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GRANT-MAKING PART I: ROUTINE GRANTS TO INDIVIDUALS AND PUBLIC CHARITIES

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Celia Roady, Esq.
Morgan, Lewis & Bockius LLP
1111 Pennsylvania Avenue, N.W.
Washington, D.C.20004
202-739-5279
croady@morganlewis.com

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Celia Roady
Morgan, Lewis & Bockius LLP
Washington, DC

I. Introduction

A. Congress enacted §4945 as part of the Tax Reform Act of 1969, in reaction to reported abuses by certain private foundations. It is designed to regulate and restrict the grantmaking activities of private foundations.

B. Section 4945 imposes an excise tax on private foundations and their managers for making payments that fall within the definition of "taxable expenditures." This includes amounts paid or incurred:

1. as a grant to an individual for travel, study or other similar purposes, unless the provisions of §4945(g) are satisfied; and

2. as a grant to an organization other than a public charity or exempt operating foundation, unless the grantor foundation exercises "expenditure responsibility" over the grant.

II. Grants to Individuals and Public Charities under §4945

A. Grants to Individuals

1. Grants to individuals for travel, study or other similar purposes are taxable expenditures, unless the requirements of §4945(g) are met. Congress enacted §4945(d)(3) to prevent private foundations from making improper grants to individuals, particularly grants allegedly made for educational purposes but in fact used for private purposes, such as vacations abroad and paid interludes between jobs.

2. §4945(d)(3) raises two primary issues for private foundations that make grants to individuals:

(a) whether the expenditure constitutes a "grant" under §4945(d)(3); and

(b) if the expenditure does constitute a "grant," whether §4945(g) excludes the grant from the definition of a "taxable expenditure."

3. The definition of "grant" under §4945:

(a) The definition of "grant" under §4945 includes, but is not limited to: scholarships, fellowships, internships, prizes, awards and loans

for purposes described in §170(c)(2)(B) (i.e., charitable purposes), but only if they do not fall under the §4945(g) exception (described below).

(b) The definition of "grant" for purposes of §4945 does not include salaries or other employee compensation.

Example: A private foundation does not make a taxable expenditure by paying an employee's educational expenses if such expenses are included in the employee's income under §61.

(c) Certain grants made by a private foundation to individuals are excluded from the definition of a "grant" for the purposes of §4945(d)(3).

(i) A foundation's grants to individuals for purposes other than travel, study or similar purposes do not constitute taxable expenditures under §4945(d)(3).

Example: A private foundation's grants to indigent individuals made to enable them to purchase furniture are not taxable expenditures under §4945(d)(3), even if the requirements of §4945(g) are not satisfied.

(ii) §4945(d)(3) also does not include grants that are not made to fund future activities.

Example: In Rev. Rul. 75–393, the IRS evaluated a private foundation's grants to individuals as awards for their past literary achievements. The grants were not made to fund any activities and contained no conditions on how the funds could be spent. The IRS concluded that the grants were made not for study, travel or similar purposes and therefore did not fall within §4945(d)(3).

(d) A private foundation's grant to an intermediary organization that in turn awards the grant funds to an individual for §4945(d)(3) purposes may be considered an individual grant by the foundation under certain circumstances.

(i) The grant will not be treated as an individual grant if the private foundation does not earmark the grant for use by a named individual and does not make a written or oral arrangement for designating the individual recipient. Even if the grantor private foundation has reason to believe that a certain individual will ultimately benefit, the grant would nonetheless be respected as a grant to the grantee organization (and not recharacterized as a grant to the

individual), so long as the grantee organization exercises control, in fact, over the selection process and makes the selection completely independently of the foundation.

(ii) If the intermediary organization is a public charity, then a grant made to it by the private foundation will not be treated as an individual grant if it is made for a project that is to be undertaken under the public charity's supervision and the public charity controls the selection of the individual grantee. The selection process, in this case, need not be made completely independently of the grantor foundation.

(e) Despite satisfying §4945(d)(3) and (g), a grant by a private foundation to an individual may be treated as a taxable expenditure if the foundation does any of the following:

(i) earmarks the grant to be used for an activity described in §4945(d)(1), (2) or (5) or in a manner violating §4945(d)(3) or (4);

(ii) makes an oral or written agreement that may cause the grantee to engage in any such activities and the grantee does in fact do so; or

(iii) makes the grant for a non-charitable purpose.

(f) Exception under §4945(g): §4945(g) provides that a foundation's grant to an individual for travel, study or other similar purposes will not be considered a §4945(d)(3) taxable expenditure if the following three requirements are met:

(i) the grant is awarded on an objective and nondiscriminatory basis. This means that the grants must be awarded in accordance with a program that, if it were a substantial part of the foundation's activities, would be consistent with:

1. the foundation's tax-exempt status under §501(c)(3);

2. the allowance of deductions to individuals under §170 for contributions to the grantor private foundation; and

3. the specific rules of §53.4945-4(b) for the pool of potential grantees, the selection criteria and the individuals making the selection, including:

- The pool of potential grantees must typically be large enough to constitute a "charitable class";

- The criteria used to select grant recipients from the pool of potential grantees should be related to the purposes of the grant; and

- The persons selecting grant recipients should not be in a position to derive a private benefit, directly or indirectly, if certain potential grantees are selected over others.

(ii) the grant procedures are approved in advance by the IRS under §53.4945-4(c); and

(iii) it is demonstrated to the satisfaction of the IRS that:

1. the grant constitutes a scholarship or fellowship and is used to study at an educational organization described in §170(b)(1)(A)(ii);

2. the grant constitutes a prize or award, if the recipient is selected from the general public; or

3. the purpose of the grant is to achieve a specific objective, produce a report or similar product, or enhance the grantee's literary, artistic, musical, scientific, teaching, or other capacity, skill or talent.

Example: Rev. Rul. 77–434 describes a private foundation that made long-term, low-interest educational loans to students. Although the loans were not scholarships or prizes, they qualified as §4945(g) grants because they were made to advance the recipients' education and were narrow and definite to ensure the use of the loans for §501(c)(3) purposes.

(g) New IRS Form 8940 (attached as Exhibit 1) is used to request approval of individual grant procedures.

(h) The regulations contain a "45 day rule" that allows foundations to treat grant procedures as approved if the IRS has not been notified, within 45 days, that the procedures are rejected. See §53.4945-4(d)(3). Such approval continues until the IRS provides notice that the procedures are not approved.

(i) Private foundations that make grants to individuals must keep the following records with respect to each grant:

(i) information used to evaluate the grantee's qualifications;

(ii) the grantee's identification and any relationship the grantee has to the foundation;

(iii) the amount and purpose of each grant; and

(iv) reports submitted by the grantee and any other information obtained by the foundation in complying with §53.4945-4(c)(2), (3), and (4).

1. §53.4945-4(c)(2) and (3) require that foundations making scholarship, fellowship and other educational grants make arrangements to obtain certain basic reports of the grantee's educational pursuits.

2. §53.4945-4(c)(4) imposes reporting requirements on a private foundation that is under a duty to investigate a misused grant.

(j) If reports submitted by a grant recipient indicate that all or any part of a grant is not being used for the purposes for which the grant was made, then §53.4945-4(c)(4) imposes a duty to investigate on the grantor foundation. The foundation must withhold further payments of the grant until any delinquent reports have been submitted. A private foundation that fails to investigate and correct such abuse may be required to treat the amounts involved as taxable expenditures.

(i) A grant will not be considered a taxable expenditure even if the grantor private foundation finds that the grantee has used all or part of a grant for improper purposes, so long as the foundation:

1. takes all reasonable and appropriate steps either to recover the grant funds or to ensure the restoration of the diverted funds and the dedication of grant funds held by the grantee to the proper grant purposes; and

2. withholds any further payments to the grantee until it receives the grantee's assurances that future diversions will not occur and has required the grantee to take extraordinary precautions to prevent

future diversions, and, in the case of a grantee that has previously diverted funds from a grantor foundation, until such funds are in fact recovered or restored.

(k) Grants made to governmental agencies (as defined by §170(c)(1)) (e.g., state colleges and universities) and earmarked for individuals for §4945(d)(3) purposes are not subject to §4945(d)(3) or §4945(g) if the governmental agency satisfies the IRS in advance that its grant-making program:

(i) furthers the charitable purposes described in §170(c)(2)(B);

(ii) requires that the individual grantee submit reports on the use of the funds and the progress made toward achieving the purposes of the grant, which must be submitted at least annually and following the completion of the undertaking for which the grant was made; and

(iii) requires that the organization investigate jeopardized grants according to the rules described in §53.4945-4(c)(4).

B. Grants to Public Charities

1. A private foundation's grant to a public charity (as defined in §509(a)(1), (2), or (3)) (other than a non-functionally integrated Type 3) is generally not a §4945(d)(4) taxable expenditure and does not require exercising "expenditure responsibility" (described below).

2. "Grant": The definition of "grant" for §4945(d)(4) is the same as for §4945(d)(3) grants to individuals, and includes loans made for charitable purposes (under §170(c)(2)(B)), "program related investments" (described below) and payments to other exempt organizations to support their exempt purposes.

(a) The definition of "grant" includes not only a foundation's payments directly to grantees, but also payments made directly to vendors for the purpose of supporting or furthering the grantees' work.

Example: If a private foundation hires a public relations firm to publicize a grantee's activities, the amount paid to the public relations firm is considered a "grant" under §4945.

(b) In contrast, §53.4945-4(a)(2) provides that §4945 ordinarily does not treat as "grants" payments such as salaries, consultants' fees and travel expense reimbursement made to individuals or entities that assist a foundation in planning, evaluating, or developing its

own activities or projects, by providing personal services such as consulting, advising or participating in conferences.

Example: Rev. Rul. 74-125 describes a private foundation that disseminates publications and develops and conducts training programs to assist educators in improving their educational methods. The foundation hires consultants to develop model curricula and to design materials to assist educators with their performance. The IRS ruled that payments to the consultants were for their personal services in helping the foundation to plan and develop its own program activity of assisting educators to employ improved educational methods. Accordingly, such payments did not constitute "grants" for purposes of §4945.

3. Earmarked Grants: A grant made by a private foundation to a grantee organization which the grantee uses to make payments to a second organization will not be considered as made directly to the second organization so long as the foundation does not earmark the grant funds for use by the second organization and there is no oral or written agreement allowing it to make such a designation.

   (a) This rule applies even if the grantor foundation has reason to believe that certain organizations would derive benefits from the grant, provided that the original grantee organization exercises control, in fact, over the selection process and makes the selection independently of the grantor foundation.

   (b) Special rules apply under §53.4945-5(a)(6)(ii) if the intermediary organization is a governmental agency.

4. Expenditure Responsibility: A private foundation must exercise expenditure responsibility over grants made to organizations other than public charities in order for the grants not to be taxable expenditures under §4945(d)(4). Expenditure responsibility, defined under §4945(h), means that a foundation must make all reasonable efforts and establish adequate procedures:

   (a) to ensure that the grant funds are spent solely for the purpose for which the grant was made, which entails –

      (i) conducting a pre-grant inquiry on potential grantees covering the grantee's identity, the prior history and experience of the grantee and its managers and other information on its management, activities and practices;

      (ii) having a written grant agreement – all expenditure responsibility grants must be subject to a written agreement

signed by an appropriate officer, director or trustee of the grantee organization and containing provisions:

- clearly stating the purposes of the grant;
- requiring the grantee to repay any funds not used for the purposes of the grant;
- requiring the grantee to submit annual reports on its progress and its use of the grant funds;
- requiring the grantee to maintain complete records of receipts and expenditures and to make them available to the grantor; and
- requiring the grantee organization not to use the funds in a manner inconsistent with §§ 4945(d)(1) through (5); and

(iii) retaining records of all expenditure responsibility grants (made available to the IRS on request), including a copy of each grant agreement, every report received from the grantee, and the results of audits or investigations conducted into any expenditure responsibility grants;

(b) to obtain full and complete reports from the grantee demonstrating how the funds are spent, compliance with the grant terms and the grantee's progress toward fulfilling the purposes of the grant (to be submitted by the grantee at the end of its annual accounting period and following completion of the grant); and

(c) to submit full and detailed reports describing its expenditures to the IRS when filing its annual Form 990-PF. A foundation may submit the reports received from grantee organizations. The 990-PF reports must include the following information:

- the grantee's name and address;
- the date and amount of the grant;
- the purpose of the grant;
- amounts spent by the grantee;
- whether the grantee diverted any part of the funds from the purpose of the grant;

- the dates of any reports received from the grantee; and

- the dates and results of the grantor foundation's efforts to verify grantee reports.

(d) In addition, the foundation must retain and make available to the IRS a copy of all expenditure responsibility agreements, reports made by grantees and reports made by persons hired by the grantor to investigate any expenditure responsibility grants.

5. Private Foundation Grants to Public Charities that Lobby

(a) A private foundation may make a general support grant to a public charity that conducts lobbying activities if the grant is not specifically earmarked for lobbying purposes. A grant is considered "earmarked" if it is made pursuant to an agreement, either written or oral, that the grant will be used for specific purposes.

(b) A private foundation may make a grant to fund a specific project by a public charity that lobbies if the grant is not earmarked for lobbying purposes and the total amount given to the grantee by the foundation for the project in any given taxable year does not exceed the amount budgeted by the grantee for nonlobbying program activities during that year.

(c) This rule also applies to a multi-year grant for a specific project, and is applied by measuring either the actual annual grant disbursement or by dividing the grant equally over the years of the grant. The foundation may choose which method of grant measurement to use, so long as the foundation uses the same method for all years.

Example: Private foundation is asked to make a two-year $100,000 grant to X for a new program. According to X's proposed budget, the program will have an annual budget of $200,000, of which $50,000 will be used annually for lobbying purposes. The proposed grant will not be a taxable expenditure. The amount of the grant is less than $150,000 which is the non-lobbying amount budgeted for the specific project.

(d) In determining whether a grant meets these requirements, a private foundation may rely on budget documents or other sufficient evidence provided by the public charity.

(e) On December 9, 2004, the IRS issued an information letter to Charity Lobbying in the Public Interest, which provides information about the rules governing private foundation grants to public charities that engage in lobbying. A copy of the letter is attached as Exhibit 2.

III. Penalties for Violations

A. Section 4945 imposes excise tax penalties on private foundations that make taxable expenditures and on private foundation managers who approve the making of such expenditures knowing them to be taxable expenditures.

B. "First-tier" taxes: Section 4945 imposes an initial tax on a private foundation and, in some cases, on foundation managers for making a taxable expenditure.

1. An initial tax of 20% of the amount of the taxable expenditure is imposed on the private foundation.

2. An initial tax of 5% of the amount involved is imposed on private foundation managers who knowingly approve the making of such expenditure, where such action is willful and not due to reasonable cause.

C. "Second-tier" taxes: Where an initial tax is imposed and the taxable expenditure is not "corrected" in the proper time frame, an additional tax is imposed.

1. The second-tier tax on the private foundation is 100% of the amount involved.

2. The second-tier tax on foundation managers is 50% of the amount involved, up to $20,000, and is imposed on foundation managers who refuse to agree with the correction.

D. "Correction" of a taxable expenditure:

1. "Correction" of a taxable expenditure means recovering the expenditure to the extent possible and, where full recovery is not possible, taking additional corrective action that may be prescribed by the IRS.

2. If the expenditure is taxable only because of inadequate reporting (in violation of §4945(h)(2) or §4945(h)(3)), correction may be accomplished by obtaining the required report.

E. Abatement of penalties:

1. Section 4962 allows the IRS to abate the first-tier tax under §4945 where the foundation can establish that the expenditure was corrected and that the making of the expenditure was due to reasonable cause and not to willful neglect.