

Equivalency or Expenditure Responsibility? A Guide in Plain English

By Betsy Buchalter Adler and Stephanie L. Petit
Silk, Adler & Colvin

A hypothetical private foundation wants to make a cross-border grant. The foundation has completed its program-specific due diligence and has also taken the steps it deems necessary in the circumstances to guard against diversion to non-charitable ends.¹ The foundation must now consider the tax technicalities of making a grant to a non-U.S. organization.

Very few foreign organizations have obtained IRS rulings classifying them as the foreign equivalent of a public charity, partly because of the cost of seeking and obtaining an IRS determination and the ongoing obligations to file Form 990 if the organization has U.S.-source income over \$25,000 per year.

Since obtaining an IRS ruling in this matter is the exception rather than the rule, our hypothetical private foundation's proposed grantee does not have an IRS ruling. How can the private foundation legally make the grant and not be subject to IRS penalties? It has two choices. First, the private foundation can review its potential grantee to see if the grantee is the *foreign equivalent* of a U.S. public charity. Second, it can exercise the specific oversight and monitoring procedures known as *expenditure responsibility*. The private foundation may choose which technique to use, depending on the circumstances of the grant. In this article, we

What is a public charity?

A public charity is an organization described in Internal Revenue Code Section 501(c)(3) (the statute that defines a charitable organization) and one of the subparts of Section 509(a) (the statute that divides charities into two categories known as private foundations and public charities).

Neither the Internal Revenue Code nor the accompanying Regulations use the term "public charity," but in practice the term refers to organizations that are described in Section 501(c)(3) and that fall in one of three categories: (1) a house of worship, school or college, hospital or medical research organization, or other enterprise that Congress has determined to be eligible for non-private foundation treatment due to the nature of its activities; (2) an organization whose base of support is diverse enough to satisfy one of three alternative mathematical tests of public support; or (3) an organization that is essentially a charitable subsidiary of one or more charities described in the

summarize the basic features of equivalency and expenditure responsibility and then suggest some factors which may lead a grantor to choose one approach or the other.

previous two categories. See Internal Revenue Code Sections 170(b)(1)(A)(i)-(vi), 509(a)(1)-(3). Refer to *Rules of the Road: A Guide to the Law of Charities in the United States* (1999) by Betsy Buchalter Adler, for more information.

Foreign Public Charity Equivalency Determination. A private foundation grantmaker can make a grant to a foreign grantee with the same level of due diligence and oversight as it would use when making a grant to a domestic public charity if the grantmaker first makes a good faith determination that the grantee is the foreign equivalent of a public charity. In Revenue Procedure 92-94, the IRS clarified that there are two ways that the private foundation can make a good faith determination.² First, the private foundation can rely on a written opinion of counsel that the proposed grantee is a public charity equivalent. Second, without the assistance of counsel, the grantor itself can make the determination, based on information provided in an affidavit completed by the grantee.

In practice, whether the foundation relies on an opinion of counsel or whether it makes the determination itself, the affidavit is an essential element of the equivalency determination process. The Revenue Procedure sets out numerous specific requirements for the affidavit. A sample affidavit that complies with the Revenue Procedure is available at <http://www.usig.org/ER%20and%20ED.asp>. Unless the grantor foundation knows that the affidavit may not be reliable or current, the foundation may rely on the information in the affidavit to determine in good faith that the grantee is the foreign equivalent of a public charity. The private foundation must retain the original affidavit or a photocopy, in case the IRS requests it.

Expenditure Responsibility. Expenditure responsibility has five elements, described more fully in *Expenditure Responsibility Step by Step, 3rd Edition* (2002) by John A. Edie, available for purchase from the publications section of the Council website (www.cof.org).

1. The grantor must conduct a *pre-grant inquiry* to determine whether the proposed grantee is reasonably likely to use the grant for the specified purposes.
2. The grantor and grantee must sign a *written grant agreement* with specific terms required by law.
3. The grantee must maintain the grant funds in a *separate account* on the grantee's books.
4. The *grantee must report* to the grantor, in writing, not less than once a year during the term of the grant, explaining how it used the funds and describing its compliance with the grant terms and its progress toward the grant purposes.
5. The *grantor must report* each expenditure responsibility grant on Form 990-PF as long as the grantee reports are required.

Equivalency and Expenditure Responsibility. In 2001, the IRS made clear in a letter to the Council on Foundations that a private foundation wishing to make a grant to a foreign organization could choose between expenditure responsibility and equivalency determination, and that there was no obligation to rule out equivalency before turning to expenditure responsibility. Because private foundations may choose between these techniques, it is worth considering what factors may influence the decision and what circumstances lend themselves to one technique or the other. (For the full text of the letter, visit:

One major difference between equivalency and expenditure responsibility involves the timing of the grantor's effort. A grantmaker undertaking a foreign public charity equivalence determination often has a tremendous amount of work initially with its grantee. In many instances, obtaining translations and trying to fit another country's laws and customs into our own can be a difficult process for both grantor and grantee, requiring much work on the grantee's part to provide the required information and much work on the grantor's part in explaining what information is necessary. This is particularly true for organizations hoping to qualify as a foreign public charity equivalent by virtue of their financial support. The required financial information is extremely detailed. Moreover, the public support calculation requires the grantee to present its financial information in a format not generally followed outside of the United States. (For organizations hoping to qualify because they are a church, a school, a hospital or a governmental organization, the process is often easier because no financial schedules are needed.)³ However, after the foundation or its counsel has made the equivalency determination, the foundation may administer the grant in the same manner as it would administer a grant to a domestic public charity. In other words, the bulk of the work comes at the beginning.

By contrast, expenditure responsibility requires ongoing effort and attention. The pre-grant inquiry is much less burdensome than the foreign public charity equivalence analysis, but the continuing oversight and follow-up are more intensive. The grantor must obtain the grantee reports on time and follow up on incomplete or missing reports, or reports that indicate that the grant is not being used for intended purposes. Communications and linguistic difficulties often complicate the reporting process. If the grantee is in a country or region that suffers from political instability or natural disasters, reporting may be disrupted by factors beyond the control of either grantor or grantee.

Apart from the kind and timing of effort required of the grantor and grantee, the grantor must consider other factors in determining which route to take. If the grantor wishes to make a general support grant, equivalency may be a better choice. Although a grantor can legally make a general support grant using expenditure responsibility, as a practical matter it may be more difficult under expenditure responsibility to ensure that such a broad grant is spent only for charitable purposes. Where the grantor expects a long-term relationship with the grantee, the time and effort investment for the foreign public charity equivalency determination may be well worth it. If the grantee plans to re-grant the funds to other organizations and individuals to accomplish the purposes of the grant, the grantor should consider equivalency because exercising expenditure responsibility over re-grants is still more complicated. Equivalency also offers the grantor the option of contracting to exactly the kind and frequency of reporting that it would like.

By contrast, if the grantee cannot provide its governing documents, then expenditure responsibility is the private foundation's only option. Similarly, if the grantee is not a church, school or hospital and cannot provide the financial data required for an equivalency determination, or if the grantee is not a charitable entity in the first place, the grantor must exercise expenditure responsibility if it wishes to make the grant at all.

Table 1: When There Is No Choice

Situation	Required Action
Grantee is a non-charitable enterprise that will use the grant for charitable purposes.	Expenditure responsibility is the only way to make this grant.
Grantee cannot supply the information required for an equivalency affidavit.	Grantor must use expenditure responsibility because it does not have enough information for an equivalency determination.
Grantor evaluates the affidavit and concludes that despite everyone's best efforts, the grantee is not the equivalent of a public charity.	Expenditure responsibility is the only way to make the grant.

Table 2: When the Grantor Can Choose

Circumstances that favor Equivalency	Circumstances that favor Expenditure Responsibility
Grantor expects long-term relationship.	Grantor plans a one-time grant.
Grantee can supply governing documents and no financial data is needed (i.e., grantee is a school, hospital or church).	Grantee may have considerable difficulty in supplying historical financial data or obtaining a certified copy of its governing documents.
Grantor wants flexible reporting procedures.	Grantor wants strict reporting provisions.
Grantor wants to make a general support grant.	
Grantee plans to re-grant funds received to accomplish its exempt purposes.	

Footnotes

¹For more information on the U.S. Government's anti-terrorism compliance measures, please refer to "A Compendium of Anti-terrorism Resources" on the U.S. International Grantmaking website at: <http://www.usig.org/treasuryregs.asp>.

²To be precise, Revenue Procedure 92-94 talks about equivalency to an organization described in Section 501(c)(3) and also described in Section 509(a)(1), (2) or (3) (what we commonly refer to as public charities) or 4942(j) (a private operating foundation).

³Schools must, however, clarify that they operate pursuant to a racially nondiscriminatory policy or explain their basis for not doing so. This requirement can create problems with equivalency determinations for foreign schools where compliance with such a policy may be impractical or illegal.

About the Authors

Betsy Buchalter Adler is a principal and Stephanie L. Petit is an associate in the San Francisco law firm of Silk, Adler & Colvin, which specializes in the law of nonprofit organizations. Silk, Adler & Colvin provides legal advice and counsel to nonprofit organizations and their donors locally, nationally, and internationally. For more information, visit www.silklaw.com.

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