

**PRIVATE FOUNDATIONS:  
What You Need To Know**

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## 1. INTRODUCTION

The most common manner in which individuals make charitable contributions is by making gifts or bequests outright to institutions and causes important to the donor. An alternative is to establish a charitable vehicle to receive the donor's assets in one or more lump-sum payments, and then make grants/distributions to operating charities over time. As all of the interests in such an entity are dedicated to charity, they are eligible to receive tax exemption from the Internal Revenue Service and the California Franchise Tax Board.

## 2. WHY CLIENTS WANT A PRIVATE FOUNDATION

### **Need for Control**

Donor wants control over his/her philanthropic vehicle, which she/he cannot get with a Donor-Advised Fund or Supporting Organization.

Donor wants a personal flexible charitable vehicle for whatever charitable undertaking might become interesting to her/him.

Donor likes to have an operation she/he can command, with people in her/his employ.

### **Prestige and Name Perpetuation**

The Smith Family Foundation has certain ring to it....

### **Involving the Next Generation**

Gives the children responsibilities and roles they may not be able to experience otherwise.

Helps with family cohesion if different generations get together to manage the foundation and discuss possible grants (or so the argument goes).

Gives the children "social capital" in addition to their "private capital".

Caution: be careful with the idea of "involving the kids" – are the parents really willing to let the children have input and, at some point, control? If not, why do we think the children will ever be interested?

Can the private foundation hire the children? See below.

## **A Buffer**

Some wealthy clients are approached frequently for charitable giving; a private foundation can act as a buffer between the donor and those seeking philanthropic funding.

Caution: On IRS Form 990-PF, private foundations have to disclose major donors to the public.

## **Liquidity Event**

The sale of an asset is imminent, but the donor has not decided what to give to yet.

## **Tax Deduction**

### **3. CREATING THE PRIVATE FOUNDATION**

#### **Forming an Entity**

The first step in establishing a charity is to form the charity as a separate legal entity. State law governs. In California, a charity can be established as a nonprofit corporation, either a nonprofit public benefit corporation or, for charities with religious purposes, a nonprofit religious corporation (see the Nonprofit Corporation Law in California Corporations Code Sections 5000 *et seq.*). Alternatively, the charity can be formed as a charitable trust or as an association (association status is the least common and will not be further discussed).

Establishing a corporation involves filing Articles of Incorporation with the Secretary of State, drafting and adopting Bylaws, appointing a first Board of Directors, and appointing officers. Establishing a charitable trust involves drafting a trust instrument, selecting one or more trustees, and funding the trust. In both cases, the California Attorney General is notified of the new charity.

#### **Considerations in Choosing Corporate or Trust Form**

Charitable trusts are typically established to be irrevocable except as specifically provided in the trust document. As a result, it is easier to impose perpetual restrictions on terms such as the purposes of the trust and the designation of trustees, if desired. On the other hand, where flexibility is desired in modifying the governance structure and activities over time, a corporation is often preferable.

Charitable trust law has generally been created by courts, with legislation eventually following, while nonprofit corporate law in California is generally codified in the Corporations Code. As a consequence, charitable trusts lack the internally cohesive and extensive statutory framework that governs nonprofit corporations in California.

Formation and dissolution of a trust involves less governmental involvement (no need to file articles of incorporation with the Secretary of State, no need to secure a waiver of objections from the Attorney General to dissolve).

Governance – Corporate law focuses upon consensus decision making via majority vote, notice of meetings, annual meetings, etc. Trust law contains little-to-no procedure regarding trustee decision making. This lack of guidance may also be viewed as a lack of bureaucracy.

Corporate law provides stronger liability protection to directors.

More importantly, charitable trusts avoid the burden of the statutory rule, discussed below, that limits the number of directors who may be (i) compensated by the charity or (ii) related to persons compensated by the charity. Under Section 5227 of the Corporations Code, not more than 49% of a nonprofit public benefit corporation's governing body may be composed of "interested directors", defined as:

- Any person who has been compensated by the corporation for services within the last 12 months, and
- Any member of such a person's family (including brother, sister, ancestor, descendant, spouse, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law, or father-in-law).

The effect of this provision is to limit the number of directors who are compensated by the charity, or related to a person who is compensated by the charity. The consequences of this statute can be broader than one might expect. For example, assume a charity has two directors, Father and Mother. The charity then hires Daughter to serve as the grants administrator. Both Father and Mother are interested directors, because they are related to Daughter, and the charity has inadvertently violated Section 5227. In this case, the Board would need to add at least three outside disinterested directors. Alternatively, a charity that intends to employ a family member could consider incorporating in another state (such as Nevada or Delaware) or organizing as a trust rather than as a corporation. However, if the charity does not wish to compensate members of the family that controls the charity, this issue does not arise; the entire governing body may legally consist of family members.

#### **4. TAX STATUS OF THE PRIVATE FOUNDATION**

##### **Application for Tax Exemption**

Once the charity has been established as a nonprofit corporation or charitable trust, the next step is to apply for a determination that the entity is tax-exempt. For Federal law purposes, charities need to apply for tax exemption under Section 501(c)(3) of the Internal Revenue Code ("IRC"). The charity must apply with the Internal Revenue Service on IRS Form 1023 (revised and much more complicated/detailed). The

equivalent exemption in California is described in Section 23701d of the California Revenue and Taxation Code. If the foundation is formed or operates in California, it must also file with the Franchise Tax Board on a Form 3500A (revised and very easy).

### **Exemption under Section 501(c)(3)**

Tax-exempt status under IRC Section 501(c)(3) permits a charitable organization to pay no tax on any surplus funds it may have at the end of a year. Moreover, it permits donors to claim a charitable deduction for their contributions (see IRC Section 170).

### **Private Foundations and Public Charities**

The world of Section 501(c)(3) organizations is divided into two classes: private foundations and public charities. A special regulatory scheme applies to private foundations in addition to the basic rules governing all charities, and the income tax charitable contribution deduction available to donors is less attractive.

### **Avoiding Private Foundation Status**

A Section 501(c)(3) organization can avoid private foundation status, and thus be classified as a public charity, in any one of three ways: (1) by being an institution that is traditionally viewed as publicly supported, such as a church, school, or hospital; (2) by meeting one of two mathematical public support tests; or (3) by qualifying as a supporting organization to another charity that falls in one of the first two categories.

## **5. DONOR-SIDE ISSUES**

The regulatory scheme imposed on private foundations limits the amount of tax deduction available to donor for *intervivos* gifts (see IRC Sections 170(b), (e)(1), and (e)(5)). *Intervivos* contributions to private foundations of property other than cash and qualified appreciated stock (stock that is traded on an established securities market and for which market quotes are readily available) are deductible only to the extent of the lesser of the donor's tax basis or fair market value. In addition, the amount of the deduction that the donor can use in a given year is more limited: cash contributions are limited to 30% of the donor's adjusted gross income ("AGI") (vs. 50% for cash donations to public charities). For donations of appreciated property, the deduction is generally limited to 20% of the donor's AGI (vs. 30% for contributions to public charities).

## **6. FOUNDATION-SIDE ISSUES**

Additional restrictions are imposed on private foundations (as opposed to public charities). These restrictions are enforced via the imposition of excise taxes on the foundation, its management, and/or its disqualified persons.

### **Excise Tax on Net Investment Income (IRC Section 4940)**

Foundations must pay an annual excise tax equal to 2% of net investment income. Net investment income is gross investment income (dividends, interest, royalties, rents, capital gains, etc.) minus ordinary and necessary expenses for the collection and management of the foundation's investment assets.

### **Self-Dealing (IRC Section 4941)**

Under federal tax law, most financial transactions between a private foundation and its insiders are outright prohibited. Self-dealing transactions are prohibited by IRC Section 4941, which makes it impossible for private foundation and their "disqualified persons" (including substantial contributors, managers and any related parties) (see IRC Section 4946) to enter into any sales, leases or other uses of property between them, unless the disqualified person is providing a benefit free of charge to the charity. Note there is *no* "fair market value" exception for most acts of self-dealing. Furthermore, a private foundation may not pay compensation to a disqualified person, nor pay nor reimburse the expenses of a disqualified person, unless two conditions are both met. First, the compensation must be for personal services that are reasonable and necessary to carrying out the foundation's exempt purposes. Second, the amount of compensation, payment, or reimbursement must be reasonable and not excessive under the circumstances. Care should be taken in applying the reimbursement exception only to reimbursements in connection with personal services. For example, the personal services exception would not apply to a reimbursement of rent paid by a disqualified person on behalf of a private foundation.

Penalties for self-dealing are severe, starting with a first-tier tax, followed by the requirement to correct the self-dealing. Unless correction is completed properly and timely, a severe second-tier tax is imposed. These penalties fall on the self-dealer, and in some circumstances on foundation managers (including directors).

### **Minimum Distributions (IRC Section 4942)**

Private foundations must make distributions for charitable purposes each year in prescribed minimum amounts, generally equal to 5% of its investment assets. Grants and charitable distributions qualify, as do reasonable and necessary administrative expenses, payments for assets used in exempt purposes, and professional fees for advice on program activity.

### **Excess Business Holdings (IRC Section 4943)**

This provision generally limits the total holdings of a private foundation and all of its disqualified persons in a business enterprise to 20%.

### **Jeopardizing Investments (IRC Section 4944)**

A private foundation is prohibited from making investments that jeopardize the foundation's ability to carry out its charitable purposes. There is an exception for investments made to further charitable rather than economic purposes (see attachment for further description of program-related investments); the rest of a private foundation's investment portfolio should meet a prudent investor standard.

### **Taxable Expenditures (IRC Section 4945)**

This provision prohibits or limits various types of direct activities and grants by a private foundation.

Private foundations are prohibited from engaging in or funding legislative lobbying, and may only fund voter registration drives under limited circumstances.

Grants to any entity that is not a U.S. public charity (or its foreign equivalent) may only be made if the private foundation exercises heightening inquiry, control, and review knows an "expenditure responsibility". See attachment for an article discussing private foundations and foreign grantmaking.

Common types of grants to individuals (scholarships, awards, and prizes) require that the private foundation obtain advance approval from the IRS for its grantmaking procedures and administration. See attachment for a copy of Schedule H to Form 1023, which must be completed to obtain such approval.

## **7. OPERATIONAL ISSUES**

### **Federal Filing Requirements**

Annual IRS Return. Private foundations must file Form 990-PF, Return of Private Foundation, with the IRS. This form asks for information about the foundation's gross receipts and expenditures. Form 990-PF must be filed within 4½ months after the close of the foundation's fiscal year.

Unrelated Business Income Tax Return. If a private foundation regularly carries on a trade or business whose conduct is not substantially related to the foundation's exempt purpose, and if the annual gross income from it equals or exceeds \$1,000, the income from that business must be reported yearly on IRS Form 990-T, Exempt Organization Business Income Tax Return, due 4½ months after the end of the foundation's fiscal year.

### **California Filing Requirements**

Annual FTB Returns. California law requires each exempt organization to file an annual information return, California Form 199, with the Franchise Tax Board (FTB) in Sacramento due 4½ months after the end of the organization's fiscal year.

Unrelated Business Income Tax Return. If a private foundation regularly carries on a trade or business that is not substantially related to its exempt purpose, and if the annual gross income equals or exceeds \$1,000, the income from that business must be reported yearly to the FTB on California Form 109, California Exempt Organization Business Income Tax Return, due 4½ months after the end of the foundation’s fiscal year with Form 199.

Registry of Charitable Trusts Filing. Form RRF-1 is designed to assist the Attorney General’s Registry of Charitable Trusts in supervising charitable organizations in order to ensure that funds and assets held for charitable purposes are actually so used. This short form is due annually within 4½ months after the close of the foundation’s fiscal year and covers the foundation’s prior fiscal year.

Secretary of State Filing. A private foundation must file the Statement of Information (Domestic Nonprofit Corporation), California Secretary of State Form SI-100, every other year after incorporation, by the last day of the month of incorporation.

### **Non-Profit Integrity Act**

For charitable organizations formed in California or “doing business” in California with annual gross revenues of \$2 million or more, California law requires an independent financial audit, appointment of an audit committee (with rules governing who may and may not serve on it) if in corporate form, and public disclosure of the audited financial statements.

## **8. TERMINATION**

Many private foundations are intended to continue in perpetuity. Nonetheless, if investments crash, or if family members cannot agree or lose interest, or if the donor or his/her descendants decide for philosophical reasons to spend down the corpus, the private foundation doesn’t disappear just because the funds have all been distributed: its tax and legal entity status must be properly terminated, which requires some planning and will consume time, effort, and money (without the excitement of launching a new philanthropic endeavor). See attachment for more information on dissolving an incorporated private foundation in California.

## **9. ALTERNATIVES**

### **Donor-Advised Fund**

An alternative is to establish a donor-advised fund (“DAF”). New requirements and limitations were imposed on DAFs under the Pension Protection Act (see IRC Sections 4966, 4967, and 4958(c)(2)). DAFs are defined as a fund or account identified by reference to a donor, with respect to which the donor (or a designee) reasonably expects



to have advisory privileges. Excluded are funds that distribute only to one identified charity, or “scholarship” funds with an independent selection committee.

A DAF is not a separate charity. Instead, a donor makes a contribution to a pre-existing public charity, which holds the contributions in a separate account. The assets in the account belong to the charity and are reported on the charity’s financial statements and returns. The charity, per an agreement with the donor, permits the donor or another designated advisor to provide non-binding advice to the charity regarding what grants to make from the DAF. If implemented correctly, the contribution to the DAF is treated as a contribution to the charity.

Contributions to the DAF are treated as contributions to a public charity, thus being subject to the more favorable deduction rules for public charities. A DAF is also less expensive to establish than a separate entity, and can typically be started with a much smaller amount of assets than would make sense for a private foundation. Another advantage is that the charity holding the fund takes care of all administration and paperwork. Many sponsors have deep knowledge of the potential grantees in their communities, and offer substantial expertise and support to donors advising grants from the DAF. (This is less true of gift funds affiliated with financial institutions.) A DAF can provide greater anonymity to a donor than a private foundation.

The real disadvantage is that the donor must give up legal control over the fund, and can only act in an advisory capacity.

In addition, DAFs may generally not make distributions to natural persons, or to entities other than public charities without following the “expenditure responsibility” rules. Grants in which the donor receives a more than “incidental” benefit are prohibited, as are grants, loans, or compensation to donors-advisors.

## Supporting Organizations

A supporting organization (“SO”) is a public charity, not because it meets a public support test, but because it supports and is controlled by one or more other public charities (the “Supported Charities”). To qualify for classification as an SO under IRC Section 509(a)(3), the SO must meet *all four* of the following tests:

- *Relationship test.* This test is most easily met if the Supported Charities control the SO, by appointing at least a majority of the Board of Directors of the SO.
- *Organizational test.* This test is met if the SO’s Articles of Incorporation have certain required language, including language limiting the purposes of the SO to operate “exclusively for the benefit of, to perform the functions of, or to carry out the purposes of” the Supported Charities.
- *Operational test.* The SO may make payments to the Supported Charities, or otherwise use its funds in a manner that supports them. It

may make grants, conduct independent programs, and raise funds. However, the permissible beneficiaries of its grants or programs are limited to:

- a. The Supported Charities named in the Articles of Incorporation;
  - b. Individual members of the charitable class served by Supported Charities, either through direct payments or benefits to the individuals, or earmarked for such individuals and given through an unrelated organization;
  - c. Other SOs that support the Supported Charities; or
  - d. Public colleges and universities.
- *Lack of outside control test.* The control test is a negative test, requiring that the SO not be “controlled” by “disqualified persons”. Generally, a person becomes a “disqualified person” by being a substantial contributor to the SO. It also includes a person who owns an entity that is a substantial contributor, and family members of a substantial contributor.

As with DAFs, the Pension Protection Act has added limitations and restrictions on SOs.

## PROGRAM-RELATED INVESTMENTS

Program-Related Investments (PRI) are a collection of financial instruments that can be used by a private foundation to support a charitable project or activity. Usually structured as loans, PRIs can also be equity investments, linked deposits or loan guarantees.

The term “program-related investment” was created by Congress in the Tax Act of 1969, which also created many of the other rules concerning private and corporate foundations. As currently defined in IRC Section 4944(c), a “program-related investment” is any investment by a foundation that meets the following three tests:

1. Its primary purpose is to further the exempt objectives of the foundation.
2. No significant purpose is the production of income or the appreciation of property (i.e., a prudent investor seeking a market return would not enter into the investment.)
3. No purpose of the investment is to attempt to influence legislation or to participate or intervene in campaigns of candidates for public office.

PRI funding comes out of a foundation’s grant budget and counts as a qualifying charitable distribution towards the foundation’s annual payout requirement in the year it is made (IRC Section 4942). PRI interest or dividend income counts as ordinary investment income. In contrast, PRI principal repayments count as *negative distribution* in any year that the foundation receives a repayment, effectively requiring the foundation to increase current distribution for the period by the re-payment amount. Well-configured PRI portfolios can minimize the negative distribution impact by continuously recycling the funds for charitable purposes.

Legally, PRIs are defined as a safe harbor protecting the foundation from jeopardizing investment rules, provided that the PRI is classified as charitable. In addition, as with any grant, a PRI may not be used to generate significant private inurement for any individual or corporation. Most PRI-makers obtain a written legal opinion that the PRI is charitable to protect the foundation and its officers.

## **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.<sup>1</sup> 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.<sup>2</sup> 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](http://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.)<sup>3</sup> 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**

<b>Situation</b>	<b>Required Action</b>
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**

<b>Circumstances that favor Equivalency</b>	<b>Circumstances that favor Expenditure Responsibility</b>
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

<sup>1</sup>For 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>.

<sup>2</sup>To 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).

<sup>3</sup>Schools 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.

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## About International Dateline

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**Schedule H. Organizations Providing Scholarships, Fellowships, Educational Loans, or Other Educational Grants to Individuals and Private Foundations Requesting Advance Approval of Individual Grant Procedures**

**Section I** *Names of individual recipients are not required to be listed in Schedule H.*

**Public charities and private foundations complete lines 1a through 7 of this section. See the instructions to Part X if you are not sure whether you are a public charity or a private foundation.**

- 1a** Describe the types of educational grants you provide to individuals, such as scholarships, fellowships, loans, etc.
- b** Describe the purpose and amount of your scholarships, fellowships, and other educational grants and loans that you award.
- c** If you award educational loans, explain the terms of the loans (interest rate, length, forgiveness, etc.).
- d** Specify how your program is publicized.
- e** Provide copies of any solicitation or announcement materials.
- f** Provide a sample copy of the application used.
- 
- 2** Do you maintain case histories showing recipients of your scholarships, fellowships, educational loans, or other educational grants, including names, addresses, purposes of awards, amount of each grant, manner of selection, and relationship (if any) to officers, trustees, or donors of funds to you? If "No," refer to the instructions.  **Yes**  **No**
- 
- 3** Describe the specific criteria you use to determine who is eligible for your program. (For example, eligibility selection criteria could consist of graduating high school students from a particular high school who will attend college, writers of scholarly works about American history, etc.)
- 
- 4a** Describe the specific criteria you use to select recipients. (For example, specific selection criteria could consist of prior academic performance, financial need, etc.)
- b** Describe how you determine the number of grants that will be made annually.
- c** Describe how you determine the amount of each of your grants.
- d** Describe any requirement or condition that you impose on recipients to obtain, maintain, or qualify for renewal of a grant. (For example, specific requirements or conditions could consist of attendance at a four-year college, maintaining a certain grade point average, teaching in public school after graduation from college, etc.)
- 
- 5** Describe your procedures for supervising the scholarships, fellowships, educational loans, or other educational grants. Describe whether you obtain reports and grade transcripts from recipients, or you pay grants directly to a school under an arrangement whereby the school will apply the grant funds only for enrolled students who are in good standing. Also, describe your procedures for taking action if the terms of the award are violated.
- 
- 6** Who is on the selection committee for the awards made under your program, including names of current committee members, criteria for committee membership, and the method of replacing committee members?
- 
- 7** Are relatives of members of the selection committee, or of your officers, directors, or **substantial contributors** eligible for awards made under your program? If "Yes," what measures are taken to ensure unbiased selections?  **Yes**  **No**
- Note.** If you are a private foundation, you are not permitted to provide educational grants to **disqualified persons**. Disqualified persons include your substantial contributors and foundation managers and certain family members of disqualified persons.

**Section II** **Private foundations complete lines 1a through 4f of this section. Public charities do not complete this section.**

- 1a** If we determine that you are a private foundation, do you want this application to be considered as a request for advance approval of grant making procedures?  **Yes**  **No**  **N/A**
- b** For which section(s) do you wish to be considered?
- 4945(g)(1)—Scholarship or fellowship grant to an individual for study at an educational institution
  - 4945(g)(3)—Other grants, including loans, to an individual for travel, study, or other similar purposes, to enhance a particular skill of the grantee or to produce a specific product
- 
- 2** Do you represent that you will (1) arrange to receive and review grantee reports annually and upon completion of the purpose for which the grant was awarded, (2) investigate diversions of funds from their intended purposes, and (3) take all reasonable and appropriate steps to recover diverted funds, ensure other grant funds held by a grantee are used for their intended purposes, and withhold further payments to grantees until you obtain grantees' assurances that future diversions will not occur and that grantees will take extraordinary precautions to prevent future diversions from occurring?  **Yes**  **No**
- 
- 3** Do you represent that you will maintain all records relating to individual grants, including information obtained to evaluate grantees, identify whether a grantee is a disqualified person, establish the amount and purpose of each grant, and establish that you undertook the supervision and investigation of grants described in line 2?  **Yes**  **No**

**Schedule H. Organizations Providing Scholarships, Fellowships, Educational Loans, or Other Educational Grants to Individuals and Private Foundations Requesting Advance Approval of Individual Grant Procedures**  
(Continued)

**Section II Private foundations complete lines 1a through 4f of this section. Public charities do not complete this section. (Continued)**

- 4a Do you or will you award scholarships, fellowships, and educational loans to attend an educational institution based on the status of an individual being an *employee of a particular employer*? If "Yes," complete lines 4b through 4f.  Yes  No
  
- b Will you comply with the seven conditions and either the percentage tests or facts and circumstances test for scholarships, fellowships, and educational loans to attend an educational institution as set forth in Revenue Procedures 76-47, 1976-2 C.B. 670, and 80-39, 1980-2 C.B. 772, which apply to inducement, selection committee, eligibility requirements, objective basis of selection, employment, course of study, and other objectives? (See lines 4c, 4d, and 4e, regarding the percentage tests.)  Yes  No
  
- c Do you or will you provide scholarships, fellowships, or educational loans to attend an educational institution to employees of a particular employer?  Yes  No  N/A  
 If "Yes," will you award grants to 10% or fewer of the eligible applicants who were actually considered by the selection committee in selecting recipients of grants in that year as provided by Revenue Procedures 76-47 and 80-39?  Yes  No
  
- d Do you provide scholarships, fellowships, or educational loans to attend an educational institution to children of employees of a particular employer?  Yes  No  N/A  
 If "Yes," will you award grants to 25% or fewer of the eligible applicants who were actually considered by the selection committee in selecting recipients of grants in that year as provided by Revenue Procedures 76-47 and 80-39? If "No," go to line 4e.  Yes  No
  
- e If you provide scholarships, fellowships, or educational loans to attend an educational institution to children of employees of a particular employer, will you award grants to 10% or fewer of the number of employees' children who can be shown to be eligible for grants (whether or not they submitted an application) in that year, as provided by Revenue Procedures 76-47 and 80-39?  Yes  No  N/A

If "Yes," describe how you will determine who can be shown to be eligible for grants without submitting an application, such as by obtaining written statements or other information about the expectations of employees' children to attend an educational institution. If "No," go to line 4f.

**Note.** Statistical or sampling techniques are not acceptable. See Revenue Procedure 85-51, 1985-2 C.B. 717, for additional information.

- f If you provide scholarships, fellowships, or educational loans to attend an educational institution to *children of employees of a particular employer* without regard to either the 25% limitation described in line 4d, or the 10% limitation described in line 4e, will you award grants based on facts and circumstances that demonstrate that the grants will not be considered compensation for past, present, or future services or otherwise provide a significant benefit to the particular employer? If "Yes," describe the facts and circumstances that you believe will demonstrate that the grants are neither compensatory nor a significant benefit to the particular employer. In your explanation, describe why you cannot satisfy either the 25% test described in line 4d or the 10% test described in line 4e.  Yes  No

## SEVEN STEPS TO TERMINATING PRIVATE FOUNDATIONS

Our firm has assisted a number of clients in terminating their private foundation, and their motivations vary. For some the administration may have become too burdensome, or the asset value may not be sufficient to support the cost of operations. For others, there may be no obvious successor to take over, or the donor's children may not agree on how to conduct their grantmaking.

Many of our clients terminate their foundation by granting its assets to a donor advised fund, like those available at a community foundation. By being involved with the community foundation, they stay involved in grantmaking while benefiting from a lower cost structure, grantmaking expertise, and educational opportunities.

To assist your clients in terminating a California private foundation in corporate form, follow these steps:

1. The board passes a resolution approving: (i) the dissolution of the corporation, (ii) the transfer of all remaining assets to one or more public charities, and (iii) the preparation of a Certificate of Dissolution (or, if the vote is not unanimous, the preparation of a Certificate of Election to Dissolve and a Certificate of Dissolution).
2. Each board member signs (but does not date) the Certificate of Dissolution.
3. The foundation requests a written waiver of objections to the plan of dissolution from the California Attorney General's office. The waiver request must contain certain specific information about the recipient charity(ies) and the planned distributions, and a copy of the signed, but undated, Certificate of Dissolution.
4. After the waiver is received, the foundation notifies its creditors of the proposed dissolution, winds up its affairs, settles any outstanding debts, and transfers all remaining assets to the designated recipient charity(ies).
5. After all debts are paid and the funds are distributed, the Certificate of Dissolution is dated and filed, along with the Attorney General's waiver of objections, with the California Secretary of State.
6. The foundation prepares and files the final information returns with the IRS and FTB, and files a final RRF-1 form with the Attorney General's office.
7. The foundation must comply with IRC Section 507 to terminate its private foundation status. Typically, filing a final Form 990-PF showing zero net assets will suffice, but each foundation should confirm the requirements that will apply to its situation, in advance.