

EXPENDITURE RESPONSIBILITY – A PRIMER & TEN PUZZLING PROBLEMS

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This outline first summarizes the basic rules governing expenditure responsibility and then considers ten puzzling problems involving expenditure responsibility.

I. THE CONTEXT.

Section 4945 of the Internal Revenue Code (the “Code”) imposes an excise tax on a private foundation’s “taxable expenditures”. A private foundation must exercise **expenditure responsibility** when it wants to make a “grant” to certain types of organizations (typically organizations that are not 501(c)(3) public charities) without incurring an excise tax for having made a taxable expenditure. Ever since the Pension Protection Act of 2006, expenditure responsibility is also applicable to certain grants from donor advised funds, although we are awaiting regulations as to precisely how the rules discussed in this outline will apply in that context.

II. WHAT IS A TAXABLE EXPENDITURE?

A taxable expenditure includes “any amount paid or incurred” by a private foundation:

- For any purpose that is not a valid charitable purpose described in Section 170(c)(2)(B);
- To carry on propaganda or influence legislation, as those terms are further defined (Sections 4945(d)(1) and 4945(e));
- To influence the outcome of an election or carry on a voter drive, as those concepts are further defined (Sections 4945(d)(2) and 4945(f));
- To make a grant to an individual for travel, study, or other similar purposes, unless the grant satisfies certain other requirements, including IRS pre-approval of procedures (Section 4945(d)(3) and 4945(g)); or

- *As a “grant” to an “organization” unless the grant is made to certain types of public charity organizations or unless the foundation exercises expenditure responsibility (4945(d)(4).)*

Our focus is on the last bullet point above.

III. WHAT IS A GRANT?

A taxable expenditure includes a “grant” to certain types of organizations. The term “grant” is defined differently in different parts of the Code. For these purposes a grant is defined by reference to Regulation 53.4945-4(a)(2), which itself is more descriptive than definitional. It is safe to say, however, that for purposes of Section 4945(d)(4) grants include at least the following:

- Amounts spent by the recipient organization to carry out a charitable activity;
- Amounts used by the recipient for scholarships, fellowships, internships, prizes, and awards;
- Loans used by the recipient for any of the above; and
- Program-related investments in the form of loans or equity.

Grants do not normally include amounts paid to an organization to provide services for the grantor. So not every payment that a private foundation makes to another is a “grant”. This makes sense of course because payments to lawyers, accountants, bookkeepers, investment firms, and even writers, scientists, and artists who provide direct services to the foundation, are not grants.

IV. GRANTS TO CERTAIN TYPES OF ORGANIZATIONS DO NOT REQUIRE EXPENDITURE RESPONSIBILITY.

A private foundation need not exercise expenditure responsibility for grants made to the organizations that are described in Section 501(c)(3) and that are also described in one of the following categories:

- Section 509(a)(1) of the Code, which consists of:
 - churches described in Section 170(b)(1)(A)(i);
 - educational institutions described in Section 170(b)(1)(A)(ii),
 - hospitals, etc. described in Section 170(b)(1)(A)(iii),

- organizations supporting state colleges described in Section 170(b)(1)(A)(iv),
- governmental units described in Section 170(c)(1), and
- organizations publicly supported by grants under Section 170(b)(1)(A)(vi)

and, via Regulations Section 53.4945-5(a)(4):

- state schools described in Section 511(a)(2)(B),
 - foreign government agencies, and
 - international organizations listed in an Executive Order under 22 U.S.C. 288;
- Section 509(a)(2) of the Code, which describes organizations that derive at least one-third of their income from smaller grants, donations, and sales or service income, and no more than one-third of their income from investments and net income from unrelated business activities;
 - Section 509(a)(3) of the Code, which is a supporting organization to a publicly-supported organization in one of the two categories above, unless the supporting organization is Type III and not functionally integrated, or unless the supporting organization either is controlled by the private foundation's disqualified persons, or supports an organization controlled by the private foundation's disqualified persons; or
 - Section 4940(d)(2) of the Code, describing certain private exempt operating foundations (which is not to be confused with the Section 4942 of private operating foundations, grants to most of which do require expenditure responsibility).

V. GRANTS TO THE FOLLOWING TYPES OF ORGANIZATIONS DO REQUIRE EXPENDITURE RESPONSIBILITY.

Private foundation grants to any organizations other than those described above require expenditure responsibility. For example, grants to the following types of entities require expenditure responsibility:

- Private foundations, including most private operating foundations, except for exempt operating foundations under Section 4940(d)(2) of the Code;

- Public charities under Section 509(a)(4) (certain organizations engaged in testing for public safety);
- Organizations tax-exempt under some other section of the Internal Revenue Code than Section 501(c)(3), most commonly:
 - social welfare organizations under Section 501(c)(4),
 - labor unions and agricultural or horticultural organizations under Section 501(c)(5),
 - trade or professional associations, business leagues or chambers of commerce under Section 501(c)(6), and
 - social clubs under Section 501(c)(7);
- Non-tax-exempt entities, like commercial businesses;
- Foreign organizations, unless the grantee has received a ruling on its public charity status from the IRS, or the grantor makes a good faith determination in accordance with Regulations Section 53.4945-5(a)(5) that the grantee is the equivalent of a U.S. public charity, by (1) relying on a reasoned written legal opinion, or (2) relying on an affidavit from the grantee demonstrating that it is equivalent to a public charity, in accordance with Revenue Procedure 92-94;
- Type III supporting organizations that are not functionally integrated with their supported organizations (but the grant still will not be a qualifying distribution); and
- Any type of supporting organization described in Section 509(a)(3) if it is controlled by the private foundation's disqualified persons, or if it supports any entity controlled by the private foundation's disqualified persons (but the grant still will not be a qualifying distribution).

VI. HOW DOES A PRIVATE FOUNDATION EXERCISE EXPENDITURE RESPONSIBILITY?¹

Section 4945(h) states that the private foundation “is responsible to exert all reasonable efforts to establish adequate procedures (1) to see that the grant is spent solely for the

¹ This section discusses expenditure responsibility procedures for private foundations. As of this writing, legal advisors are debating whether there are or should be any differences between expenditure responsibility in the private foundation context (for which the expenditure responsibility rules were originally designed) and the DAF context (to which the expenditure responsibility rules newly apply, due to enactment of the Pension Protection Act of 2006 on August 17, 2006). Until guidance is forthcoming from the IRS, the answers are unclear.

purpose for which it is 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 Regulations fill in and break down the requirements in more detail:

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

We now review each requirement in more detail:

- Pre-grant inquiry (Regulations Section 53.4945-5(b)(2)).

The legal standard: “a limited inquiry concerning the potential grantee . . . complete enough to give a reasonable man [*sic*] assurance that the grantee will use the grant for the proper purposes” covering the “identity, prior history and experience (if any)” of the grantee and its managers, and “knowledge which the private foundation has,” or information that is “readily available” about the “management, activities and practices” of the potential grantee. The scope of the inquiry will vary with the size and purpose of the grant, the payment period, and the grantor’s prior experience with the grantee.

Examples (in the Regulations) demonstrate how widely the level of inquiry required may vary depending on the situation, and make clear that uncovering some adverse information need not dictate denial of a grant.

- Written grant agreement (Regulations Section 53.4945-5(b)(3)).

Expenditure responsibility requires that a grant to an organization that has non-charitable activities be made for specific charitable projects, programs, or activities, rather than general or operating support. The written grant agreement must require the grantee to: (1) use the grant only for the purposes specified in the agreement; (2) repay to the grantor any funds not so used; (3) refrain from a list of prohibited activities; (4) make reports on the use of grant funds to the grantor; and (5) maintain appropriate documentation of expenditures and make books and records available to the grantor’s inspection. The rules differ a bit for program-related investments, which are discussed below.

- Grantee reporting (Regulations Section 53.4945-5(c)).

In general, the reports required of an expenditure responsibility grantee must cover how grants funds were used (including salaries, travel, and supplies), compliance with the grant agreement, and the grantee's progress towards grant purposes. The first report is due within a reasonable period after the close of the grantee's fiscal year in which grant funds were first received, then reports are required annually until the grant is spent in full or terminated. The final report must cover expenditures over the life of the grant. (If the grant is to a private foundation for endowment or capital expenses, the reports must also cover the use of income from grant funds; if the grantor finds the grantee's first three reports satisfactory, no further reports are required.)

While the grantor need not conduct any independent verification of the grantee's reports unless it has reason to doubt their accuracy or reliability, the grantor does need to make sure it actually receives reports, and that the reports comply with the reporting requirements, as described in the grant agreement. Grantors should calendar the fiscal year end of each expenditure responsibility grantee. That way, if needed, the grantor can call grantees and remind them that no renewals or future funding will be considered unless reports are complete and timely; the grantor should also keep records of its efforts to ensure grantee compliance.

- Reporting to the IRS.

Each expenditure responsibility grant must be reported on the grantor's IRS Form 990-PF annual tax return as long as grantee reporting on that grant is required. If the grantee's report contains the required information, it may be submitted to the IRS by the grantor as the grantor's report. Seven items of information are required: (1) the name and address of the grantee; (2) the date and amount of the grant; (3) the purpose of the grant; (4) the grantee's expenditures through the grantee's most recent report; (5) whether the grantor is aware of any diversion of funds (or income, in the case of endowment grants) from grant purposes; (6) the dates of reports received from the grantee; and (7) the date and results of any verification of the grantee's reports undertaken by or on behalf of grantor, if warranted. Grantors should ensure that their tax preparers are informed each time an expenditure responsibility grant is made, and updated annually on all such grants outstanding.

- Strict compliance and documentation.

Exercising expenditure responsibility is not particularly difficult. Many foundations comply in substance with most of the expenditure

responsibility rules as standard operating procedure even in their grantmaking to public charities. However, in situations where expenditure responsibility is obligatory, it must be followed strictly. For example, in a 1989 case, the Tax Court held that the Hans S. Mannheimer Charitable Trust had made a taxable expenditure even though the required level of grantee oversight had occurred, because it had not been properly documented. Similarly, improper reporting to the IRS could cause an otherwise proper expenditure responsibility grant to be treated as a taxable expenditure.

The following items must be in the grantor's files in the event of an IRS audit:

- Grant agreements for every expenditure responsibility grant.
- Every grantee report received on an expenditure responsibility grant. Also, although not required by the Regulations, documentary evidence of efforts to obtain missing or late reports, results of the grantor's review of reports received, and follow-up with grantees on any inadequate reports.
- A copy of any internal or independent auditor's report on any audits or investigations relating to any expenditure responsibility grant.
- Documentary evidence of the pre-grant inquiry process and its results – notes of conversations, memos to the file, copies of any documents received, etc. (Although not listed in the Regulations as required, in an IRS audit, the burden is on the grantor to demonstrate that it complied with the expenditure responsibility rules by conducting an appropriate pre-grant inquiry.)

VII. WHAT HAPPENS IF SOMETHING GOES WRONG?

The Regulations address three things that can go wrong with an expenditure responsibility grant: the grantee diverts grant funds from grant purposes; the grantee fails to make reports as required; or the grantor simply fails to follow expenditure responsibility requirements properly.

- Diversions by the grantee (Regulations Section 53.4945-5(e)(1)).

Any diversion of grant funds (or income from grant funds, in the case of an endowment grant) from the purposes stated in the grant agreement may cause some or all of the grant to be treated as a taxable expenditure by the grantor. Using funds

differently than indicated in the budget is not a diversion unless the use of funds does not comply with the grant agreement. Once a grantor discovers that a diversion did or may have taken place, it can avoid a taxable expenditure by: (1) taking all reasonable and appropriate steps (including legal action in some circumstances) to recover the diverted funds or ensure their restoration, and ensure grantee's proper use of remaining grant funds; and (2) withholding any further payments to the grantee until it has received grantee's assurances that no future diversions will occur, and require grantee to take extraordinary precautions to prevent future diversions. (If this is not the first diversion by this grantee, the grantor must take more drastic measures.) If the grantor does not comply with (1), the amount of the diversion plus any further payments will be a taxable expenditure; if the grantor complies with (1) but does not comply with (2), any further payments will be taxable expenditures.

- The grantee fails to make required reports (Regulations Section 53.4945-5(e)(2)).

If a grantee fails to make the required reports, or makes inadequate reports, the grant is a taxable expenditure unless the grantor: (1) conducted a proper pre-grant inquiry, (2) made the grant with a proper grant agreement, (3) has properly reported the grant to the IRS, (4) makes a reasonable effort to obtain the report, and (5) withholds all future payments on this and any other grant to this grantee until the report is provided.

- The grantor fails to properly follow the expenditure responsibility rules (Regulations Section 53.4945-5(e)(3)).

Failing to conduct a proper pre-grant inquiry, failing to use a proper written grant agreement, or failing to report properly to the IRS, in connection with a grant for which the law requires expenditure responsibility, will cause the grant to be a taxable expenditure.

VIII. WHAT IS DIFFERENT ABOUT EXPENDITURE RESPONSIBILITY FOR PROGRAM-RELATED INVESTMENTS?

The Regulations require that program-related investments, in whatever form, comply with the requirements set forth above for grants, except that the Regulations provide a bit more flexibility for the contents of the program-related investment agreement and for the frequency and types of reporting. Regulation 53.4945-5(b)(3) provides for the terms that must be in grant agreements, while Regulation 53.4945-5(b)(4) provides that for program-related investments, the foundation must receive a written commitment signed by an appropriate officer of the recipient organization. The commitment must specify the purpose of the investment and must include an agreement by the recipient to do all of the following:

- (i) To use all the funds received from the private foundation (as determined under paragraph (c)(3) of this section) only for the purposes of the investment and to repay any portion not used for such purposes,

provided that, with respect to equity investments, such repayment shall be made only to the extent permitted by applicable law concerning distributions to holders of equity interests;

(ii) At least once a year during the existence of the program-related investment, to submit full and complete financial reports of the type ordinarily required by commercial investors under similar circumstances and a statement that it has complied with the terms of the investment;

(iii) To maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances and to make such books and records available to the private foundation at reasonable times; and

(iv) Not to use any of the funds for any of other purposes prohibited under Section 4945, namely, lobbying, political activity or grants to individuals (unless approved under Section 4945(g)).

In addition, while a grant recipient must either hold the grant funds in a separate bank account, or at least account for the funds separately, the recipient of a PRI investment need not hold the funds in a separate account or even account for the funds separately, unless the private foundation asks it to do so.

Any tax advice contained in this memo is not intended to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under federal tax law. A taxpayer may rely on our advice to avoid penalties only if the advice is reflected in a more formal tax opinion that conforms to IRS standards. Please contact us if you would like to discuss the preparation of a legal opinion that conforms to these rules.

TEN PUZZLING PROBLEMS

1. How are private foundations (“PF”), large and small, actually complying with all of these pre-grant inquiry rules, record keeping, and IRS reporting rules, as a practical matter, and how does IRS audit ER grants?

Context: The ER Regulations require that the PF conduct an appropriate pre-grant inquiry, maintain certain records in the file, and provide certain reports to the IRS as part of the 990PF. Despite the fact that most of this is just good grant making process anyway, we are focusing on the legal requirements.

- The pre-grant inquiry rules suggest that a PF’s pre-grant inquiry will vary depending on how familiar the PF is with the grantee, and the Regulations give some examples. See Reg. 53.4945-5(b)(2).
- The Regulations provide a list of the information that the PF must maintain in its file. See Reg. 53.4945-5(d)(3). The following items must be in the grantor’s files in the event of an IRS audit:
 - Grant agreements for every expenditure responsibility grant.
 - Every grantee report received on an expenditure responsibility grant. Also, although not required by the Regulations, documentary evidence of efforts to obtain missing or late reports, results of the grantor’s review of report received, and follow-up with grantees on any inadequate reports.
 - A copy of any internal or independent auditor’s report on any audits or investigations relating to any expenditure responsibility grant.
 - Documentary evidence of the pre-grant inquiry process and its results – notes of conversations, memos to the file, copies of any documents received, etc. (Although not listed in the Regulations as required, in an IRS audit, the burden is on the grantor to demonstrate that it complied with the expenditure responsibility rules by conducting an appropriate pre-grant inquiry.)

In a 1989 case, the Tax Court held that the Hans S. Mannheimer Charitable Trust had made a taxable expenditure even though the required level of grantee oversight had occurred, because it had not received and maintained proper reports from the grantee. 93 T.C. 35 (1989).

- The Regulations provide that each expenditure responsibility grant must be reported on the grantor's IRS Form 990-PF annual tax return as long as grantee reporting on that grant is required. Reg. 53.4945-5(d)(2). If the grantee's report contains the required information, it may be submitted to the IRS by the grantor as the grantor's report. Seven items of information are required: (1) the name and address of the grantee; (2) the date and amount of the grant; (3) the purpose of the grant; (4) the grantee's expenditures through the grantee's most recent report; (5) whether the grantor is aware of any diversion of funds (or income, in the case of endowment grants) from grant purposes; (6) the dates of reports received from the grantee; and (7) the date and results of any verification of the grantee's reports undertaken by or on behalf of grantor, if warranted. Improper reporting to the IRS could cause an otherwise proper expenditure responsibility grant to be treated as a taxable expenditure

2. When do ER grant recipients have to (a) keep the grant money in a separate bank account, (b) separately account for the money, but not keep it in a separate bank account, or (c) none of the above?

Context: Regulation 53.4945-5(c)(3) states that a private foundation grantee or the recipient of a program-related investment "need not segregate grant funds physically nor separately account for such funds on its books unless the grantor requires such treatment of the grant funds." It goes on to provide timing rules where money is not separately tracked.

Regulation 53.4945-6(c)(2) provides that other grantees must "continuously maintain the grant funds (or other assets transferred) in a separate fund dedicated to one or more purposes described in Section 170(c)(2)(B)." Otherwise, the Regulations suggest, the PF grantor cannot know that its funds are dedicated to charitable purposes.

3. If a grantee does not provide reports or you hear a rumor that a grantee has misspent money, what do the rules say you are supposed to really do and what do private foundations really do in practice?

Context: The Regulations impose an obligation on the PF to take reasonable steps under the circumstances to recover misspent funds and to continue to make additional payments to a non-compliant grantee. Reg. 53.4945-(e). This principle also applies to reports that grantee fails to submit. What measures are normally reasonable? What do foundations typically do?

4. A private foundation ("PF") makes a grant to an organization. The grantee organization, in turn, makes grants to other organizations and individuals. How does the grantor PF comply with Section 4945?

Context: Usually, a PF makes a grant to an organization that uses the money directly for its own programs and can then provide the appropriate ER report. Sometimes, the PF makes a grant to another entity, which in turn re-grants. Sometimes the grantor PF selects the intermediary as an agent to re-grant to an earmarked charity or charity. Sometimes, the PF wants its grantee to

make grants, but wants the grantee to exercise its own judgment about the re-grants. Who reports to the PF? Consider the following possibilities:

- PF makes a grant to a U.S. public charity or the foreign equivalent of a public charity, and the grant is not earmarked for further granting. No ER required.
 - PF makes a grant to any entity and the grant is earmarked for further granting. We look to the ultimate grantee to determine whether or not ER is required and ignore the intermediary. What if the PF does not have any contract with the ultimate grantee?
 - PF makes a grant to another PF, which will in turn make grants. Normally, the first PF exercises ER over the second PF and also requires the second PF to make grants only to public charities or if not, to exercise ER and also abide by all of the other Section 4945 restrictions. Who gives reports to whom?
 - PF makes a grant to another entity (not a PF), which will in turn make grants. Normally, the first PF exercises ER over its grantee, but what about grants that its grantee might make. Who is responsible? Who gives reports to whom?
5. **Endowment and Capital grants to a PF have a three year time limit on ER. Is an “endowment” for purposes of this rule the same as UPMIFA? Also can this three year limit ever apply to a foreign grantee?**

Context: In most states the term “endowment” is defined by reference to a state statute, typically a version of UPMIFA. The Regulations do not define endowment. Private foundations may grant a large amount of cash or other assets to another private foundation as part of a reorganization or other transaction without legally limiting the ability of the recipient PF to spend principal. Is this an endowment for purposes of the Regulations, even if it is not one for purposes of state law?

As to the foreign grantee, the Regulations provide as follows:

(2) *Capital endowment grants to exempt private foundations.* If a private foundation makes a grant described in section 4945(d)(4) to a private foundation which is exempt from taxation under section 501(a) for endowment, for the purchase of capital equipment, or for other capital purposes, the grantor foundation shall require reports from the grantee on the use of the principal and the income (if any) from the grant funds. The grantee shall make such reports annually for its taxable year in which the grant was made and the immediately succeeding 2 taxable years. Only if it is reasonably apparent to the grantor that, before the end of such second succeeding taxable year, neither the principal, the

income from the grant funds, nor the equipment purchased with the grant funds has been used for any purpose which would result in liability for tax under section 4945(d), the grantor may then allow such reports to be discontinued.

Even though IRS allows private foundations in similar contexts to make a reasonable determination about whether a foreign organization is the equivalent of a private foundation (see, e.g., the COF letter referred to below), this Regulation describes a foreign private foundation that is “exempt from taxation under Section 501(a)”. A private foundation can be described in Section 501(a), but it can only be exempt from taxation by applying to IRS. Can a grant to a foreign PF that has not applied to for an IRS letter ever rely on this three year limit, or must ER continue forever in the case of an endowment or capital purchase?

6. What is different about ER for a Program-Related Investment (“PRI”)?

Context: The Regulations tell us that the term “grant” includes program-related investments. The Regulations also provide some different rules for ER involving program-related investments. These different rules include the following:

- Reg. 53.4945-5(b)(3) and (4) provide different rules for what has to be in the ER grant agreement in each case. Consider the following chart:

Grant	PRI
Written commitment by grantee’s officer, director or trustee that contains the following:	Written commitment by PRI recipient signed by an officer, director, or trustee that specifies the purpose of the investment and contains the following:
To repay any portion of the amount granted that is not used for the purposes of the grant	To use all funds received only for the purposes of the investment and to repay any portion not so used; repayment in an equity PRI is limited to the extent permitted by applicable law concerning distributions to holder of equity interests.
To submit full and complete annual reports on the manner in which the funds are spent and the progress made in accomplishing the purposes of the grant.	To provide an annual report, including financials, of a type ordinarily provided to commercial investors under similar circumstances PLUS a statement that the recipient has complied with the terms of the PRI.
To maintain records and receipts and make the books available.	To maintain books and records ordinarily required by a commercial investor and to make the books available.
Not to use funds for improper purposes, including certain lobbying, political activity, or grants to that do not comply with 4945(d)(3) or (4).	Not to use funds for improper purposes, including certain lobbying, political activity or in the case of grants made to a PF, to make any grants that do not comply with 4945(d)(3) or (4), suggesting that grants to others need not so comply.

There is one point of ambiguity in the Regulations, as well. Section 53.4945-5(b)(3) lays out the grant agreement requirements. The next Section, 53.4945-5(b)(4) spells out the terms that must be in a PRI agreement. These differences are described above in the chart. In addition, however, Section 53.4945-5(c)(1) talks about “reports from grantees”. This section adds detail about what the grantee reports must contain and fits in well with the section describing the content of the

written grant agreement. Section 53.4945-5(c)(1) however goes well beyond what the written agreement requirements for a program-related investment seem to require in terms of reporting, but on its face, the Section 53.4945-5(c)(1) rules do not exclude program-related investments.

Therefore, do we require PRI recipients to provide the detail of reporting required by Section 53.4945-5 (c)(1), and what are the practical difficulties in doing so?

- 7. How does a private foundation ensure that a program-related investment equity agreement contains the appropriate expenditure responsibility provisions? Is this process easier with an L3C? Discuss common problems that arise.**

Context: The following questions arise in each PRI deal:

- In a grant there is a grant agreement. In a PRI, what document does the PRI recipient's officer actually sign, and what document actually contains the requirements listed above?
- In an equity transaction how does a PF investor get repaid if the investee violates the ER rules?

- 8. Is there really any real benefit to the general information letter that COF received in 2001?**

Context: In a response to a request from the Council on Foundations, the IRS issued a general information letter (April 18, 2001) that concludes as follows: "IRS will respect how a grant making foundation treats a foreign grantee for purposes of applying sections 4942 and 4945. If the grant making foundation has treated a foreign grantee as a noncharitable entity, a grant to that foreign entity for exclusively charitable purposes will be treated as a qualifying distribution and not as a taxable expenditure..." if the grantor exercises expenditure responsibility. The value of this letter is that the grantor PF can exercise expenditure responsibly and treat the grant as a qualifying distribution under Section 4942. The grantor PF does not have to think about whether the grantee would qualify under 501(c)(3) and therefore might be a private foundation that under Section 4942 is not eligible to receive a qualifying distribution (unless out of the corpus is used).

- 9. How are the expenditure responsibility rules being applied for private foundation grants to type III, on functionally integrated supporting organizations, and to grants out of donor advised funds to organizations?**

Context: the Pension Protection Act of 2006 extends the ER rules to donor advised funds. It also changed the rules as to what type of supporting organizations could receive grants without ER. How is this all working?

10. More and more, private foundations are making program-related investments in the form of guarantees or credit enhancement. How does expenditure responsibility apply to these vehicles?

Context: Sometimes it is most effective for a PF to further its mission by providing a guarantee or other form of credit enhancement to an entity instead of making a cash grant. Sometimes the PF is required to make a cash deposit in a bank or other institution to securitize the guarantee, but sometimes it is not. In what situations does ER actually apply and from whom does the PF receive ER reports in these types of transactions?

Any tax advice contained in this memo is not intended to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under federal tax law. A taxpayer may rely on our advice to avoid penalties only if the advice is reflected in a more formal tax opinion that conforms to IRS standards. Please contact us if you would like to discuss the preparation of a legal opinion that conforms to these rules.