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GRANTMAKING CHALLENGES
FOR PRIVATE FOUNDATIONS

by

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I. Introduction

In the first few decades following passage of the Tax Reform Act of 1969, many private foundations were understandably conservative in their grantmaking practices. It was common for private foundations to adopt, as the bedrock of their grantmaking guidelines, a policy of making grants only to Section[1] 501(c)(3) organizations classified as public charities. Time and time again, for example, private foundations would reiterate that as a matter of policy "we don't make expenditure responsibility grants." Many foundations were also unwilling to make individual grants.

Slowly but surely, things are changing. Private foundations are becoming more willing to explore alternative grantmaking forms and structures, and this opens new funding opportunities for the accomplishment of foundation goals and objectives. As foundations explore new and innovative grantmaking techniques, it is important for them to understand the rules of the road.

This outline describes some of the most common grant-making challenges for private foundations, and summarizes the applicable rules and regulations governing these grants.

II. Individual Grants

Grants to individuals for travel, study or other similar purposes are taxable expenditures, unless the requirements of Section 4945(g) are met. Congress enacted Section 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.

A. Definition of "Individual Grant"

The definition of "grant" for the purposes of Section 4945 (as defined in Treas. Reg. § 53.4945–4(a)(2)) includes, but is not limited to scholarships, fellowships, internships, prizes, awards and loans for purposes described in Section 170(c)(2)(B) (i.e., charitable purposes), but only if they do not fall under the Section 4945(g) exception (described below). The definition does not include salaries or other compensation for services.

A foundation's grants to individuals for purposes other than travel, study or similar purposes do not constitute taxable expenditures under Section 4945(d)(3). For example, a private foundation's grants to indigent individuals made to enable them to purchase furniture are not taxable expenditures under Section 4945(d)(3), even if the requirements of Section 4945(g) are not satisfied. Section 4945(d)(3) also does not include grants that are not made to fund future activities. 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

[1] References to "Section" refer to Sections of the Internal Revenue Code.

were made not for study, travel or similar purposes and therefore did not fall within Section 4945(d)(3).

B. Grants to Intermediaries

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

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.

C. Individual Grant Procedures

Section 4945(g) provides that a foundation's grant to an individual for travel, study or other similar purposes will not be considered a Section 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 grant must be awarded in accordance with a program that, if it were a substantial part of the foundation's activities, would be consistent with (i) the foundation's tax-exempt status under Section 501(c)(3); (ii) the allowance of deductions to individuals under Section 170 for contributions to the grantor private foundation; and (iii) the specific rules of Treas. Reg. 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 Treas. Reg. 53.4945-4(c); and

(iii) it is demonstrated to the satisfaction of the IRS that the grant constitutes a scholarship or fellowship and is used to study at an educational organization described in Section 170(b)(1)(A)(ii); the grant constitutes a prize or award if the recipient is selected from the general public; or 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.[2]

New IRS Form 8940 (attached as Exhibit 1) is used to request approval of individual grant procedures. The regulations contain a "45-day rule" that allows foundations to treat grant procedures as approved if the IRS has not notified the foundation, within 45 days of submission, that the procedures are rejected. Such approval continues until the IRS provides notice that the procedures are not approved.[3]

D. Recordkeeping Requirements and Investigations of Diversions

In accordance with Treas. Reg. § 53.4945-4(c)(6), 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 Treas. Reg. § 53.4945-4(c)(2), (3), and (4).

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

(i) 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 Treas. Reg. § 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.

(ii) 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 (a) 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 (b) 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.[4]

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[2] Treas. Reg.§ 53-4945-4(a)(3)(ii)(c).
[3] Treas. Reg.§ 53.4945-4(d)(3).
[4] Treas. reg. § 53.4945-4(c)(4)(iii).

III. Expenditure Responsibility Grants

Section 4945 imposes initial taxes and additional taxes on "taxable expenditures" of a private foundation. Under Section 4945(d)(4), "taxable expenditures" include amounts paid as a grant to an organization (other than an organization described in Section 509(a)(1), 509(a)(2), or 509(a)(3) or an exempt operating foundation described in Section 4940(d)(2)), unless the private foundation exercises expenditure responsibility with respect to such grant.[5] Following enactment of the Pension Protection Act ("PPA") in 2006, grants to nonfunctionally integrated Type 3 supporting organizations also require expenditure responsibility.

Under Section 4945(h), exercising expenditure responsibility requires a private foundation to exert all reasonable efforts and establish adequate procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain full and complete reports from the grantee on how the funds are spent, and to make full and detailed reports with respect to such expenditures on the Form 990-PF.

A. Pregrant Inquiry

The first step in exercising expenditure responsibility is to conduct a pregrant inquiry concerning the potential grantee. Such inquiry should be complete enough to give a reasonable person assurance that the grantee will use the grant for the proper purposes, and the foundation should maintain documentation of this process.[6]

B. Written Grant Agreement

The second step in exercising expenditure responsibility is to have the grantee enter into a written agreement signed by an appropriate officer, director, or trustee of the recipient organization. The IRS regulations provide that such agreement must specify the purpose of the grant, and include an agreement by the grant recipient:

(1) to use all the funds received from the private foundation only for the purposes of the grant and to repay any portion not used for such purposes;

(2) to submit full and complete annual reports on the use of funds and the progress made in accomplishing the grant;

(3) to maintain books and records of receipts and expenditures and to make such books and records available to the private foundation at reasonable times; and

(4) not to use any of the funds:

(a) to carry on propaganda, or otherwise to attempt, to influence legislation (within the meaning of Section 4945(d)(1));

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[5] Treas. Reg. 53.4945-5(a).

[6] Treas. Reg. 53.4945-5(b)(2)(i).

(b) to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive (within the meaning of Section 4945(d)(2));

(c) to make any grant that does not comply with the requirements of Section 4945(d)(3) or (4); or

(d) to undertake any activity for any purpose other than one specified in Section 170(c)(2)(B).[7]

C. Reports from Grantees

The third step in exercising expenditure responsibility is to obtain reports from the grantee regarding the use of funds and the grantee's compliance with the terms of the grant. The IRS regulations provide that "the granting private foundation shall require reports on the use of funds, compliance with the terms of the grant, and the progress made by the grantee toward achieving the purposes for which the grant was made."[8]

D. IRS Reporting

The final step in exercising expenditure responsibility is to include the required information on the Form 990-PF regarding the status of the grant. A foundation making expenditure responsibility grants is required to include an attachment to its Form 990-PF listing its expenditure responsibility grants and including the information required by Treas. Reg. § 53.4945-5(d), including the following: (1) name and address of the grantee; (2) date and amount of the grant; (3) purpose of the grant; (4) amount expended by the grantee based on the most recent grant report; (5) whether the grantee has diverted any portion of the grant to the knowledge of the grantor; (6) the dates of any reports received from the grantee; and (7) the date and results of any verification of the grantee's reports undertaken.

IV. Grants to Foreign Organizations

The IRS regulations provide that organizations that are "foreign equivalents" of U.S. public charities are treated as such for purposes of the taxable expenditure rules.[9] The foundation may satisfy the foreign equivalency determination by making a good-faith determination and reasonable judgment that the foreign grantee meets the criteria to be deemed a public charity based on either an affidavit from the grantee or an opinion of counsel.

Typically, a foundation will rely on an affidavit from the grantee, which must reflect the organization's current data (often accomplished by reflecting the organization's most recent accounting year), in English, and include the following:

(1) copies of the grantee's founding documents, a description of its purpose and activities, and a copy of its written dissolution arrangements (either pursuant to statute or the grantee's founding documents);

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[7] Treas. Reg. 53.4945-5(b)(3).
[8] Treas. Reg. 53.4945-5(c)(1).
[9] Treas. Reg. 53.4945-5(a)(5).

(2) a detailed analysis of the grantee's financial information sufficient to demonstrate that it meets the public support test;

(3) restrictions the grantee faces with respect to private benefit, noncharitable activities, lobbying, and campaigning; and

(4) a signature by a principal officer of the organization.

Rev. Proc. 92-94 contains the requirements for an affidavit and includes a sample affidavit. Since the issuance of that revenue procedure, the IRS has changed the requirements of the public support test and the sample affidavit does not reflect those changes. The IRS is currently working on a guidance project to update Rev. Proc. 92-94 to reflect the public support changes.

In September 2012, the IRS also issued new regulations that expand the class of qualified tax practitioners who can assist private foundations in making the foreign equivalency determinations. These regulations are intended to help pave the way for foundations to take advantage of a more centralized equivalency determinations process. Following issuance of these regulations, NGOSource, a project of the Council on Foundations and Tech Soup (a 501(c)(3) public charity), was formed to help U.S. foundations streamline their international giving by reducing the complexity of getting foreign equivalency determinations.[10]

V. Grants to Donor-Advised Funds

With the passage of the PPA, public charities offering donor-advised funds have been subject to special rules and regulations. The PPA made donor-advised funds subject to some of the same rules as private foundations, including (1) restrictions on excess business holdings under Section 4943; (2) imposition of an excise tax on donor-advised funds that make "taxable distributions," which include grants to noncharitable organizations and Type 3 nonfunctionally integrated supporting organizations, under the donor-advised fund exercises expenditure responsibility in accordance with Section 4945(h); and (3) excise taxes on donors or donor-advisors that receive "prohibited benefits" (more than incidental benefits) from the making of grants by donor-advised funds.

Many private foundations make grants to donor-advised funds, which may be held at their local community foundations or by one of the national donor-advised funds such as the Vanguard Charitable Endowment Program. These donor-advised funds are often used to fund grants for which a foundation wants to remain anonymous; to fund smaller grants, such as grants made under matching gift programs; to support grants outside the foundation's usual program areas; to honor a legacy on behalf of a particular family member; to support grants that the foundation does not feel equipped to handle on its own (such as international grants); or to continue supporting grantees after the foundation terminates.

Donor-advised funds can also be used to resolve disputes within family foundations. A foundation may establish a donor-advised fund for the benefit of a family member whose priorities are at odds with those of the rest of the family. The foundation can then provide annual

[10] *See* http://www.ngosource.org/mission.

or one-time funding to the donor-advised fund to enable that family member to pursue his or her philanthropic interests separately from the foundation. In 2010, the Association of Small Foundations issued a paper on the use of donor-advised funds by private foundations titled *The Best of Both Worlds: Using Private Foundations and Donor-Advised Funds*.[11]

In some cases, private foundations have used grants to donor-advised funds to avoid incurring an excise tax for failure to meet the annual distribution requirements when they have not been able to identify other grantees within the deadline. Some donor-advised funds have policies that will not allow foundations to establish donor-advised funds solely for this purpose and require some active grant-making from the donor-advised fund accounts. The IRS has also shown interest in this issue. In 2011, it added the following as question 12 in Part VII-A to the Form 990-PF: "Did the foundation make a distribution to a donor advised fund over which the foundation or a disqualified person had advisory privileges? If 'Yes,' attach statement (see Instructions)." The Form 990-PF instructions require a foundation to state whether it treated any distribution to a donor-advised fund as a qualifying distribution, and to explain how such distribution will be used to accomplish a charitable purpose.

VI. Grants to Fiscal Agents

Private foundations are often asked to fund projects conducted by organizations that do not have tax exemption under Section 501(c)(3). In some cases, the organizations may plan to seek exemption but have not gotten around to doing so yet; in other cases, the application for exemption may be pending with the IRS. Some projects involve one-time or short-term efforts for which the project leaders never intend to seek exemption. In all of these cases, it is common for the project leaders to identify a friendly Section 501(c)(3) organization to act as a "fiscal agent," and private foundations are asked to make the grants to these intermediary organizations.

Making a grant to a fiscal agent, or, more precisely, a fiscal sponsor, of a project can be an acceptable option for a private foundation as long as the foundation satisfies itself that the fiscal sponsor will exercise financial and programmatic responsibility and oversight over the project. The difference in terminology is critical. A fiscal agency relationship suggests that the charity is the agent of the project for purposes of passing through the grant proceeds. A fiscal sponsor, on the other hand, serves as the "sponsor" of the project, taking overall financial and programmatic responsibility for the project during the pendency of the grant.

If the arrangement is not a valid fiscal sponsorship, the grant would be considered "earmarked" for the underlying recipient and would be a taxable expenditure because the foundation would not have exercised expenditure responsibility on the grant. *See*, e.g., Treas. Reg. § 53.4945-5(a)(6)(i), which holds that a private foundation grant that is earmarked for a secondary grantee can be treated as made directly to such secondary grantee.

Greg Colvin's book, *Fiscal Sponsorship: 6 Ways To Do It Right*, Study Center Press 2006 (2d ed.), is an essential resource for any foundation that makes grants pursuant to fiscal sponsorship

[11] A 2015 version of this paper, issued by Exponent Philanthropy (formerly the Association of Small Nonprofits) is available at http://www.fidelitycharitable.org/docs/Using-Private-Foundations-and-Donor-Advised-Funds.pdf.

arrangements. Colvin identifies six models by which the fiscal sponsor can exercise sufficient financial and programmatic responsibility as to be recognized as the legitimate grantee of a private foundation grant for a project. The models used most commonly include the following:

(1) the project is operated as a direct project of the fiscal sponsor;

(2) the fiscal sponsor enters into an independent contractor relationship for the conduct of the project; and

(3) the fiscal sponsor investigates the project and independently approves its own grant to the project, which is funded by the private foundation grant.

In each case, the relationship between the fiscal sponsor and the project would be reflected in a written agreement that makes it clear that the fiscal sponsor maintains financial and programmatic oversight over the use of project funds. Similarly, the grant agreement between the fiscal sponsor and the private foundation funder would reflect the fiscal sponsor's control over the project, and there would be no earmarking of grant funds for regranting to the organization or leader of the project.

VII. Grants to Public Charities that Lobby

Under Treas. Reg. § 53.4945-2(a)(6)(i), 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.

Under Treas. Reg. § 53.4945-2(a)(6)(ii), 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 same project for the same year does not exceed the amount budgeted by the grantee for nonlobbying program activities during that year. This rule also applies to a multiyear grant for a specific project, and is applied either by measuring 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:** A private foundation makes an annual $25,000 general support grant to Charity X. This grant is not specifically earmarked for any specific project and is mixed in with X's other funds for various administrative and programmatic uses, including some lobbying. In addition to this general support grant, the foundation has been asked to give an additional $100,000 grant to X for a new program. According to X's proposed budget, the program will have a budget of $200,000, of which $50,000 will be used for lobbying purposes. Neither of these grants constitutes a taxable expenditure. The general support grant is not earmarked and is therefore not lobbying. The specific project grant of $100,000 is less than $150,000, which is the nonlobbying amount budgeted for the specific project.

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. 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.

VIII. Grants for Voter Registration

Under Section 4945(d)(2), a private foundation's expenditures to fund voter registration activities, directly or indirectly, are considered to be taxable expenditures unless the foundation complies with the following requirements listed in Section 4945(f):

(1) the voter registration activity must be carried on by a Section 501(c)(3) organization;

(2) the organization's activities must be nonpartisan, carried on in five or more states, and not confined to one specific election period;

(3) the organization must expend substantially all of its income directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated (meaning the organization spent at least 85% of its income for the active conduct of activities, rather than to make grants to fund the activities of other organizations);

(4) the organization must receive substantially all of its support (other than gross investment income, as defined in Section 509(e)) from exempt organizations, the general public, governmental units or any combination of the foregoing, without receiving more than 25% of such support from any one tax-exempt organization or deriving more than 50% of its support from gross investment income; and

(5) contributions to the organization for voter registration drives may not be subject to conditions that they be used only in specified states or areas of the United States or that they be used in only one specific election period (however, so long as these provisions are met, grant funds may be earmarked for voter registration purposes generally).

Note that Section 4945(f) applies only to the funding of voter registration and not "get-out-the vote" drives and similar activities. The IRS has ruled privately that voter registration drives may be targeted to specific populations, such as the homeless, low-income persons, and particular racial or ethnic groups, as long as the voter registration efforts are nonpartisan and nondiscriminatory and seek to register all interested voters in the targeted population.

A private foundation considering a grant to a charitable organization for voter registration activities should receive an opinion letter (which may come from the grantee) that the grantee qualifies as a Section 4945(f) organization and that the grant activities are consistent with the requirements of Section 4945(f). In addition, the grant proposal should represent that the voter registration activities will be conducted in a nonpartisan manner, and that the grantee's staff and volunteers will be instructed (i) to decline to express preference among candidates or political parties, even if asked; (ii) not to make statements in support of or in opposition to any particular candidate or party; (iii) not to carry on any other activities that reflect a preference or

recommendation for any political candidate or party; and (iv) not to refuse the registration of anyone, or to refuse assistance in transport to the polls to anyone if such assistance is offered to others.

IX. Program-Related Investments

Section 4944(c) provides an exception to the jeopardy investment ruling for "program-related investments" ("PRIs"). PRIs must meet three requirements: (1) the primary purpose must be charitable; (2) no significant purpose may be to earn income or appreciation; and (3) there must not be a purpose to lobby or intervene in political campaigns. Each of these requirements is described in more detail below.

A. Primary Section 170(c)(2)(B) Purpose

To qualify as a program-related investment, an investment must have as its primary purpose the accomplishment of one or more Section 170(c)(2)(B) purposes. In applying this standard, Treas. Reg. § 53.4944-3(a)(2)(i) provides that "[a]n investment shall be considered as made primarily to accomplish one or more of the purposes described in Section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities."

PRIs are made for a variety of charitable purposes, including relief of the poor and distressed through the provision of decent, safe and affordable low-income housing, the provision of job training and employment opportunities, combating community deterioration and promoting community revitalization, promoting positive environmental change, promoting healthcare for underserved populations, and promoting alternative education such as charter schools. Some of the more innovative PRIs, particularly in the environmental, healthcare and economic development arena, may require careful structuring to ensure that there are sufficient indicia of charitability.

B. No Significant Income or Appreciation Purpose

A PRI must not have significant purpose to produce income or appreciation. "In determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation. However, the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property."[12]

There are many forms of PRIs, including loans, equity investments, and loan guarantees. In 2012, the IRS issued proposed regulations containing examples of these types of PRIs.[13] In the

[12] Treas. Reg. 53.4944-3(a)(2)(iii).

[13] See Prop Treas. Reg. § 53.4944-3, 77 Fed. Reg. 23,429 (Apr. 19, 2012) (examples 11, 12, 13, 14, 15, 16, 17, 18 and 19).

case of loans, it is fairly simple to establish that the "no significant income or appreciation purpose" is met by showing that the interest rate on the loan is below the fair-market rate for a loan of comparable terms and risk. It can require a bit more documentation to establish that an equity investment meets this requirement, particularly if the investment has a significant projected internal rate of return. Foundations typically begin this analysis by showing that the proposed PRI investment would fail to meet their own internal benchmarks established for private equity investments; in some cases, it may be necessary to have a further analysis by one of the foundation's outside investment advisors to document the basis for concluding that the potential rate of return is below market on a risk-adjusted basis.

PRIs in the form of loan guaranties may raise special issues, since the guaranties typically run in favor of for-profit lenders, bondholders and the like, and typically come into play only when there is a problem with the project. The IRS has issued several private letter rulings that approve the making of PRIs through the vehicle of loan guaranties.

C. No Section 170(c)(2)(D) Purpose

A PRI cannot have any Section 170(c)(2)(D) purposes. Section 170(c)(2)(D) purposes include influencing legislation . . . and participating in, or intervening in (including the publishing or distributing of statements) any political campaign on behalf of any candidate for public office. This requirement is typically not an issue.

X. Passthrough Grants

Passthrough grants—grants that require the grantee to redistribute some or all of the grant funds to another organization—can raise several issues. The redistribution requirement may be considered "earmarking," requiring the foundation to exercise expenditure responsibility unless the sub-recipient is itself a public charity for which a direct grant from the foundation would not require the exercise of expenditure responsibility.

It is common for large grants either to include a component of regranting or to provide funding for the engagement of parties to assist the grantees in the performance of the grants. How do foundations ensure that such grants will not be considered "earmarked" for such sub-recipient? Foundations should follow a four-step process to protect against inadvertent earmarking:

(1) Understand the definition of "earmarking." Under Treas. Reg. § 53.4945-5(a)(6)(i), a grant will be not considered as earmarked if "there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the secondary grantee by the organization to which it has given the grant." The regulation further provides that a grant "shall not be regarded as a grant by the foundation to the secondary grantee even though such foundation has reason to believe that certain organizations would derive benefits from such grant so long as the original grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation."

(2) Examine the proposal for possible evidence of earmarking. If the grant proposal includes, as part of the grant, a provision stating that there will be sub-grants to specific

organizations, there is a danger that the grant would be considered earmarked for such sub-grantees.

(3) Confirm the independent selection of any named sub-recipients. If the grant proposal includes a specific designation of sub-recipients, ensure that the sub-recipients were selected by the grantee completely independently of the private foundation.

(4) Include anti-earmarking language in the grant letter. Grant letters for projects with designated sub-recipients should include an anti-earmarking disclaimer ("No part of this grant is earmarked for any party other than the named grantee, and there does not exist any oral or written agreement whereby the grantor may cause the selection of any sub-recipient."). In addition, a grant letter should provide that the grantee has complete control over the selection of any sub-recipients, including any parties listed in the grant proposal, and has the right to change or substitute sub-recipients in its discretion.

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