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Private Foundations Bulletin

Expenditure Responsibility and Equivalency Determination

As many in the private foundation community know, private foundations may distribute grants to organizations other than public charities – such as foreign entities, for-profit entities, individuals, and other private foundations – as long as the disbursements are strictly for charitable purposes and certain steps are taken. A common issue that we see on private foundation tax filings is the incorrect listing and lack of required disclosure for grants made to organizations other than public charities. The required compliance that comes along with grants made to non-public charities must be met in order to avoid the transaction being deemed a taxable expenditure.

Often times grant recipients – such as foreign entities, family foundations, and even for-profit companies – are incorrectly listed as "public charity" or "PC" on the foundation's grant list on the Form 990-PF, and there is no disclosure or mention that either an equivalency determination was conducted or expenditure responsibility requirements were followed.

In order to satisfy compliance and documentation requirements, private foundations should – at the very least – have a grant file that includes its determination that the organization is eligible to receive donations and is in good standing with the Internal Revenue Service (IRS). In the event the prospective recipient is not eligible, the foundation must do one of two things: either have an equivalency determination (in the event it is a foreign grant) or conduct expenditure responsibility.

Equivalency Determination

The IRS allows foundations that give to organizations that have not been recognized under one of the eligible categories to determine through a good faith determination that a grantee is an organization equivalent to a public charity. This good faith determination is known as an equivalency determination and is most common when making grants to foreign organizations. An equivalency determination may be accomplished through either of the following:

- An affidavit of the grantee organization; or
- An opinion of counsel or qualified tax practitioner (of the grantor or the grantee) that the grantee is equivalent to a United States public charity.

Expenditure Responsibility

For all other organizations that are not deemed equivalent, or if the equivalency determination is not completed, a process known as expenditure responsibility must be undertaken to meet tax law requirements of performing compliance and documentation. If this process is not undertaken, the grant will be considered a taxable expenditure.

For organizations subject to expenditure responsibility, Internal Revenue Code (IRC) §4945(h) states that a private foundation is responsible to exert all reasonable efforts to establish adequate procedures:

1. to see that the grant is spent solely for the purpose for which it was 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 [to the IRS].

The IRS regulations fill in and break down the requirements in more detail:

1. The private foundation must conduct a pre-grant inquiry.
2. The private foundation must receive a written agreement that contains certain terms.
3. The private foundation must obtain certain reports from the grantees.
4. The private foundation must properly report the expenditure responsibility grants to the IRS.
5. If the grantee fails to comply in some way, the private foundation must take action.

Each of the requirements must be met for the grant to qualify as a charitable distribution. A grant file should be maintained with all relevant documents, reports and evidentiary support of the private foundation's due diligence. The foundation must then disclose on its annual federal Form 990-PF the activity of the grant.

The foundation is required to disclose the following on the federal Form 990-PF:

1. The name and address of grantee,
2. The date and amount of grant,
3. The purpose of the grant,
4. The amounts expended by the grantee,
5. Whether the grantee has diverted any portion of the funds from the purpose of the grant,
6. The dates of any reports received from the grantee,
7. The date and results of any verification of the grantee's reports undertaken pursuant to, and to the extent required under, Section 52.4945-5(c)(1) by the grantor or by others at the direction of the grantor.

Grantor Violations

The IRS has upheld that the following grant situations constitute a violation as they do not comply with IRC §4945(h) and thus are taxable expenditures:

- The grantor private foundation failed to conduct an appropriate pre-grant inquiry;
- The grantor private foundation failed to obtain the required grant agreement from the grantee; and
- The grantor private foundation failed to file one of the required grantor reports with the IRS.

Taxes on Taxable Expenditures

If a private foundation makes any taxable expenditures, it is liable for taxes on these expenditures. The taxes are imposed on both the foundation and on any foundation manager who knowingly and willfully agrees to the expenditures.

Initial tax – The initial tax on the foundation is 20 percent of the amount expended. The foundation manager is not liable for the tax if it can show the expenditure was due to reasonable cause and not to willful neglect, and the expenditure was corrected within the correction period. If a foundation manager knowingly, willfully, and without reasonable cause agrees to the taxable expenditure, the initial tax on the management is 5 percent of the amount expended, up to a maximum tax of $10,000 for any expenditure. A foundation manager who acts on advice of counsel, given in a reasoned legal opinion in writing, is not liable for the tax.

Additional tax – If the expenditure is not corrected within the taxable period, an additional tax of 100 percent of the amount expended is imposed on the foundation. The tax will not be assessed, or if assessed will be abated, if the expenditure is corrected within the correction period. Any foundation manager who refuses to agree to any part of the correction must pay an additional tax of 50 percent of the expenditure, up to a maximum tax of $20,000.

In Conclusion

While private foundations may make grants to numerous types of entities, it is important that these compliance requirements are being followed to avoid taxable expenditures.

Contact Us

We welcome the opportunity to answer any questions you may have related to this topic or any other accounting, audit, tax or advisory matters relative to private foundations. Please call 212.286.2600 or email any of the Private Foundation Services team members below:

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