PROFESSIONAL Tax & Estate Planning NOTES

The New York Community Trust

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1 Grants by Private Foundations to Individuals and Foreign Organizations

In the aftermath of September 11th, Americans opened their wallets and their checkbooks to help the thousands of individuals and families who had been devastated by the attacks. Businesses made their own contributions and organized employee donations.

The unique circumstances of the disaster focused the attention of the charities involved on the legal issues concerning grants to individuals. This series of *Professional Notes* is prompted, in part, by our role as a founder of The September 11th Fund and our interest in the questions raised. This and other issues will examine and compare the rules governing grantmaking by private foundations and public charities, such as The New York Community Trust, especially as they relate to grants to individuals and foreign organizations. As is often the case, private foundations must meet technical requirements that are not applicable to public charities.

DISTINGUISHING A PRIVATE FOUNDATION FROM A PUBLIC CHARITY

The Internal Revenue Service ("IRS") classifies each organization that is exempt from federal income taxation under Code Section 501(c)(3)[1] as either a private foundation or a public charity. An exempt organization is classified as a private foundation unless it meets one of the requirements for a public charity, generally, either by passing a numerical public support test or by conducting certain types of activities (such as operating a church, school, or hospital). A private foundation typically is a grantmaking organization that receives its support from a single or small number of individuals or corporations.

Because private foundations are considered more susceptible to possible operation for the private benefit of their donors and managers, the Code contains special rules for private foundations that do not apply to public charities. For example, Code Section 4945 sets forth activities which, if engaged in by a private foundation, result in the imposition of an excise tax on both the foundation and any foundation manager who willfully and knowingly participated. These "taxable expenditures" include certain grantmaking activities of private foundations, such as grants to individuals for "travel, study or other similar purposes," unless the foundation has received advance approval from the IRS for its grant procedures. Grants made by a foundation to an organization other than a public charity, including most foreign organizations, also are taxable expenditures unless the foundation exercises "expenditure responsibility" with respect

[1]All Code references are to the Internal Revenue Code of 1986, as amended.

Special thanks to William Gaske of Patterson Belknap Webb & Tyler.

to the grants or determines that the organization is the equivalent of a public charity. The rules governing these types of grantmaking activities by private foundations are explained below.

GRANTS BY PRIVATE FOUNDATIONS TO INDIVIDUALS

Under Code Section 4945, a private foundation may not make a grant to an individual for "travel, study or other similar purposes" unless the grant meets certain requirements and the foundation's grant procedures have been approved *in advance* by the IRS. For example, a private foundation that wants to award scholarships to students for college tuition, grants to scholars to conduct academic research, or prizes to artists or writers to improve or enhance their artistic or literary skills or talent must establish specific procedures for the grant program and obtain the approval of the IRS for such procedures before awarding any such scholarships, grants or prizes. To obtain IRS approval, the grant procedures must be objective and nondiscriminatory and must meet the following requirements:

1. Grantees must be selected from a group large enough to constitute a charitable class.

2. The criteria for selection of grantees must be reasonably related to the purposes of the grant.

3. Persons selecting grant recipients must not be in a position to derive a private benefit, directly or indirectly, from the selection of grantees.

4. Grants must be made according to a procedure that is reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance.

5. The foundation must obtain reports from the grantees to determine whether they have performed the intended activities.

6. A grant to an individual may be renewed if the grantor has no information indicating that the original grant was used for any purposes other than the purpose for which it was made, all reports required at the time of renewal have been submitted, and any additional criteria and procedures for renewal are objective and nondiscriminatory.

Furthermore, the foundation is required to file reports with the IRS on its annual Form 990-PF concerning its grantmaking activities. Thus, appropriate grant procedures require the foundation to establish selection procedures, monitor the recipients, and report to the IRS.

Advance IRS approval is required only for grants to individuals for "travel, study or similar purposes." Advance IRS approval of grant procedures is not required for other types of grants, such as grants to indigent individuals to enable them to buy basic necessities or for prizes that (i) are awarded in recognition of past achievements, (ii) are not intended to finance any future activities of an individual grantee, and (iii) do not impose any conditions upon the manner in which the prize funds may be expended by the grantee. For example, a foundation may award prizes to accomplished writers in recognition of their literary achievements without advance IRS approval so long as the writers may use the prize funds in any way they desire. Grant procedures not subject to advance IRS approval still must be objective and nondiscriminatory, and the grants must not run afoul of other restrictions on private foundations, such as the prohibition against self-dealing, or the general prohibitions against private benefit and inurement applicable to all Code Section 501(c)(3) organizations.

GRANTS TO INDIVIDUALS BY EMPLOYER-CONTROLLED PRIVATE FOUNDATIONS UNDER THE VICTIMS OF TERRORISM TAX RELIEF ACT OF 2001

The recently enacted Victims of Terrorism Tax Relief Act of 2001 (the "Act") establishes a special standard for victims of the September 11 attacks and the anthrax attacks that occurred between September 11 and December 31, 2001. The Act also creates a new Code Section 139 regarding the

tax treatment of payments to victims of other "qualified disasters." The Act will be discussed in more detail in the upcoming June 2002 *Professional Notes*, but this section addresses a specific grantmaking activity relating to the Act — disaster relief grants by employer-controlled private foundations.

The explanation of the Act issued by the Joint Committee on Taxation (the "JCT Explanation") includes a significant departure from recent IRS treatment of employer-controlled private foundations that provide disaster relief assistance to employees. In 1999, the IRS issued two private letter rulings revoking the tax-exemptions under Code Section 501(c)(3) that it had previously granted to two such employer-controlled private foundations.[2] While conceding that a disaster relief program provides assistance to people who otherwise are the proper objects of charity, the IRS held in those rulings that a disaster relief program by an employer-controlled foundation for the employees and retirees of the controlling employer was not operated solely for charitable purposes because it provided a significant benefit to the employer by enhancing its ability to recruit and retain a more stable and productive workforce. The IRS also ruled that the programs resulted in private inurement contrary to the requirements of Code Sections 501(c)(3) and 170(c)(2)(B).

Although not specifically addressed in the Act, the JCT Explanation addresses payments by an employer-controlled foundation to employees of the controlling employer and their family members in connection with a qualified disaster. Recently enacted Code Section 139 defines the term "qualified disaster" to include (i) a disaster that results from a terrorist or military action, (ii) a Presidentially declared disaster, or (iii) a disaster that results from an accident involving a common carrier or from any other event that is determined by the Secretary of the Treasury or his delegate to be of a catastrophic nature. In such a qualified disaster, an employer-controlled foundation will be presumed to act consistently with the requirements of Code Section 501(c)(3) if (i) the class of beneficiaries is sufficiently large or indefinite so that it qualifies as a charitable class and (ii) the recipients are selected based on an objective determination of need by an independent committee, the majority of the members of which must not be individuals in a position to exercise substantial influence over the affairs of the controlling employer, or an adequate substitute procedure. The JCT Explanation also states that it is expected that the IRS will reconsider its ruling on employer-controlled foundations and directs the IRS to issue guidance concerning private foundations providing assistance in connection with qualified disasters consistent with the requirements described above.

GRANTS BY PRIVATE FOUNDATIONS TO FOREIGN ORGANIZATIONS[3]

A grant by a private foundation to an organization other than a public charity will result in a taxable expenditure unless the foundation adheres to special rules. Although foreign organizations can seek determinations from the IRS that they are public charities, most do not. Code Section 4945 provides that a private foundation can make a grant directly to a foreign organization, without making a taxable expenditure, either by (i) making a "project grant" and exercising "expenditure responsibility" over the grant or (ii) making a determination that the foreign organization is the equivalent of a Code Section 501(c)(3) organization and a public charity.

Project Grant and Expenditure Responsibility: If a private foundation wants to make a grant to a foreign organization and has not made or chooses not to make a determination that the foreign organization is the equivalent of a Code Section 501(c)(3) organization and a public charity (see below), the private foundation may make the grant by restricting the grant to a specified project that is charitable under U.S. law and exercising

[2] Although private letter rulings apply only to the organizations that requested them and may not be cited as precedent, they offer insight into the position of the IRS on an issue. *See* Code Section 6110(j)(3).

[3] This section assumes, as is generally the case, that the foreign organizations do not have determinations from the IRS that they are Code Section 501(c)(3) organizations and classified as public charities.

expenditure responsibility. Following is a brief summary of the steps a private foundation must take to exercise expenditure responsibility.

1. Pre-Grant Inquiry. Prior to making a grant to a foreign organization, a private foundation must make a reasonable determination that the organization is capable of fulfilling the charitable purposes of the grant. The pre-grant inquiry should include information about the identity, history, and experience of the foreign organization and its managers, and any other information which the foundation has about the organization and which is readily available concerning its management, activities, and practices.

2. Grant Agreement. The private foundation and the foreign organization must enter into a written grant agreement that clearly states the purposes of the grant. The grant agreement also must commit the foreign organization to maintain the grant funds in a separate fund, to repay any funds not used for the purpose of the grant, to submit reports on how the funds are spent and the progress made in accomplishing the purposes of the grant, to maintain records of receipts and expenditures and make its books and records available to the foundation, and not to use any grant funds to engage in legislative or political activities or any activity for a nonexempt purpose. Expenditure responsibility rules would apply to the regranting of funds by a foreign organization, and grant agreements with foreign organizations often prohibit the regranting of funds to individuals or organizations or permit it only with the prior approval of the foundation.

3. Reporting Requirement. The foreign organization must report to the foundation annually as to its use of the grant funds. The report must describe the manner in which the funds were spent, compliance with the terms of the grant, and the progress made in accomplishing the purposes of the grant.

4. Reporting to the IRS. For each year during which any expenditure responsibility grant amount or report is outstanding, the private foundation must include on its annual tax return (Form 990-PF) certain information about the foreign organization, the grant, and reports received from the foreign organization.

Equivalency Determination: As an alternative to exercising expenditure responsibility, a private foundation may make a good faith determination that a foreign organization is the equivalent of a Code Section 501(c)(3) organization and a public charity. In order for a private foundation to make such an equivalency determination, it must either (i) obtain an opinion of legal counsel that the organization is the equivalent of a Code Section 501(c)(3) organization and a public charity or (ii) obtain an affidavit from the foreign organization and make its own equivalency determination. Obtaining a legal opinion can be very expensive and complicated, and it is more common these days for private foundations to follow Revenue Procedure 92-94, which was promulgated by the IRS in an effort to simplify the process. Under that Revenue Procedure, the foreign organization must provide the foundation with an affidavit of a principal officer of the organization stating certain required information that is indicative of a Code Section 501(c)(3) organization. The foreign organization must attach to the affidavit copies of the charter, by-laws, or other governing documents, which must be translated into English.

Making an equivalency determination can be complex under the best of circumstances, but language and cultural differences can complicate things further. For example, in order to make a determination that an organization is a public charity because it is a school, the foreign organization must state in the affidavit that it has adopted and adheres to a racially nondiscriminatory policy. A school located in a country where the population is not as racially diverse as in the United States may not have a formal policy. Foreign organizations also do not always have English translations of their governing

documents and statutes on hand, and even if available, sometimes the translations are awkward, raising additional questions about the meaning of the translated documents.

Unless the foreign organization is a religious, educational, or medical institution, it usually also must submit the sources and amounts of its financial support for the four most recently completed tax years in order to demonstrate that it is the equivalent of a public charity. To qualify as a public charity, such an organization must be "publicly supported," which generally means at least 33 1/3 percent of the organization's total support must be received from governmental units, other public charities, or the general public. However, several alternative public support tests exist, and the public support calculations can be complicated and outside the expertise of many private foundation managers and staff.

FAILURE TO MEET GRANTMAKING REQUIREMENTS

Code Section 4945 imposes an excise tax on a private foundation that makes a taxable expenditure by making a grant to an individual or foreign organization without properly following the rules described above. The excise tax is imposed on the private foundation at the rate of 10 percent of the amount of the taxable expenditure. In addition, each foundation manager who knowingly, willfully, and without reasonable cause agreed to make the grant is taxed 2½ percent of the value of the taxable expenditure (subject to a limit of $5,000). If the expenditure is not corrected, an additional tax equal to 100 percent of the amount of the grant is imposed on the foundation and a tax of 50 percent of the amount of the grant is imposed on the participating foundation manager (subject to a limit of $10,000). To the extent possible, a taxable expenditure must be corrected by recovering the grant amount from the grantee. In the most egregious situations, such as situations that involve violations of the prohibitions against self-dealing, private benefit, or inurement, a private foundation could lose its tax-exemption under Code Section 501(c)(3).

CONCLUSION

Private foundations may make grants to individuals and foreign organizations, but to do so properly, a private foundation must know and comply with technical requirements and procedures contained in the Code, Treasury Regulations, and various IRS publications. These requirements and procedures can be costly and burdensome, particularly for foundations that do not have professional staff, and may contain landmines for the unwary or uninitiated. As discussed in the next two issues of *Professional Notes*, public charities are not subject to many of the requirements applicable to private foundations and have greater latitude in their procedures for making grants to individuals and foreign organizations.

For further reference, see:

Code Section 4945: Taxable expenditures
Victims of Terrorism Tax Relief Act of 2001, P.L. 107-134
Joint Committee on Taxation, Technical Explanation of the "Victims of Terrorism Tax Relief Act of 2001," as passed by the House and the Senate on December 20, 2001
Treas. Reg. §53.4945-1: Taxes on taxable expenditures
Treas. Reg. §53.4945-4: Grants to individuals
Treas. Reg. §53.4945-5(a)(5): Certain foreign organizations
Treas. Reg. §53.4945-5(b): Expenditure responsibility
Revenue Ruling 77-380, 1977-2 C.B. 419
Revenue Procedure 92-94, 1992-2 C.B. 507
PLR 199917077
PLR 199914040

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About The Trust

For 78 years, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations that are crucial to a community's vitality.

Grants made from these funds—which now number more than 1,600—meet the needs of children, youth and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust is alert to emerging issues and develops strategies to deal with them, works collaboratively with other funds and with government, and gets out information to the public. Recent initiatives have included programs that address youth violence, managed health care, immigration, child abuse, and public school reform.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. Its staff is recognized for its expertise in grantmaking, financial administration, and donor services. Local divisions are located on Long Island and in Westchester.

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