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# INNOVATIVE GRANT-MAKING TECHNIQUES, INCLUDING USE OF DONOR-ADVISED FUNDS, FISCAL AGENTS, EXPENDITURE RESPONSIBILITY GRANTS, AND PASS-THROUGH GRANTS

**by**

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# INNOVATIVE GRANT-MAKING TECHNIQUES, INCLUDING USE OF DONOR-ADVISED FUNDS, FISCAL AGENTS, EXPENDITURE RESPONSIBILITY GRANTS, AND PASS-THROUGH GRANTS

## I. Introduction

In the first few decades following passage of the Tax Reform Act of 1969, many private foundations were understandably conservative in their grant-making practices. It was common for private foundations to adopt, as the bedrock of their grant-making guidelines, a policy of making grants only to Section 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."

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

This outline describes some of the most common innovative grant-making techniques, and summarizes the applicable rules and regulations governing these grants.

## II. Grants to Donor-Advised Funds

With the passage of the Pension Protection Act ("PPA") in 2006, 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 and can provide annual or one-time funding 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*.

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.

## III. 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's common for the project leaders to identify a friendly 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. *See Fiscal Agency versus Fiscal Sponsorship* by Jane C. Nober, Council on Foundations 2012, *available* at http://www.foundationnews.org/CME/article.cfm?ID=3069.

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)96)(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 2005 (2d ed.), is an essential resource for any foundation that makes grants pursuant to fiscal

sponsorship 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.

## IV. Expenditure Responsibility Grants

Section 4945 imposes initial taxes and additional taxes on "taxable expenditures" of a private foundation. "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.[1]

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.[2]

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.[3]

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:

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[1] Section 4945(d)(4).
[2] Section 4945(h).
[3] Treas. Reg. § 53.4945-5(b)(2)(i).

(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));

(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).[4]

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."[5]

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.

## V. Pass-Through Grants

Pass-through 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

[4] Treas. Reg. § 53.4945-5(b)(3).
[5] Treas. Reg. § 53.4945-5(c).

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.