

January 2022

Private Foundations Bulletin

Refresher on Expenditure Responsibility and Equivalency Determination

As many in the private foundation community know, private foundations are allowed to distribute grants to organizations other than public charities – such as foreign entities, for-profit entities, individuals, and other private foundations – on condition that 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 these types of grants. The required compliance that accompanies these grants must be met in order to avoid the transaction being deemed a taxable expenditure to the foundation.

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 ascertain 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:

- to see 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 [to the IRS].

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

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

Each of the above 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 the activity of the grant on its annual federal Form 990-PF.

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

- The name and address of grantee,
- The date and amount of grant,
- The purpose of the grant,
- The amounts expended by the grantee,
- Whether the grantee has diverted any portion of the funds from the purpose of the grant,
- The dates of any reports received from the grantee,
- The date and results of any verification of the grantee's reports undertaken pursuant to, and to the extent required under, IRC §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 the manager 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 manager 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:

Thomas Blaney, CPA, CFE
Partner, Co-Director of Foundation Services
tblaney@pkfod.com

Joseph Ali, CPA
Partner
jali@pkfod.com

Scott Brown, CPA
Partner
sbrown@pkfod.com

Anan Samara, EA
Principal
asmara@pkfod.com

Christopher Petermann, CPA
Partner, Co-Director of Foundation Services
cpetermann@pkfod.com

Elizabeth Gousse Ballotte
Principal
eballotte@pkfod.com

Raymond Jones, Sr., CPA
Partner
rjones@pkfod.com

Barbara Van Bergen, CPA
Partner
bvanbergen@pkfod.com

About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, the Firm has 16 offices in New York, New Jersey, Connecticut, Maryland, Massachusetts, Florida and Rhode Island and more than 1,200 professionals providing a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is led by over 135 partners who are closely involved in the day-to-day management of engagements, ensuring a high degree of client service and cost effectiveness.

The Firm is a top-ranked firm, according to *Accounting Today's* 2021 "Top 100 Firms" list and was recently recognized as one of "America's Best Tax Firms" by *Forbes*. PKF O'Connor Davies was named one of *Vault's* 2022 Accounting 50, a ranking of the 50 best accounting employers to work for in North America and ranked among the top 50 most prestigious accounting firms in America in a complementary *Vault* survey.

PKF O'Connor Davies is the lead North American representative of the international association of PKF member firms. PKF International is a network of legally independent member firms providing accounting, tax and business advisory services in over 400 locations in 150 countries around the world. With its tradition, experience and focus on the future, PKF O'Connor Davies is ready to help clients meet today's ever-changing economic conditions and manage the growing complexities of the regulatory environment. For more information, visit www.PKFOD.com.

Our Firm provides the information in this e-newsletter for general guidance only, and it does not constitute the provision of legal advice, tax advice, accounting services, or professional consulting of any kind.