsibility referred to in subsection (d)(4) means that the private foundation is required to exert all reasonable efforts and establish adequate procedures—

- (1) to see that the grant is spent solely for the purpose for which made,
- (2) to obtain full and complete reports from the grantee on how the funds are spent, and
- (3) to make full and detailed reports with respect to such expenditures to the Secretary.



## ‘[T]o exert all **REASONABLE** efforts’

- Statutory Interpretation
  - Objective Standard: What would a similarly-situated foundation do?
- Treas. Reg. § 53.4945-5(b)(1)
  - “A private foundation is not an insurer of the activity of the organization to which it makes a grant.”



## 26 U.S.C.A. § 4945, I.R.C. § 4945

### § 4945. Taxes on taxable expenditures

...

**(h) Expenditure responsibility.**--The expenditure responsibility referred to in subsection (d)(4) means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures—



- (1) to see that the grant is spent solely for the purpose for which made,
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- (1)** to see that the grant is spent solely for the purpose for which made,
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  - (3) to make full and detailed reports with respect to such expenditures to the Secretary.
-



## **Step 1: Pre-Grant Inquiry**

- Identify prior history and experience of grantee
- Knowledge of management, activities, and practices of grantee
- Scope may vary depending on size of grant and prior experience with grantee



## **Step 1: Pre-Grant Inquiry (cont.)**

### Common documentation (not legally required)

- Evidence of legal status
- Description of grantee's recent activities and future plans
- A recently audited financial statement
- Grantee's governing board and key officers
- Description of any prior experience with the grantee
- Evidence of grants made to other organizations
- Brief report of any site visit



## Pre-Grant “Eval”

- ABC is a Private Foundation
- Grant to 501(c)(4) – *XYZ Organization*
- Inquiry reveals Official M of XYZ has arrest record
- ABC reviews police records & speaks with M’s probation officer



Source: Freerangestock.com



## Step 2: Written Agreement

- Form not important, but must be in writing
- Officer, director, or trustee of the grantee must sign
- Must:
  - ✓ Specify the charitable purpose of the grant
  - ✓ Require the grantee to maintain the funds in a separate account





## **Step 2: Written Agreement (cont.)**

Grantee must agree to:

- Repay any portion not used for the purposes of the grant
- Submit full and complete annual reports
- Maintain records of receipts and expenditures
- Make its books and records available at reasonable times



## Step 2: Written Agreement (cont.)

Grantee must agree *not* to:

- Lobby: carrying on propaganda or attempt to influence legislation
- Influence elections: promote or oppose candidates, support or conduct voter registration drives
- Re-grant to individuals or non-charities unless the grantee agrees to follow the private foundation rules when it re-grants
- Undertake any activity for any purpose other than §170(c)(2)(B)



## **Step 2: Written Agreements - Re-granting and Expenditure Responsibility**

Grants for re-granting allowed if initial grantee agrees in writing that it will:

- Re-grant only in compliance with rules
- Maintain funds in separate account
- Prohibit subgrantees from making re-grants
- Agree in writing to use expenditure responsibility
- Provide U.S. grantmaker with satisfactory reports



## Step 3: Separate Account

- Key is to prevent comingling of funds
- Regulations say “in a separate fund”
- Must use either:
  - A physically separate bank account; or
  - A separate bookkeeping account
- Grants to other private foundations are excepted from this requirement



- (1) to see that the grant is spent solely for the purpose for which made,
  - (2) to obtain full and complete reports from the grantee on how the funds are spent, and**
  - (3) to make full and detailed reports with respect to such expenditures to the Secretary.
-



## Step 4: Grantee Reporting

Substance – report must include information about

- Use of the funds
- Compliance with the terms of the grant
- Progress made in achieving goals

Frequency

- First report – due at the end of grantee’s annual accounting period
- Ongoing – due each year until funds are expended in full
- Final – full report on all activity over the life of the grant
- For short-term grants, these may all be the same

Verification

- No need to verify reports unless reliability is in doubt



## Step 4: Grantee Reporting (cont.)

### Reporting Problems

- Timely filing is a common problem
- Taxable expenditure unless the foundation/grantor:
  - Has completed all the other requirements
  - Has made the required reports to the IRS
  - Has made a reasonable effort to obtain the required reports; and
  - Withholds all future payments of this or any other grant



- (1) to see that the grant is spent solely for the purpose for which made,
  - (2) to obtain full and complete reports from the grantee on how the funds are spent, and
  - (3) to make full and detailed reports with respect to such expenditures to the Secretary.**
-





## Step 5: IRS Reporting

### 990-PF reporting

- First year a grant is made
- Each year funds or a report are outstanding

### Contents

- Name and address of the grantee
- Date and amount of the grant
- Purpose of the grant
- Grantee expenditures based on latest report
- Report any diversion of funds
- Dates of any reports received from the grantee
- Date and result of verification conducted (if any)



## Step 5: IRS Reporting (cont.)

### Record Keeping

- Regulation require that the grantor keep the following documents for IRS inspection:
  - ✓ Copy of the agreement
  - ✓ Copy of each report received
  - ✓ Copy of any audits or other investigations
- Audit window = 3 years (can be 6)
- Keep pre-grant inquiry as well



## Added Complications

For many foundations, completing the 5 steps above is not that cumbersome, However, there is an added complexity and importance that must be understood when Expenditure Responsibility is applied in certain circumstances such as grants to organizations for the subsequent purpose of creating or adding to an **endowment**, or purchases of **capital equipment**



## Added Complications (cont.)

### Grants for Capital Equipment

(such as computers, office furniture or automobiles)

The IRS regulations make clear the reporting requirements when a private foundation makes an ER grant to another private foundation for capital equipment (such as computers, office furniture or automobiles)

- Unfortunately, the same regulations give NO guidance as to how long reports must be collected from the grantee and reported to the IRS *when made to an organization that is **not** a private foundation.*



## Added Complications (cont.)

### Grants for Endowments

#### Burdensome Reporting Requirements?

Because the recipient's assets may not be wholly or permanently dedicated to charitable purposes, the grantmaker cannot assume that the income and principal of its grant will always be used for charitable purposes described in the written grant agreement

- As a result, a never-ending reporting requirement might ensure that the funds are used appropriately but is unduly burdensome on both the grantor and the grantee



## 2017 Update

[Revenue Procedure 2017-53](#) was issued by the IRS on **September 14, 2017**. It updates and modifies 1992 IRS guidance (Rev. Proc. 92-94) with respect to foreign public charity equivalency determinations (“EDs”). Similar to the Treasury Regulations issued in late 2015, the new Revenue Procedure largely confirms current practices in preparing and issuing EDs for grantmakers. In addition, Rev. Proc. 2017-53 suggests several “preferred” practices in issuing Eds. The components of a “preferred written advice,” provide a safe harbor on which private foundations may ordinarily rely in making a reasonable judgment and good faith determination that a grantee meets Section 501(c)(3) and public charity requirements, and include the following:



## 2017 Update cont.

English. Preferred written advice along with all attachments, must be in English.

More attachments explicitly required. The grantee's organizing document (translated to English if needed) should be attached with support schedules, and translated foreign law relied on.

Terrorism. Verification that the grantee has not been designated a terrorist organization by the U.S. government.

Schools. Preferred written advice regarding a school FPCE grantee must confirm that the grantee does not discriminate on the basis of race, color, or national or ethnic origin, both by policy and in practice.

"Incubating" or new foreign charities. A foreign grantee in its first five years of existence may be treated as publicly-supported if the preferred written advice determines that, as of the time of the determination, the grantee can reasonably be expected to meet the applicable public support test.



## 2017 Update cont.

Must attach public support schedule. If the grantee has been existence for more than five years and is publicly-supported within the meaning of Section 170(b)(1)(A)(vi) or 509(a)(2), preferred written advice should attach support schedules.

Treatment of foreign charity and government gifts in public support test. Confirms that a foreign grantee's public support includes contributions and grants from charities described in Section 509(a)(1), whether domestic or foreign. Grants from a domestic or foreign government, or international organization designated as such under 22 U.S.C. 288, also constitute public support.

Simplified update affidavits permitted. Rev. Proc. 2017-53 confirms that where a grantee has previously supplied an affidavit, an updated affidavit describing only material changes (along with the previously-supplied affidavit) may be relied upon.

Applies to DAFs. Until further guidance is issued, sponsoring organizations of DAFs may also follow this guidance.





## Final Notes

- ER [and ED] are now both available for private foundations and donor advised funds
  - Funds other than donor advised funds at public charities such as community foundations do not have these legal requirements when making grants, but may require additional due diligence
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## Resources

- Council on Foundations website
  - <http://www.cof.org/resources/grants-management>
  - <http://www.cof.org/resources/expenditure-responsibility>

Questions?

Email [legal@cof.org](mailto:legal@cof.org)



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