MacArthur Foundation

COMMENTARY

Re-grants by International Intermediaries that are Not Public Charities: Is Expenditure Responsibility Required and, if so, by Whom?

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In international grantmaking, private foundations often make grants to organizations ("Initial Grantees") that, in turn, re-grant those funds to other non-public charity organizations or individuals ("Secondary Grantees").

Legal issues arise when a private foundation makes a grant to an Initial Grantee that is not a 501(c)(3) organization or that re-grants the Foundation's funds to a Secondary Grantee that is not a 501(c)(3) organization. Most of those issues center around IRS expenditure responsibility rules: specifically, which organization—the private foundation or the Initial Grantee—is responsible for adhering to those rules, if any.

The question is of significance for private foundations and their managers because if a private foundation fails to exercise expenditure responsibility where required, the grant will constitute a taxable expenditure and subject the foundation, and possibly its managers, to penalty taxes.

This article discusses various approaches a private foundation should consider when making such grants and explains how the expenditure responsibility rules might apply.

Making Sense of the Rules

In general, a private foundation must exercise expenditure responsibility whenever it makes a grant to an organization that is neither a public charity nor an exempt operating foundation.[1] Many grants made by private foundations to organizations that are organized outside the United States require expenditure responsibility because the IRS does not recognize most organizations established outside the Unites States as public charities.[2] The Internal Revenue Code (the "Code") and the Treasury Regulations (the "Regulations") have set forth clear steps that a foundation must follow when making expenditure responsibility grants to organizations located overseas.

The rules are less clear, however, when a private foundation makes an expenditure responsibility grant to an Initial Grantee that does not have section 501(c)(3) status and that "re-grants" the funds to individuals or to organizations that also are not public charities. In such circumstances, several questions arise:

- Which organization—the private foundation or the Initial Grantee— has responsibility to exercise expenditure responsibility for the re-grants, if any?
- If the private foundation is not required to exercise expenditure responsibility, does it need to take any other steps? If so, what are they?
- What additional issues should the private foundation consider?

Private foundations can avoid these issues altogether—and be relieved of any expenditure responsibility requirement—by using a U.S. public charity as an Initial Grantee.[3]

In some situations, however, the private foundation may conclude that the most appropriate Initial Grantee is not a U.S. organization with section 501(c)(3) status and the foundation cannot make an equivalency determination regarding this Initial Grantee. In those instances, the private foundation will have to determine which entity, if any, must exercise expenditure responsibility with respect to the re-granted funds.

Expenditure Responsibility and Re-Granting

When the Initial Grantee Is Also a Private Foundation
Sometimes, a private foundation will make a grant to another private foundation that serves as the Initial Grantee. In such cases, the Initial Grantee must provide a signed, written commitment that states it will use the grant funds solely for the purposes for which the grant was made. In this written commitment, the Initial Grantee must agree not to use any of the funds for certain purposes, including "[t]o make any grant which does not comply with the requirements of section 4945(d)(3) or (4)" of the Code.[4] The statutory language is clear that, if the Initial Grantee is a private foundation, the Initial Grantee must exercise expenditure responsibility for re-grants to non-public charities. Note: These sections apply only when the Initial Grantee is also a private foundation.

When the Initial Grantee Is Not a Private Foundation
The Regulations are not at all clear as to whether an Initial Grantee that is not a private foundation must still comply with Code sections 4945(d)(3) and 4945(d)(4) when re-granting to Secondary Grantees. The requirement that all grantees in their written agreement must agree not to use the grant funds to make any grant that does not comply with these Code sections is ambiguous as to whether it effectively requires the Initial Grantee to comply as if it was a private foundation, or whether only private foundations are required to comply.

When the Initial Grantee Is a Non-U.S. Organization The Regulations do not directly address whether the Foundation's expenditure responsibility extends beyond the Initial Grantee in a re-grant situation. However, the Regulations do provide that, with respect to a grant to a non-U.S. organization, the private foundation may satisfy certain of its expenditure responsibility requirements if it has a written commitment with the non-U.S. organization which imposes restrictions on the non-U.S. organization that are substantially equivalent to those required to be imposed on a domestic private foundation grantee.[5]

This arguably suggests that the commitment must include an agreement from the non-U.S. grantee to mimic the elements of expenditure responsibility if the grantee uses the grant funds to make other types of grants. It seems logical, therefore, that any expenditure responsibility as to any subsequent grant made by the Initial Grantee be exercised, if at all, by the Initial Grantee. After all, the Initial Grantee is the one required to make an agreement to exercise expenditure responsibility if it uses the grant funds to make grants to non-public charities, and the private foundation that made the initial grant is already exercising expenditure responsibility on its grant to the Initial Grantee. And yet, as described above, if the Initial Grantee is not a private foundation, it is not clear whether it is covered by the statutory requirement. Therefore, one could naturally conclude that neither the private foundation (Grantor) nor the Initial Grantee must exercise expenditure responsibility for re-grants to Secondary Grantees. This conclusion may seem incongruous, given:

The statutory scheme that applies to private foundations; and

The legislative intent to require private foundations to exercise expenditure responsibility on grants to non-public charities which, under the circumstances, would include the Initial Grantee.

It is worth noting that the IRS does not have jurisdiction to enforce the expenditure responsibility requirements on a non-U.S. Initial Grantee and that it could well view the conclusion expressed above as an unintended anomaly. Consequently, the IRS could interpret the Regulations in a manner that puts more responsibility on the private foundation (Grantor) to ensure expenditure responsibility is followed on all levels.

Private Letter Ruling 9717024
To date, a private letter ruling issued in 1997 represents the best window into the IRS's thinking on these issues. The IRS has not issued any Revenue Rulings or other forms of official guidance on this topic that can be cited as precedent.
Private Letter Ruling 9717024 (the "PLR") involved the following:

X, a private foundation, makes grants to organizations to further its charitable goals.

In some cases, X wants its grantee organizations to re-grant its funds to other organizations or

individuals to further X's charitable goals.

X requires each Initial Grantee to:
o Sign a written grant commitment stating that the Initial Grantee will not use any of the grant funds received from X to make any re-grant that will not comply with Sections 4945(d)(3) or 4945(d)(4) of the Code;
o Maintain the grant money in a separate fund; and
o Prohibit any Secondary Grantee from making further re-grants with the funds received from the initial Grantee

According to the PLR, X would not be held responsible if the Initial Grantee fails to exercise expenditure responsibility adequately with respect to its re-grant of X's grant funds to a Secondary Grantee. Instead X's expenditure responsibility requirements regarding the grant funds that are re-granted to a Secondary Grantee would be met if X properly reports any grant it makes to the Initial Grantee on its Form 990-PF and if X requires the Initial Grantee to:

Sign a written agreement that the Initial Grantee will exercise expenditure responsibility when re-granting;

Provide X with satisfactory reports; and

Give X no reason to doubt the accuracy of these reports.
Additionally, according to this PLR, the Initial Grantee would not be required to make reports directly to the IRS regarding the re-granting of funds to Secondary Grantees. Rather, X agreed to include, in its Form 990-PF filing, any reports it received from the Initial Grantee regarding the re-granting of X's funds.

Further, the PLR provided for instances in which the Initial Grantee was itself a private foundation and wanted to re-grant X's funds to an individual rather than an organization. In such cases, according to the PLR, the Initial Grantee may use and rely on procedures that the IRS previously approved for either X or the Initial Grantee.

As with all private letter rulings, PLR 9717024 may not be used or cited as precedent. This PLR has been criticized for requiring more of the private foundation and intermediary than the Regulations actually require.

Some foundations believe that no one is required to exercise expenditure responsibility with respect to re-grants. These foundations view the provisions in the PLR that seem to require grantees to exercise expenditure responsibility as well as the requirements that the private foundation obtain reports on the Initial Grantee's re-grants and provide these reports to the IRS as part of the foundation's Form 990-PF, as excessive and beyond what the regulations require. The rationale for such requirements in the PLR was the IRS's concern that it did not have jurisdiction over non-U.S. Initial Grantees or non-U.S. Secondary Grantees and, therefore, could not enforce a requirement that the Initial Grantee exercise expenditure responsibility. Thus, the only way the IRS could ensure that the funds were ultimately used for charitable purposes was by requiring the private foundation to secure commitments and reports from the Initial Grantee.

Given that, to date, there are no other IRS publications or rulings that set forth the expenditure responsibility requirements with respect to re-granting, it is unclear whether the IRS will require all private foundations to obtain written grant commitments from Initial Grantees that contain the same or similar provisions as those required in the PLR in order to satisfy the private foundation's expenditure responsibility requirements. It is also unclear what determination a court reviewing this issue would make.

Approaches to Expenditure Responsibility and Re-Granting
What options exist for a private foundation making an expenditure responsibility grant to an overseas Initial Grantee that intends to re-grant the funds? (In this example, we are assuming that a public charity Initial Grantee is not available and that the funds are not earmarked to the Secondary Grantee.)

Option A: The foundation can take a conservative approach and choose to follow the requirements set forth in the PLR.
o The IRS has previously approved these requirements, but the PLR is not authoritative precedent.
o This approach places additional burdens on the foundation and its grantees that are not specifically required by the Regulations.
o Each foundation should assess how burdensome these requirements are, given the potential benefits and comfort it may receive by following the procedure.

Option B: The foundation can take a risk-based approach. Assuming the foundation is comfortable that the funds have not been earmarked to the Secondary Grantee,[6] the foundation needs only exercise expenditure responsibility with respect to its initial grant as a logical interpretation of the Code and Regulations suggests is sufficient. Nonetheless, the foundation must require a written commitment from the Initial Grantee not to use the funds to make a re-grant that does not comply with requirements of Code sections 4945(d)(3) or 4945(d)(4).

In deciding whether to take additional steps, the foundation should consider a number of factors, including the:

Nature of the Initial Grantee;

Amount of the grant;

Types of activities undertaken by the Initial Grantee;

Types and purposes of the re-grants;

Foundation's familiarity with, and confidence in, the Initial Grantee; and

Sophistication of both the Initial Grantee and any Secondary Grantee(s).

If the foundation perceives a risk that either the Initial Grantee might not supervise the re-granted funds appropriately or that earmarking is present, it may choose to impose additional requirements on the Initial Grantee or be more aggressive with ensuring the funds are used by the Secondary Grantee for the charitable purposes for which the grant was made. Such additional requirements might include requiring the Initial Grantee to:

Agree to obtain reports from the Secondary Grantee and provide copies of these reports to the foundation;

Provide more detailed reports on its re-grants; and

Take additional due diligence steps before re-granting any of the foundation's funds and report such steps to the private foundation.

In determining whether these additional requirements are appropriate, the foundation should consider how burdensome these requirements would be on the Initial Grantee and Secondary Grantee, particularly smaller organizations.

Conclusion

In international grantmaking, private foundations commonly use Initial Grantees to re-grant funds. Many private foundations use public charities as Initial Grantees in order to avoid expenditure responsibility requirements. Nonetheless, they must still take care to avoid earmarking issues in such instances.

At times, a private foundation may conclude that an Initial Grantee that is located overseas (and as to which the Foundation cannot make an equivalency determination) may be more effective in a re-granting program. In such a case, the private foundation must decide how to fulfill its expenditure responsibility requirements. The Regulations are not entirely clear, and although the PLR provides some guidance, it also arguably places additional obligations on the foundation that otherwise would not be required.

A private foundation should assess all factors in determining the steps it wishes to take to meet the requirements. In some cases where greater risk may be present, the private foundation may want to take the conservative but prudent approach of following all or some of the procedures outlined in the PLR. In other cases, the private foundation may conclude that simply exercising expenditure responsibility with respect to the initial grant is sufficient as being consistent with the Regulations. In all cases, the private foundation should be cognizant of the issues described in this article and make an informed and conscious decision after balancing the risks involved, the burdens on the grantees, and the costs of implementing the approach chosen.

About the Authors

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1 “Expenditure responsibility” requires that the grantmaking foundation be responsible for exerting all reasonable efforts and establishing adequate procedures (i) to ensure that the grant is spent solely for the purpose for which the grant was made; (ii) to obtain full and complete reports from the grantee on how the grant funds are spent; and (iii) to make full and detailed reports with respect to such expenditures to the IRS. (Regs. § 53.4945-5(b)(1)).

2 This assumes the foundation has not made a determination that the organization is the equivalent of a U.S. public charity under Revenue Procedure 92-94.

3 Additionally, a Foundation is not required to exercise expenditure responsibility if the Foundation has made a good faith determination (based on an affidavit from the grantee or an opinion of legal counsel) that the non-U.S. Initial Grantee is the equivalent of a U.S. public charity (such as a non-U.S. school or hospital).

4 Regs. §53.4945-5(b)(3)(iv)(c). Code section 4945(d)(3) provides that any amount paid or incurred by a private foundation “as a grant to an individual for travel, study, or other similar purposes by such individual,” constitutes a taxable expenditure unless the foundation follows certain guidelines in making the grant (e.g., the grant must be awarded on an objective and nondiscriminatory basis and must be made pursuant to procedures approved in advance by the IRS). Code section 4945(d)(4) provides that any amount paid or incurred by a private foundation as a grant to an organization that is not a public charity constitutes a taxable expenditure unless the private foundation exercises expenditure responsibility with respect to that grant.

5 Regulations section 53.4945-5(b)(5) provides that, with respect to a grant to a non-U.S. organization (other than a public charity or its equivalent), Regulations section 53.4945-5(b)(3)(v) or (4)(iv) shall be deemed satisfied if the expenditure responsibility grant agreement imposes restrictions on the use of the grant substantially equivalent to the limitations imposed on a domestic private foundation under Code section 4945(d). Such restrictions may be phrased in appropriate terms under foreign law or custom and ordinarily will be sufficient if an affidavit or opinion of counsel (of the grantor or the grantee) is obtained stating that, under foreign law or custom, the agreement imposes restrictions on the use of the grant funds that are substantially equivalent to the restrictions imposed by the Regulations on a domestic private foundation.

6 Regs. §53.4945-5(a)(6)(i) provides that a grant by a private foundation to an Initial Grantee, which the Initial Grantee uses to make payments to another organization, shall not be regarded as a grant by the foundation to the Secondary Grantee if the foundation does not earmark the use of the grant for any named Secondary Grantee and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the Secondary Grantee by the Initial Grantee. It further provides that such a grant will not be regarded as a grant by the private foundation to the Secondary Grantee even if the foundation has reason to believe that certain organizations would derive benefits from the grant so long as the Initial Grantee exercises control, in fact, over the selection process and actually makes the selection of the Secondary Grantee completely independently of the private foundation. Therefore, when a foundation makes a grant to a non-public charity Initial Grantee with the intention that the Initial Grantee re-grant its funds, the foundation may not participate in the selection of the Secondary Grantee if it wishes to avoid expenditure responsibility over the re-grants (otherwise the grant will effectively be treated as if made directly to the Secondary Grantee); instead, the Initial Grantee must control the selection process and select the Secondary Grantee completely independently of the foundation.