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Proactive Grantmaking Can Reach Beyond the Public Charity Grantee:

BETSY BUCHALTER ADLER
Adler & Colvin

BETSY BUCHALTER ADLER is a partner in the San Francisco firm of Adler & Colvin.

All charities are regulated. Private foundations, however, are subject to an additional array of Regulations and restrictions. Many private foundations limit their activities to making grants to established public charities because they fear they might run afoul of these rules. Moreover, donors to private foundations receive less generous tax benefits than those available to donors to public charities.

Despite these drawbacks, however, donors continue to create and fund private foundations. In fact, private foundations are the vehicle of choice for many imaginative philanthropists who prize autonomy, independence, and the ability to act as entrepreneurs in the charitable sector.

Section 4945 treats as taxable expenditures—subject to a penalty—grants to any grantees other than public charities unless certain specific rules are followed. Many private foundations are deterred from supporting other grantees because those rules appear, at first sight, technical and forbidding. The rules are not an unknowable mystery, however, and need not deter foundations from exploring a variety of options for making grants.

GRANTS AND AWARDS TO INDIVIDUALS

Section 4945 characterizes grants to individuals for travel, study, or similar purposes as taxable expenditures. Fortunately, the law does not stop there. Section 4945 and the accompanying Regulations allow private foundations to make grants to individuals for these purposes if the following conditions are met:

- The procedures for selecting the grantees are objective and non-discriminatory, and the Service has formally determined in advance that the foundation's selection procedures meet that standard, as described in Reg. 53.4945-4(a)(3).
- The Service has formally determined in advance that the grant is either (1) a scholarship or fellowship for study at an educational institution described in Section 170(b)(1)(A)(ii); (2) a grant enabling the recipient to achieve a specific objective,

produce a specified product (such as a report), or improve or enhance a particular skill, capacity, or talent; or (3) a prize or award that is excluded from the recipient's gross income under Section 74(b), as long as the recipient is selected from the general public.[1]

An existing private foundation that wishes to begin a program of individual grants must first obtain a determination from the Service that the program does not involve any taxable expenditures. In Thorne, 99 TC 67 (1992), the Tax Court ruled that a private foundation's grants to individuals, in the absence of prior IRS approval of the selection procedures, were taxable expenditures that resulted in penalties to the foundation. This problem can easily be avoided with advance planning. When forming a private foundation, for example, it is wise to ask the Service to approve grant selection procedures for individual grantees as part of the tax exemption application if the donor has any interest in using the foundation to make such grants. This will save the foundation the cost and delay of subsequently obtaining a ruling or the risk of proceeding without one.

A private foundation does not need advance approval from the Service for other payments to individuals, however, such as distributions to relieve financial need.[2] The term "grant" does not include compensation that the foundation pays for personal services, whether the recipient of the compensation is an individual or an entity.[3]

It is not difficult to design a selection procedure that will satisfy the requirements of Section 4945 and still allow the foundation enough flexibility in its operations. Here are the basic requirements:

- Consistency with exempt purposes. The purposes and operations of the individual grant program must be consistent with the foundation's exempt purposes and tax-exempt status, and with the ability of individuals to deduct contributions to the foundation.

- Potential grantees. The group of potential grantees must be defined by criteria that are reasonably related to the purposes of the grant. The group must be sufficiently broad to constitute a charitable class unless selection of the grantees is based on exceptional qualifications, such as expertise in the area on which the grant program is focused. For example, Reg. 53.4945-4(b)(2) favorably refers to the example of a foundation that selected a scientist to work on a particular research project from a candidate pool of only three scientists with expertise in the field of activity at issue.

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[1] A prize or award must be made in recognition of past achievements, with no expectation of future services or activities; and the foundation may not impose conditions on how the recipient spends the money.

[2] See, e.g., Ltr. Rul. 9252031 (private foundation that bought and distributed holiday gifts to needy children was not engaged in grantmaking, and distributions were not taxable expenditures).

[3] Reg. 53.4945-4(a)(2). A payment to a consultant for program-related services, for example, is not a grant. Rev. Rul. 74-125, 1974-1 CB 327.

- Selection criteria. The selection of grantees must be based on criteria that are related to the purposes of the grant, and must be undertaken in an objective and nondiscriminatory manner. The selection process must be reasonably likely to result in the grantee's accomplishment of the grant purposes.
- No conflicts of interest. Those who select grantees must not derive, or be in a position to derive, direct or indirect private benefit from the selection of grantees.
- Monitoring, supervision, and records. The foundation must plan on monitoring grantee performance by obtaining reports from the grantees, investigating any indication of misuse, and taking reasonable steps to recover any misused grant funds or to restore them to proper use.

These requirements are stated in broad general terms. They leave much room for foundations to develop the criteria, the selection process, and the implementation of the program in ways that suit their distinctive priorities.

EXPENDITURE RESPONSIBILITY

When a private foundation makes a grant to an organization other than a public charity, the grant is considered a taxable expenditure unless the private foundation exercises expenditure responsibility. "Expenditure responsibility" refers to the specific oversight and monitoring procedures required by Section 4945 and described in detail in Reg. 53.4945-5(b). Expenditure responsibility consists of four elements:

1. A pre-grant inquiry.

2. A written grant agreement containing certain specific terms and conditions.

3. A written report from the grantee.

4. Providing information to the Service on Form 990-PF.

Many private foundations, especially those without professional staff, hesitate to make expenditure responsibility grants because of the additional paperwork involved, especially as the IRS enforces the expenditure responsibility rules strictly. For example, in Hans S. Mannheimer Charitable Trust, 93 TC 35 (1989), the Tax Court found that a taxable expenditure existed even though the oversight had, in fact, occurred. The problem was that the oversight had not been documented as required by law, so it effectively did not count.

In practice, with the exception of the Form 990-PF reporting (which is not difficult), many foundations already monitor grants for specific projects in the manner required for expenditure responsibility grants. Counsel or accountants who are familiar with these rules can work with foundations to design forms and procedures that will enable those who administer the foundation to satisfy the rules without burdensome paperwork.

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com

The pre-grant inquiry. It is not surprising that, before making a grant to an organization that is not a public charity, a private foundation is required by law to assure itself that the grantee will use the grant properly. This "limited inquiry," as the Regulations term it, will vary from grantee to grantee, depending on the circumstances. For example, if the grantee has used prior grants from the foundation properly and has provided the reports as discussed below, no further pre-grant inquiry is necessary for subsequent grants to the same grantee. Generally, however, the pre-grant inquiry should include the identity, history, and experience of the potential grantee and its managers, along with any other information pertinent to the grantee under the circumstances. Useful examples of acceptable pre-grant inquiries appear in Reg. 53.4945-5(b)(2)(ii). In all cases, the private foundation must keep a written record of its pre-grant inquiry.

The written grant agreement. Normally, a private foundation would use a written grant agreement if the grant is for a specific project or subject to conditions as to its use. That agreement can be adapted for expenditure responsibility grants by including the following written commitments (as required by Reg. 53.4945-5(b)(3)) on the part of the grantee:

- To repay any part of the grant that is not used for the grant purposes.
- To submit full and complete annual reports on the manner in which the funds were spent and on the progress made toward accomplishing the purposes of the grant, as described below.[4]
- To maintain records of receipts and expenditures and to make its books and records available to the grantor at reasonable times for inspection.
- Not to use any of the funds to influence legislation within the meaning of Section 4945(d)(1), to influence the outcome of any specific public election, to conduct a voter registration drive within the meaning of Section 4945(d)(2), to make any grant that does not comply with Sections 4945(d)(3) or (4), or to conduct any activity for purposes outside the scope of Section 170(c)(2)(B).

The grant agreement must also, of course, specify the purpose for which the funds are to be used.[5]

Grantee reports. The private foundation must require its grantees to provide written reports on their use of the funds, their compliance with the terms of the grant, and their progress toward achieving the purposes of the grant. The Regulations define the due date of the report as a "reasonable time" after (1) the end of the tax year of the grantee during which it receives the funds or (2) for any subsequent year, the end of the tax year of the

[4] Special rules apply where the expenditure responsibility grant is made for endowment, for the purchase of capital equipment, or for other capital purposes. See Reg. 53.4945-5(c)(2).

[5] If the grant takes the form of a program-related investment, the grant agreement must conform to the requirements of Reg. 53.4945-5(b)(4). See Cerny, "Case Studies Illustrate New and Creative Uses of Program-Related Investments," 9 JTEO 72 (Sep/Oct 1997).

grantee during which it spends the funds. This means that the private foundation needs to know the end of the grantee's tax year, so the foundation can remind the grantee when the reports are due. The foundation is not required to verify the accuracy of the reports independently, unless it has reason to doubt their accuracy.

In practice, the grantee report obligation is the only real challenge. Grantees often need to be reminded—more than once—of their obligation to provide the report. It is important for the foundation to keep records of its efforts to get grantee reports. Foundations should make clear in the text of the grant letter that grantees will not be considered for renewals or other funding unless their reports are complete and timely.

The purpose of the grantee reports, of course, is to enable the foundation to see whether its funds are being properly used. The foundation is obligated to take action if it learns that misuse is occurring. Failure to act will convert an otherwise proper grant into a taxable expenditure. The foundation's follow-up obligations are set out in Reg. 53.4945-5(e).

IRS reporting obligations. During any year in which an expenditure responsibility grant is outstanding, the private foundation grantor must include the following information as part of its IRS Form 990-PF for each such grant:

- The grantee's name and address.
- The date, amount, and purpose of the grant.
- The amounts expended by the grantee, based on the grantee's most recent report.
- Whether the grantee has diverted any portion of the grant from the purposes specified in the agreement.
- The dates of any reports received from the grantee.
- The date and results of any verification of the report, if the foundation has determined that verification is necessary.

GRANTS TO FOREIGN CHARITIES

In recent years, the international nonprofit sector has developed with remarkable vigor. American charities, including private foundations, have contributed significantly to this growth. The easiest and most commonly used way for private foundations to support activities in other countries is through grants to American public charities that conduct or support programs in those countries.[6] It is not, however, the only way.

[6] See Reg. 53.4945-5(a)(6)(i).

Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94105
Telephone: (415) 421-7555
Fax: (415) 421-0712
www.adlercolvin.com

Private foundations may make grants directly to foreign organizations for charitable purposes if they exercise expenditure responsibility over the grant. Expenditure responsibility is not required, however, if the private foundation makes a good faith determination that the foreign grantee is the equivalent of a U.S. public charity.[7] This determination may be made in any one of three ways:

1. The foundation obtains and relies on a reasoned written legal opinion that concludes that the foreign organization is the equivalent of a U.S. public charity.

2. The foreign charity completes an affidavit, as described in Rev. Proc. 92-94, 1992-2 CB 507, that provides sufficient information for the private foundation to conclude that the foreign charity is the equivalent of a U.S. public charity.

3. The foreign charity obtains a determination from the IRS that it is an organization described in Section 501(c)(3) and a public charity under Section 509.[8]

A grant to foreign charity that is not a public charity equivalent must comply with the technical provisions of Reg. 53.4942(a)-3(d) to count toward the private foundation's minimum payout requirement.

PRIVATE FOUNDATIONS AND ADVOCACY

Private foundations are more severely limited than public charities with regard to lobbying. They may not conduct or pay for any type of lobbying activity at all. Section 4945 bars private foundations from "any attempt to influence any legislation ... other than through making available the results of nonpartisan analysis, study, or research" by imposing excise taxes on the foundation and potentially on the foundation's managers. There is even a risk that the foundation could lose its exempt status under Section 501(c)(3).

Many advocacy efforts fall outside the Regulations' definition of lobbying however, and private foundations may conduct these efforts. In addition, private foundations may grant funds to a public charity for a specific project that includes some lobbying activity, so long as the amount of the grant is less than the non-lobbying component of the project.

There are two categories of lobbying under Section 4911—direct lobbying and grass roots lobbying, both of which are defined by Reg. 53.4945-2(a)(1). In addition, Section 4945 lists four activities that, though they may involve advocacy and may touch on

[7] Reg. 53.4945-5(a)(5).

[8] Such a determination does not, of course, allow U.S. taxpayers to claim a charitable deduction for direct gifts to the foreign charity. Under Section 170, a charity that is organized under the laws of another country is not an eligible donee for purposes of the charitable deduction. See also Edie, Beyond Our Borders (Council on Foundations, 1994), which contains an affidavit form that complies with Rev. Proc. 92-94 and a sample opinion of counsel.

legislation, are neither lobbying nor taxable expenditures. These sources provide essential guidance to private foundations that wish to support or conduct advocacy, voter education, or other public policy activities without funding or conducting lobbying and thereby making a taxable expenditure. If the activity is not included within the prohibited areas, the foundation may go forward.

Prohibited. Section 4911 defines direct lobbying as any attempt to influence any legislation through a communication with any member or employee of a legislative body, or with any government official or employee who may participate in formulating the legislation. A communication with a legislator or government official is direct lobbying if, and only if, it contains two elements:

- It refers to specific legislation.
- It reflects a view on that specific legislation.[9]

Direct lobbying includes communications with the public regarding ballot measures, because the voting public itself is the legislative body that will adopt or reject the legislation.

Generally, communications with the public about legislation should be tested under the Section 4911's definition of grass roots lobbying—an attempt to influence any legislation through an attempt to affect public opinion. This definition is so broad as to be nearly meaningless. Fortunately, the IRS issued Regulations to Section 4911 and 4945 in 1990 that provide clear and useful guidance as to the meaning of grass roots lobbying. Under these Regulations, a communication with the public (or a segment of the public) is grass roots lobbying if and only if the communication:

- Refers to specific legislation.
- Reflects a view on that legislation.
- Contains a call to action—that is, encourages the recipient to take action regarding the legislation.[10]

If any one of these elements is not present, the communication is not grass roots lobbying.

Permitted. The Regulations carve out four areas of activity that do not qualify as lobbying.[11] A private foundation is free to fund and conduct the activities within these four categories, without limitation. These areas are:

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[9] Reg. 56.4911-2(b)(1).

[10] Reg. 56.4911-2(b)(2).

[11] See Reg. 53.4945-2(d).

- Nonpartisan analysis, study, or research. An independent and objective exposition of a particular subject is not necessarily lobbying. A particular position or viewpoint may be advocated as long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. The mere presentation of unsupported opinion, however, does not qualify. Distribution of such communications may not be limited to, or directed toward, persons who are interested solely in one side of a particular issue.[12]

- Examinations and discussions of broad social, economic, and similar problems. Public discussions and communications with members of legislative bodies or governmental employees may escape treatment as lobbying communications, so long as the discussion does not address itself to the merits of a specific legislative proposal and there is no direct call to action.

- Requests for technical advice. Providing technical advice to a governmental body or committee in response to a written request by that body is not lobbying, if certain conditions are met. The request must be made in the name of the committee or agency, and not just from an individual member of the body.

- Self-defense lobbying. Appearing before, or communicating with, any legislative body on a possible decision of that body that might affect the existence of the foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to the foundation are not lobbying. This exception does not cover legislation, such as an appropriations bill, that affects merely the scope of the organization's future activities. A private foundation may, however, discuss jointly funded projects with government officials.[13]

Example. The Planet Foundation (PF) funds research and public education on potential solutions to the problems created by overpopulation. PF is aware that legislation is introduced each year to ban the use of federal funds for family planning clinics, both in this country and in foreign countries, whose services include abortion.

What can PF do, without engaging in a taxable expenditure, to promote its exempt purposes through advocacy? The surprising answer is—plenty. PF can, and does, conduct nonpartisan analysis, study, and research, and it distributes the results of its research as widely as its budget will permit, through a variety of media—brochures, press releases, position papers, video segments for rebroadcast on public and commercial television, press conferences, and the like. These publications and communications clearly state PF's position that overpopulation is a problem that must be remedied by means which include contraception and the early termination of pregnancy, even though that position is controversial in significant segments of American society and even though the question of family planning funds is frequently the subject of legislation. Contrary facts and

[12] For a description of how one private foundation educated voters about a California ballot measure through broadly distributed nonpartisan analysis, study, and research, see Colvin, "A Case Study in Using Private Foundation Funds to Educate Voters," 6 JTEO 243 (May/Jun 1995).

[13] Reg. 53.4945-2(a)(3).

arguments are also presented. PF's staff members have testified before Congressional subcommittees, when requested to do so in a letter from the subcommittee chair. PF has conducted briefing sessions for government officials on overpopulation issues, being careful not to discuss the merits of any specific legislative proposal. PF has convened public forums, avoiding any communication that could be construed as a grass roots call to action as defined above. All of these activities are not lobbying, and therefore are not taxable expenditures, because they are excluded from the definition of lobbying by statute.

PF can also promote solutions to the overpopulation problem through grants to public charities that seek to influence the opinions of legislators and voters on legislation that affects that issue. The law permits private foundations to:

- Make grants for nonpartisan analysis, study, and research, and for the dissemination of the results of that research, even if the analysis concludes with support of or opposition to particular legislation.
- Make grants for public policy research and education projects before any specific legislative proposal comes into existence (or, with regard to ballot measures, before the initiative petition is circulated), so long as the legislation is merely a possibility and the project has multiple purposes.
- Make grants to a public charity for general support, which the charity then independently decides to spend on lobbying.
- Make grants to a public charity for a specific project that includes some lobbying, but only if the amount of the grant is less than the non-lobbying components of the project. This is specifically authorized by Reg. 53.4945-2(a)(6).

VOTER REGISTRATION

Many foundations and their advisors are under the impression that private foundations cannot fund voter registration efforts. In fact, under Section 4945(f) and Reg. 53.4945-3(b), this is not the case. The law makes clear that, if the voter registration effort meets four straightforward criteria designed to ensure the nonpartisan nature of the activity, a private foundation can grant funds to a public charity for voter registration. The requirements are:

- Nonpartisan. The grantee's activities must be nonpartisan, not restricted to one specific election period, and actively conducted in at least five states.
- Activity level. The grantee must spend at least 85% of its income directly for the active conduct of its exempt-purpose activities.
- Sources of support. The grantee must receive at least 85% of its support (aside from gross investment income) from other exempt organizations, the general public, or agencies of government. In addition, the grantee must not receive more than 25% of its

support from any one exempt organization and not more than half of its overall support may come from gross investment income.

- No restrictive conditions. The grantee may not accept contributions that are restricted for use only for voter registration efforts in specified states or political subdivisions or in a specific election period.

To avoid inadvertent taxable expenditures, a private foundation that wishes to support voter registration drives should require potential grantees to submit evidence that they comply with these conditions. The best evidence, from the private foundation grantor's standpoint, is a determination by the IRS that the organization satisfies the requirements of Section 4945(f). Organizations that seek private foundation support for voter registration drives are likely to have obtained such a ruling. A private foundation should ask applicants to provide a copy of their Section 4945(f) ruling as part of the grant application. If the ruling is not of recent date, the foundation should ask the grantee to provide evidence that the grantee continues to satisfy the requirements of Section 4945(f), and the foundation should obtain the written advice of counsel before making the grant. Because the requirements are clear, however, it is generally not difficult to assess a potential grantee's compliance.

Other voter education. The five-state requirement and the other restrictions of Section 4945(f), as interpreted by the Regulations, apply only to voter registration activities. Therefore, a private foundation may fund other forms of voter education following the same rules that apply to Section 501(c)(3) organizations generally. These include nonpartisan voter guides, candidate debates, issue advocacy, and other efforts to educate the electorate that are truly devoid of any purpose to improve or diminish the prospect for any candidate or group of candidates to be elected to public office.[14]

CONCLUSION

Private foundations should not be deterred from imaginative and venturesome grantmaking by the technical rules discussed here. Compliance is not difficult, and the rewards can be great.

[14] See Colvin and Finley, The Rules of the Game: An Election Year Legal Guide for Nonprofit Organizations (Alliance for Justice, 1996).

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235 Montgomery Street, Suite 1220
San Francisco, CA 94105
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