

NONPROFIT STUDY GROUP

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Grantmaking:
The Good, The Bad, and
The Proceed with Caution

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Agenda

- ▣ Basic private foundation rules in grantmaking context
- ▣ Grants to 509(a)(1) and (a)(2) public charities
- ▣ Grants to 509(a)(3) supporting organizations
- ▣ Grants to Governmental Entities
- ▣ Grants to Other Private Foundations
- ▣ Grants to Non-(c)(3)'s (Domestic and International)
- ▣ Grants to Individuals
- ▣ Program-Related Investments

Prohibited Transactions

- ▣ Foundations are subject to prohibited transaction rules
- ▣ Violation of these rules result in excise taxes, and can arise from
 - Self Dealing (4941)
 - Failure to meet Minimum Distribution Requirements (4942)
 - Excess Business Holdings (4943)
 - Jeopardizing Investments (4944)
 - Taxable Expenditures (4945)

Minimum Distribution Requirement

- ▣ §4942 (d)– “Distributable Amount”:
 - For any tax year must distribute:
 - ▣ *Minimum investment return* (5% of average FMV of non-charitable use assets with adjustments)
 - ▣ Less certain taxes
 - Must distribute by end of succeeding tax year

Qualifying Distributions

§4942(g)

- ▣ Any amount paid to accomplish exempt purposes (including reasonable and necessary administrative expenses) or acquire assets used or held for use for exempt purposes (as per §170(c)(2)(B))
 - Grants
 - Distributions for charitable purposes
 - Costs of direct charitable activities
 - Amounts paid for charitable use assets
 - Reasonable and necessary administrative expenses
 - Certain set-asides
 - Program-related investments

Taxable Expenditures - § 4945

- ▣ What are Taxable expenditures?
 - Amounts expended for lobbying;
 - To influence the outcome of any specific public election, or to carry on (directly or indirectly) any voter registration drive (nonpartisan voter registration drives are not considered taxable expenditures [IRC Sec. 4945(f)]);
 - Amounts paid as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved in advance by the IRS;

Taxable Expenditures - § 4945

- ▣ What are Taxable expenditures? (cont.)
 - Amounts paid as a grant to an organization unless such organization is:
 - ▣ A 509(a)(1) or 509(a)(2) organization
 - ▣ A 509(a)(3) organization other than that described in clause (i) or (ii) of sec. 4942(g)(4)(A)
 - ▣ An exempt operating foundation
 - ▣ Or, the foundation exercises expenditure responsibility
 - Amounts expended for any non-charitable purpose.

Expenditure Responsibility

- ▣ Requires foundation to make all reasonable efforts and establish adequate procedures:
 - To see that the grant is spent only for the purpose for which it is made
 - To obtain full and complete reports from the grantee organization on how the funds are spent, and
 - To make full and detailed reports on the expenditures to the IRS

Expenditure Responsibility- Requirements

- ▣ Pre-grant inquiry
 - Investigating the identity, prior history and experience of the grantee organization and its managers to determine if the grantee is capable of accomplishing the grant purpose
- ▣ Written grant commitment, signed by an appropriate officer of the grantee, containing the grantee's agreement to:
 - Repay any portion of grant not used for the purposes of grant,
 - Submit full and complete annual reports on expenditures and progress made in accomplishing purposes of grant,
 - Maintain records of receipts and expenditures and make its books and records available to the grantor, and
 - Not use any grant funds to carry on propaganda, or otherwise attempt to influence legislation; to influence the outcome of any specific public election or to carry on directly or indirectly any voter registration drive; to make any grant which does not comply with 4945(d)(3) or (4) or to undertake any activity for any purpose other than one specified in section 170(c)(2)(B).
- ▣ Receive and review grantee reports
- ▣ Investigate any diversions of funds.
- ▣ Report to Internal Revenue Service (annually)

Expenditure Responsibility- Violations

▣ Diversions by Grantees

- Are taxable expenditures of the Grantor unless Grantor takes all reasonable and appropriate steps to recover any diverted grant funds and the dedication of other grant funds held by the Grantee, withhold all future payments until funds are restored, receives Grantee's assurances that no future diversions will occur, and requires Grantee to take extraordinary measures to prevent future diversions

▣ Grantee's Failure to Make Reports

- Are taxable expenditures of the Grantor unless the Grantor has made a written grant commitment as discussed on the previous slide, complied with the IRS reporting requirements, made reasonable efforts to obtain the required reports, and withholds all future payments on the grant and all other grants to the Grantee until the report is furnished

Expenditure Responsibility- Violations

- ▣ Violations by the Grantor
 - Fails to make a pre-grant inquiry,
 - Fails to make a grant agreement as discussed on the previous slide, or
 - Fails to report to the Internal Revenue Service.

Grants to Public Charities

- ▣ Count as **qualifying distributions** unless PC/grantee is “controlled” by PF or PF’s **DPs**
 - If PC/grantee controlled by PF or PF’s DPs, “out of corpus” rules must be followed to count grants as qualifying distributions

- ▣ Will not be **taxable expenditures** unless earmarked for improper purposes (e.g. private inurement, political campaign intervention, etc.)

Disqualified Persons

What is a Disqualified Person?

- ▣ Substantial Contributor
- ▣ Foundation manager
- ▣ Owner of more than 20% of an enterprise which is a substantial contributor
- ▣ A member of the family of the three above
- ▣ An Enterprise in which a DP discussed above owns more than 35% of the total combined voting power

What is Control?

- ▣ PF or its DPs may, by aggregating their votes or positions of authority, require grantee to make expenditure or prevent the expenditure
- ▣ Based upon ability to control (actual exercise of control irrelevant)

Out of Corpus Rules - § 4942(g)(3)

- ▣ Grantee must redistribute (or expend for charitable purposes) the amount of the grant by the end of the taxable year after grant is received
- ▣ PF must obtain records/evidence to show redistribution (names/addresses of recipients and amounts received) or other use of grant

Type I Supporting Org.

- ▣ Operated, supervised or controlled by one or more publicly supported organizations
- ▣ Parent/Subsidiary relationship
 - Control by publicly supported org
 - Majority of officers, directors, trustees appointed by supported org
 - Purposes must be similar to and no broader than that of supported org
 - Specified organization requirement
 - ▣ Designate by name in governing docs
 - ▣ Designate by class in governing docs, or
 - ▣ Have historic and continuing relationship with supported org and by virtue of this relationship have developed a substantial identity of interest between the orgs

Type II Supporting Org.

- ▣ Supervised or controlled in connection with publicly supported charity
- ▣ Brother/Sister Relationship
 - Common supervision or control
 - ▣ Such that SO will be responsive to needs and requirements of supported org

Type III Supporting Org.

- ▣ “Operated in Connection With” one or more publicly supported charities
 - Notification Requirement
 - Responsiveness Test
 - Integral Part Test
 - ▣ Functionally-related Type III supporting organization
 - ▣ Non functionally-related Type III supporting organization

Integral Part Test

Functionally Integrated

▣ Two Alternatives

■ “But For” Test

- ▣ Engage in activities substantially all of which directly further the exempt purposes of the supported org(s) to which responsive; “but for” the activities of the SO, the supported organization would carry on the activity itself
- ▣ Fundraising/investing/managing non-exempt-use property, etc. insufficient

■ Supporting org is the parent of supported orgs.

- ▣ Exercise substantial degree of control/direction over policies/programs/activities of supported org.
- ▣ Appoint majority of governing persons

Integral Part Test

Non-Functionally Integrated

- ▣ **Distribution Requirement:** Greater of 85% of AGI or 3.5% of FMV of non-exempt-use assets
- ▣ **Attentiveness Requirement:** Distribute at least 1/3 of distributable amount to one or more supported orgs that are attentive to the supporting org and to which the supporting org is responsive
 - Attentive = receive sufficient part of total support from the supporting org.

Grants to SO's: QD and TE Analysis

- ▣ A grant to a Type I, Type II, or FI Type III will be a qualifying distribution and not a taxable expenditure
 - Exception: When supporting org or any of its supported orgs are controlled (directly or indirectly) by the PF's DPs
 - ▣ Must exercise ER or will be a taxable expenditure
 - ▣ Never count as a qualifying distribution

Grants to SO's: QD and TE Analysis

- ▣ A grant made to a non-FI Type III treated consistent with grants to controlled Type I,II, FI III SOs
 - Will be a taxable expenditure unless PF exercises ER
 - Never considered a qualifying distribution

Determining SO Type

- ▣ IRS Business Master File and Determination Letter indicate SO status (Guidestar Charity Check)
- ▣ Type of SO (I and II)
 - Written representation signed by officer, director, or trustee describing process for selecting foundation managers and relationship to supported orgs
 - Obtain and review copies of the grantee supporting org's governing documents
 - Alternative: Reasoned written opinion of counsel

Determining SO Type

- ▣ Type III (functionally integrated vs. non-FI)
 - Grantee written representation identifying supported organizations
 - Review of grantee supporting organization's governing documents re: relationship
 - Written representation signed by an officer, director or trustee of **each supported organization** stating that the supporting organization is functionally integrated and but for the supporting org, the supported org would engage in the activities itself
 - Alternative: opinion of counsel

Grants to Governmental Entities

- ▣ Includes federal government, D.C., state governments, possessions of the U.S., and their political subdivisions
- ▣ Treated as public charities (see 170(b)(1)(A)(v))
 - Grants treated as qualifying distributions
 - Grants will not be taxable expenditures unless inappropriately earmarked

Grants to Private Non-operating Foundations

- ▣ Grants to private non-operating foundations not qualifying distributions
 - Exception: Out of corpus rules followed
 - ▣ Grantee redistributes as a QD by end of tax year after year in which grant received (charitable admin expenses and qualified set asides are okay)
 - ▣ Grantee also satisfies its own minimum distribution requirement
 - ▣ Add these requirements to written grant agreement
- ▣ Will be a taxable expenditure unless grantor exercises expenditure responsibility

Grants to Private Operating Foundations

- ▣ Grants to POFs will be qualifying distributions
 - Exception: Grantor PF or its DPs control the grantee POF -- result: not a qualifying distribution *unless* out of corpus rules are followed

- ▣ Grants to POFs are taxable expenditures *unless* expenditure responsibility is exercised by grantor (distinguishes these grants from grants to public charities)

Grants to Non-(c)(3)'s -- Domestic

- ▣ Grants made to non-(c)(3)'s must be made for one or more purposes described in 170(c)(2)(B) to count as a qualifying distribution
 - ▣ Example: grant to chamber of commerce for educational symposium
 - ▣ Exception: If the grant is to an organization controlled by the PF or its DPs, it will not be a qualifying distribution (NOTE: this is true regardless of whether there is a redistribution or use – out of corpus rules are inapplicable)
- ▣ Grants made to non-(c)(3)'s will be taxable expenditures *unless* grantor PF exercises expenditure responsibility
 - ▣ Additional ER requirement: funds must be maintained in a separate, segregated account dedicated to the grant's charitable purpose
 - ▣ If grant made for charitable purpose but ER not exercised, QD but also TE

Grants for International Work

- ▣ Private foundations may support international philanthropic efforts in several ways:
 - Grants to domestic organizations for international work
 - ▣ Treated as described previously unless earmarked for use of foreign org in which case foreign org treated as grantee
 - Grants to foreign charities recognized as exempt
 - ▣ Treated consistent with analysis for public charities
 - Grants made to foreign organizations directly

Grants to Non-(c)(3)'s – International Organizations

- ▣ Grants to international organizations that do not have 501(c)(3) status from the IRS must be made for charitable purposes to count as qualifying distributions
 - If the foreign org is the equivalent of a PF, must satisfy out of corpus rules to be counted as qualifying distributions
- ▣ Grants to international organizations that do not have 501(c)(3) status from the IRS will be taxable expenditures *unless* the grantor PF makes an equivalency determination or exercises expenditure responsibility
 - Certain treaties may apply.

Grants to Non-(c)(3)'s – International Organizations: Equivalency Determination

- ▣ Foreign Grantees must either have:
 - A § 501(c)(3) public charity status determination letter from the IRS, or
 - The Grantor Foundation must make a good faith determination that the foreign organization would likely qualify as a public charity (501(c)(3) Equivalent).
 - Equivalency Affidavit (of foreign organization)
 - Opinion of Counsel (grantee or grantor)
 - Rev. Proc. 92-94, 1992-2 C.B. 507, describes the requirements for making such a good faith determination.

Grants to Non-(c)(3)'s – International Organizations: Equivalency Determination

- ▣ Obtaining appropriate documentation to determine if the grantee is a 501(c)(3) equivalent
 - Detailed financial information, organizational documents, program activity descriptions (statement of being operated exclusively for charitable purposes) and other information.
 - ▣ Information must be translated into English
 - ▣ Information must be accompanied by a sworn statement of validity from the grantee.
 - ▣ Additionally, the foundation must obtain follow-up reports that its grant was, in fact, spent for the purpose for which it was awarded.
 - If the grantee is a 501(c)(3) equivalent, but would qualify as a private foundation as opposed to a public charity, the foundation must still exercise expenditure responsibility with regard to the grant

Grants to Non-(c)(3)'s – International Organizations: Expenditure Responsibility

- ▣ PFs can always forego determining whether grantee is a 501(c)(3) equivalent and exercise expenditure responsibility
- ▣ In addition to standard requirements, grant funds must be maintained in a separate, segregated account dedicated to one or more charitable purposes

Compliance with Anti-Terrorism Measures

- ▣ Executive Order 13224 (September 2001)
 - Blocks property of and prohibits transactions with certain individuals and organizations
- ▣ The Patriot Act (October 2001)
 - Prohibits an organization from willfully providing or collecting funds with the intention or knowledge that such funds will be used to carry out terrorism
- ▣ The Treasury Guidelines (2002, 2005, and 2006)
 - Voluntary guidelines issued in 2002
 - Amended version and invitation for public comment issued in 2005
 - Upon receipt of comments, revised version issued in September 2006

Grants to Individuals

- ▣ Grants to individuals for the following purposes will count as qualifying distributions
 - Grants for travel, study, or other similar purposes
 - Grants for charitable purposes (e.g. grants for disaster relief)
 - Grants as achievement awards

Grants to Individuals: Travel, Study, or Similar Purposes

- ▣ Will be taxable expenditures *unless* made pursuant to procedure approved in advance by IRS
 - Objective and nondiscriminatory selection process
 - Whether procedures reasonably calculated to result in performance by grantees of activities intended to finance
 - Whether PF will obtain adequate follow up reporting (verified follow up reports)
 - PF must retain records demonstrating selection process, amounts, follow up

Grants to Individuals

- ▣ Company scholarship programs
 - Require advance approval from the IRS
 - Requirements are in Rev. Proc. 76-47 (grants) and Rev. Proc. 80-39 (loans)
 - Foundation grants to public charities to fund scholarships for children of employees are treated as individual grants and require advance approval by the IRS – Rev. Rul. 81-217

Grants to Individuals: Charitable Purposes

- ▣ Grants to indigent are not taxable expenditures (Treas Reg 53.4945 – 4(a)(3))
 - Persons who lack the basic necessities of life as a result of poverty or temporary distress
 - No advance approval is required
 - Must have an objective and nondiscriminatory practice (pool of applicants must be charitable class)
 - Consider short term vs long term need in collecting information (i.e. performing due diligence)
 - *See IRS Publication 3833, Disaster Relief: Providing Assistance Though Charitable Organizations*

Grants to Individuals: Achievement Awards

- ▣ Not taxable expenditures
- ▣ No preapproval required
- ▣ Awards must be for past achievement with no strings attached
- ▣ Example: Noble Prize

Why PRIs?

- ▣ Provide alternative form of financing for charitable programs
- ▣ Enables recirculation/reinvestment of capital
- ▣ Tool allowing the PF ability to leverage philanthropic dollars

Exception to the Jeopardizing Investments Prohibition

- ▣ Exception For Program-Related Investments. – For purposes of this section, investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

Treasury Regulation 53.4944-3

1. The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B);
2. No significant purpose of the investment is the production of income or the appreciation of property; and
3. No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(B)(2)(D) [political purposes].

The Primary Purpose Test

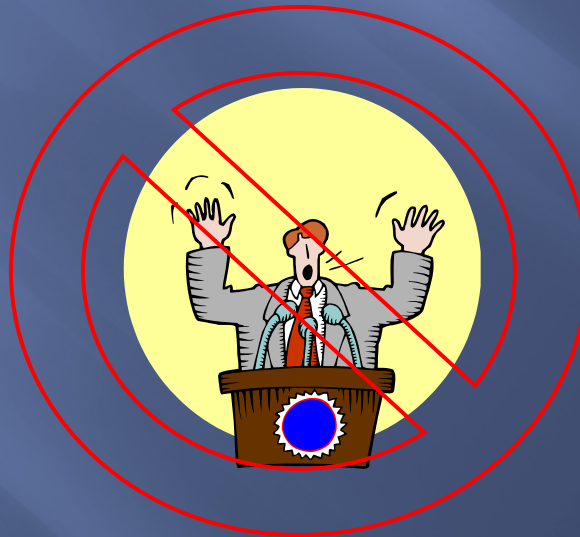
1. *Significantly furthers* PF's exempt purposes
 - Examine PF's purposes
 - Analyze how investment furthers purposes
 - Analysis focuses on purposes, not tax status of recipient entity
2. Investment would not have been made *but for* relationship to PF's exempt purposes
 - Provide contemporaneous documentation of due diligence

No Significant Investment Purpose Test

- ② Would for profit investors make same investment
 - Interest rate
 - Risk level
 - Level of security
 - Time to payout
- ② Would investment fit within parameters of PF's investment policy
- 🎯 Key is analyzing at front end of investment (document!)

No Political Purpose Test

- Absolute prohibition on:
 - Attempting to influence legislation (prohibition more strict than standard for PF)
 - Political campaign intervention



Minimum Distribution Requirement:

- PRIs are qualifying distributions
- Not included in asset base while outstanding
- Recaptured in year repaid

Taxable Expenditures:

- Must exercise ER where made to other than public charities*
 - Each investment made subject to written commitment signed on behalf of recipient
 1. Use all funds only for purposes of investment and repay any funds not so used (tweaked for equity investments)
 2. At least 1X/yr submit financial reports of type ordinarily required by commercial investors in like circumstances + statement of compliance with investment's terms
 3. Maintain and hold open to PF books and records adequate to provide info normally required by commercial investors in like circumstances
 4. Not use funds for lobbying/political campaign intervention
 5. If a PF, not make a grant which fails to comply with 4945(d)(3)(4)

The information set forth in this outline should not be considered legal advice, because every fact pattern is unique.

The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

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