THE SALK INSTITUTE
FOR BIOLOGICAL STUDIES

32nd ANNUAL TAX SEMINAR
ON PRIVATE FOUNDATIONS

GRANTMAKING ISSUES UNDER SECTION 4945

May 12, 2004

Celia Roady, Esq.
Tamar R. Rosenberg, Esq.
Morgan, Lewis & Bockius LLP
1111 Pennsylvania Avenue, NW
Washington, DC 20004
202-739-5279
croady@morganlewis.com

GRANTMAKING ISSUES UNDER SECTION 4945

I. Introduction

A. Congress enacted §4945 as part of the Tax Reform Act of 1969, in reaction to reported abuses by certain private foundations. It is designed to regulate and restrict the grantmaking activities of private foundations.

B. Overview of §4945

1. Section 4945 imposes an excise tax on private foundations and their managers for making payments that fall within the definition of "taxable expenditures" – meaning amounts paid or incurred:

   (a) to carry on propaganda or otherwise attempt to influence legislation;

   (b) to influence the outcome of any specific public election or to carry on, directly or indirectly, a voter registration drive (unless certain requirements are met);

   (c) as a grant to an individual for travel, study or other similar purposes, unless the provisions of §4945(g) are satisfied;

   (d) as a grant to an organization other than a public charity or exempt operating foundation, unless the grantor foundation exercises "expenditure responsibility" over the grant; and

   (e) for any non-charitable purpose.

2. "First-tier" taxes:

   (a) Section 4945(a)(1) imposes an excise tax of 10% on each taxable expenditure made by a private foundation.

   (b) The foundation's managers may also be subject to an excise tax of 2.5% under §4945(a)(2), capped at $5,000, if they approved an expenditure knowing that it was a taxable expenditure and their approval was not due to reasonable cause.

3. "Second-tier" taxes:

   (a) §4945(b)(1) imposes an additional excise tax of 100% on a private foundation that does not make a timely correction of a taxable expenditure.
   (b) §4945(b)(2) imposes an additional excise tax of 50%, capped at $10,000, on foundation managers who refuse to agree to all or part of a correction of a taxable expenditure.

4. The IRS may terminate a private foundation's status for repeatedly or flagrantly violating §4945.

II. Taxable Expenditures Under §4945

A. §4945(d)(1): Lobbying expenditures

1. Taxable expenditures include lobbying expenditures, meaning any amount paid by a private foundation to carry on propaganda or otherwise to attempt to influence legislation.

2. For this purpose, "legislation" is defined to include action by Congress, a state legislature, a local council or similar legislative body and by the public in a referendum, ballot initiative, constitutional amendment or similar procedure. The definition of "legislation" is, therefore, not limited strictly to the passage of a bill.

   (a) The definition of "legislative body" does not include executive, judicial or administrative bodies. Attempts to influence the executive branch or administrative agencies with respect to regulatory – rather than legislative – matters are not considered lobbying. Therefore, private foundations may engage in unlimited advocacy with respect to administrative agency action on purely regulatory matters.

3. §4945(e) defines two types of activities that constitute lobbying:

   (a) Grassroots lobbying: Attempting to influence legislation through an attempt to affect the opinions of the general public or any segment thereof. A communication is a grassroots communication if it:

   (i) refers to specific legislation;

   (ii) reflects a view on such legislation; and

   (iii) includes a "call to action" that encourages the recipient to take action with respect to the legislation – meaning a communication that does any one of the following:

      1. urges the recipient to contact a legislator, staffer or other government official or employee who may participate in the formulation of legislation, for the principal purpose of influencing legislation;
      2. states the address, telephone number or similar information of a legislator or employee of a legislative body;
      3. provides a petition, tear-off postcard or similar material, for the principal purpose of influencing legislation by facilitating such communication; or
      4. specifically identifies legislators' positions on the legislation or identifies the legislators as members of a committee or subcommittee that will consider the legislation (however, this does not include naming the main sponsor(s) for purposes of identifying the legislation).

(b) Direct lobbying: Attempting to influence legislation through communication with members or employees of a legislative body and other government officials or employees who may participate in formulating legislation, including administrative agency officials who have some responsibility for legislative matters.

(i) A communication is a direct lobbying communication if it refers to specific legislation and reflects a view on such legislation.

4. The following activities are not considered to be lobbying: Treas. Reg. §53.4945-2 describes exceptions to the lobbying rules, which are important because they provide a road map as to how private foundations can support or engage in advocacy in the public policy arena without violating the lobbying prohibition.

(a) Nonpartisan Study, Analysis and Research: Lobbying does not include the conduct of nonpartisan analysis, study and research, meaning independent and objective exposition of a particular subject matter.

(i) The analysis may advocate a particular position or viewpoint if it contains a "sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion," and is not a mere presentation of unsupported opinion.

(ii) This exception does not apply if such study, analysis or research is disseminated to those interested in only one side of a particular issue.

(b) Examinations of Broad Social, Economic and Similar Problems: Lobbying does not include examinations of broad social, economic and similar problems, even if the government would ultimately be expected to deal with such problems.

(i) Public discussion and communication with members of legislative bodies or governmental employees on a general topic that is also the subject of legislation before a legislative body will not be considered lobbying communications so long as the discussion does not address the merits of a specific legislative proposal or encourage taking action with respect to such legislation.

(c) Requests for Technical Advice or Assistance: Although Congress has restricted the lobbying activities of private foundations, it has done so in a manner that preserves lawmakers' access to the vast expertise represented by such organizations and their employees. So that such expertise remains available to lawmakers, amounts paid in connection with providing technical assistance to a governmental body, committee or subcommittee in response to a written request by such body, committee or subcommittee are not considered taxable expenditures.

(i) Because "technical advice or assistance" may be given only in response to an express written request, the response need not qualify as nonpartisan analysis, study or research. Therefore, under this exception, a foundation employee or a foundation

grantee may provide oral or written testimony at Congressional hearings on proposed legislation, and may express a view about such legislation's merits (or lack thereof), so long as the view is directly related to the request for technical advice.

(ii) Note that this exception covers only technical advice that is made available on a bipartisan basis, such as at a committee or subcommittee hearing. It does not apply to advice provided at the request of an individual legislator.

(d) Self-Defense Communications: Congress and the IRS have also recognized that private foundations must be free to engage in lobbying with respect to issues which go to the heart of their existence, powers, duties, tax-exempt status and the deductibility of contributions. Therefore, this exception allows private foundations to communicate with legislators and their staff with respect to a possible decision of such legislative body on such issues, and even to initiate legislation on those issues.

(i) The exception is fairly limited, however, and does not cover proposed legislation involving public policy issues that may be of importance to foundations in carrying out their educational programs.

> **Example:** Lobbying against legislation that would reduce federal funding for a particular program of interest to a private foundation would not qualify under the self-defense exception, whereas lobbying against legislation to eliminate the charitable contribution deduction would qualify.

5. Special Rules

(a) Mass Media Exception: By avoiding making a "call to action," private foundations and the charities they fund can communicate an advocacy message intended to arouse public action without crossing the boundary that separates what is considered education from what is considered grassroots lobbying. There is, however, a special rule that applies in the case of mass media advertisements involving highly publicized legislation, even if such advertisements do not constitute grassroots lobbying under the regular test described above. Treas. Reg. §53.4911-2(b)(5)(ii) imposes a rebuttable presumption that mass media advertisements involving highly publicized legislation constitute grassroots lobbying if they:

(i) appear in the mass media two weeks before a vote of a legislative body or a committee thereof (but not a subcommittee) on a piece of highly publicized legislation;

(ii) reflect a view on the general subject of such legislation; and

(iii) either refer to the legislation or encourage the public to communicate with legislators on the general subject of such legislation.

(b) Subsequent Use of Nonpartisan Study, Analysis and Research: In many cases, a communication that initially fell within the grassroots lobbying exception for "nonpartisan analysis, study or research" is subsequently used in another communication that does not fall within the exception, and consequently must be treated as a grassroots lobbying communication. For example, the results of an analysis may indicate so clearly that legislation is – or is not – appropriate that the private foundation funder itself, or others, may seek to adapt the product to a lobbying use. This often happens with the products of research and analysis undertaken by public charities. The issue is whether – and under what circumstances – the subsequent lobbying use of a nonpartisan analysis or other nonlobbying product may, in retrospect, taint the nonlobbying nature of the original product.

(i) The regulations provide that the subsequent grassroots lobbying use of materials that originally were not lobbying communications will cause the expenses of preparing the original materials to be treated as grassroots lobbying only in limited circumstances.

(ii) This rule covers only materials or communications that refer to and reflect a view on specific legislation but that do not, in their initial format, directly encourage recipients to engage in lobbying.

(iii) If such materials are later used to encourage grassroots lobbying, they will not be treated as grassroots lobbying communications if the charity's primary purpose in preparing the materials was not for use in lobbying.

(iv) The IRS will assume that there was a nonlobbying primary purpose if the charity makes a "substantial distribution" of the materials in their nonlobbying form either prior to or contemporaneously with the lobbying distribution. If there is no such substantial nonlobbying distribution, the regulations may treat expenditures made within six months of the lobbying use as lobbying expenditures.

(c) Private Foundation Grants to Charities that Lobby

(i) A private foundation may make a general support grant to a public charity that conducts lobbying activities if the grant is not specifically earmarked for lobbying purposes. A grant is considered "earmarked" if it is made pursuant to an agreement, either written or oral, that the grant will be used for specific purposes.

(ii) A private foundation may make a grant to fund a specific project by a public charity that lobbies if the grant is not earmarked for lobbying purposes and the total amount given to the grantee by the foundation in any given taxable year does not exceed the amount budgeted by the grantee for nonlobbying program activities during that year.

(iii) This rule also applies to a multi-year grant for a specific project, and is applied by measuring either the actual annual grant disbursement or by dividing the grant equally over the years of the grant. The foundation may choose which method of grant measurement to use, so long as the foundation uses the same method for all years.

Example: Private foundation makes an annual $25,000 general support grant to Charity X. This grant is not specifically earmarked for any specific project and is mixed in with X's other funds for various administrative and programmatic uses, including some lobbying. In addition to this general support grant, the foundation has been asked to give an additional two-year $100,000 grant to X for a new program. According to X's proposed budget, the program will have an annual budget of $200,000, of which $50,000 will be used annually for lobbying purposes. Neither of these grants constitutes a taxable expenditure. The general support grant is not earmarked and is therefore acceptable. The specific project grant, plus the general support grant, amounts to a $75,000 annual grant to X. This amount is less than $150,000 which is the non-lobbying amount budgeted for the specific project.

(iv) In determining whether a grant meets these requirements, a private foundation may rely on budget documents or other sufficient evidence provided by the public charity.

B. §4945(d)(2): Amounts paid to influence the outcome of any specific public election or to carry on a voter registration drive

1. Influencing Elections: A private foundation is considered to influence the outcome of a specific public election if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.

   (a) "Candidate for public office" means any individual who offers himself or herself, or is proposed by others, as a contestant for an elective national, state or local public office.

   (b) Participating or intervening in a political campaign includes (but is not limited to) paying the salaries or expenses of campaign workers and publishing or distributing written statements, or making oral statements, for or against a political candidate.

2. Voter Registration: A private foundation's expenditures to fund voter registration activities, directly or indirectly, are considered to be taxable expenditures unless the foundation complies with the following requirements listed in §4945(f):

   (a) the voter registration activity must be carried on by a Section 501(c)(3) organization;

   (b) the organization's activities must be nonpartisan, carried on in five or more states and not confined to one specific election period;

   (c) the organization must expend substantially all of its income directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated (meaning the organization spent at least 85% of its income for the active

conduct of activities, rather than to make grants to fund the activities of other organizations);

(d) the organization must receive substantially all of its support (other than gross investment income, as defined in §509(e)) from exempt organizations, the general public, governmental units or any combination of the foregoing, without receiving more than 25% of such support from any one tax-exempt organization or deriving more than 50% of its support from gross investment income; and

(e) contributions to the organization for voter registration drives may not be subject to conditions that they be used only in specified states or areas of the United States or that they be used in only one specific election period (however, so long as these provisions are met, grant funds may be earmarked for voter registration purposes generally).

C. §4945(d)(3): Certain grants to individuals for travel, study or other similar purposes

1. Grants to an individual for travel, study or other similar purposes are taxable expenditures, unless the requirements of §4945(g) are met. Congress enacted §4945(d)(3) to prevent private foundations from making improper grants to individuals, particularly grants allegedly made for educational use but in fact used for private interests, such as vacations abroad and paid interludes between jobs.

2. §4945(d)(3) raises two primary issues for private foundations that make grants to individuals:

   (a) whether the expenditure constitutes a "grant" under §4945(d)(3); and

   (b) if the expenditure does constitute a "grant," whether §4945(g) excludes the grant from the definition of a "taxable expenditure."

3. The definition of "grant" under §4945:

   (a) The definition of "grant" under §4945 includes, but is not limited to: scholarships, fellowships, internships, prizes, awards and loans for purposes described in §170(c)(2)(B) (*i.e.*, charitable purposes), but only if they do not fall under the §4945(g) exception (described below).

   (b) The definition of "grant" for purposes of §4945 does not include salaries or other employee compensation.

> **Example:** A private foundation does not make a taxable expenditure by paying an employee's educational expenses if such expenses are included in the employee's income under §61.

   (c) Certain grants made by a private foundation to individuals are excluded from the definition of a "grant" for the purposes of §4945(d)(3).

(i) A foundation's grants to individuals for purposes other than travel, study or similar purposes do not constitute taxable expenditures under §4945(d)(3).

> **Example:** A private foundation's grants to indigent individuals made to enable them to purchase furniture are not taxable expenditures under §4945(d)(3), even if the requirements of §4945(g) are not satisfied. (Nonetheless, to avoid being treated as taxable expenditures, such grants must not fall under the scope of any other part of §4945.)

(ii) §4945(d)(3) also does not include grants that are not made to fund future activities.

> **Example:** In Rev. Rul. 75–393, the IRS evaluated a private foundation's grants to individuals as awards for their past literary achievements. The grants were not made to fund any activities and contained no conditions on how the funds could be spent. The IRS concluded that the grants were made not for study, travel or similar purposes and therefore did not fall within §4945(d)(3).

(d) A private foundation's grant to an organization that in turn awards the grant funds to an individual for §4945(d)(3) purposes may be considered an individual grant by the foundation under certain circumstances.

(i) The grant will not be treated as an individual grant if the private foundation does not earmark the grant for use by a named individual and does not make a written or oral arrangement for designating the individual recipient. Even if the grantor private foundation has reason to believe that a certain individual will ultimately benefit, the grant would nonetheless be respected as a grant to the grantee organization (and not recharacterized as a grant to the individual), so long as the grantee organization exercises control, in fact, over the selection process and makes the selection completely independently of the foundation.

(ii) If the intermediate grantee organization is a public charity, then a grant made to it by the private foundation will not be treated as an individual grant if it is made for a project that is to be undertaken under the public charity's supervision and the public charity controls the selection of the individual grantee. The selection process, in this case, need not be made completely independently of the grantor foundation.

(iii) Grants made to governmental agencies (as defined by §170(c)(1)) (*e.g.*, state colleges and universities) and earmarked for individuals for §4945(d)(3) purposes are not subject to §4945(d)(3) or §4945(g) if the governmental agency satisfies the IRS in advance that its grant-making program:

1. furthers the charitable purposes described in §170(c)(2)(B);

2. requires that the individual grantee submit reports on the use of the funds and the progress made toward achieving the purposes of the grant, which must be submitted at least annually and following the completion of the undertaking for which the grant was made; and

3. requires that the organization investigate jeopardized grants according to the rules described in Treas. Reg. §53.4945-4(c)(4).

(e) Despite satisfying §4945(d)(3) and (g), a grant by a private foundation to an individual may be treated as a taxable expenditure if the foundation does any of the following:

(i) earmarks the grant to be used for an activity described in §4945(d)(1), (2) or (5) or in a manner violating §4945(d)(3) or (4);

(ii) makes an oral or written agreement that may cause the grantee to engage in any such activities and the grantee does in fact do so; or

(iii) makes the grant for a non-charitable purpose.

(f) Exception under §4945(g): §4945(g) provides that a foundation's grant to an individual for travel, study or other similar purposes will not be considered a §4945(d)(3) taxable expenditure if the following three requirements are met:

(i) The grant is awarded on an objective and nondiscriminatory basis. This means that the grants must be awarded in accordance with a program that, if it were a substantial part of the foundation's activities, would be consistent with:

1. the foundation's tax-exempt status under §501(c)(3);

2. the allowance of deductions to individuals under §170 for contributions to the grantor private foundation; and

3. the specific rules of §53.4945-4(b) for the pool of potential grantees, the selection criteria and the individuals making the selection, including:

- The pool of potential grantees must typically be large enough to constitute a "charitable class";
- The criteria used to select grant recipients from the pool of potential grantees should be related to the purposes of the grant; and
- The persons selecting grant recipients should not be in a position to derive a private benefit, directly or indirectly, if certain potential grantees are selected over others.

(ii) The grant procedures are approved in advance by the IRS under §53.4945-4(c); and

(iii) It is demonstrated to the satisfaction of the IRS that:

1. the grant constitutes a scholarship or fellowship that is not includible in the recipient's gross income under §117(a) and is used to study at an educational organization described in §170(b)(1)(A)(ii);

2. the grant constitutes a prize or award excluded from the recipient's gross income under §74(b), if the recipient is selected from the general public; or

3. the purpose of the grant is to achieve a specific objective, produce a report or similar product, or enhance the grantee's literary, artistic, musical, scientific, teaching, or other capacity, skill or talent.

> **Example:** Rev. Rul. 77–434 describes a private foundation that made long-term, low-interest educational loans to students. Although the loans were not scholarships or prizes, they qualified as §4945(g) grants because they were made to advance the recipients' education and were narrow and definite to ensure the use of the loans for §501(c)(3) purposes.

(g) Private foundations that make grants to individuals must keep the following records with respect to each grant:

(i) all information used to evaluate the grantee's qualifications;

(ii) the grantee's identification and any relationship the grantee has to the foundation;

(iii) the amount and purpose of each grant; and

(iv) all reports submitted by the grantee and any other information obtained by the foundation in complying with §53.4945-4(c)(2), (3), and (4).

1. §53.4945-4(c)(2) and (3) require that foundations making scholarship, fellowship and other educational grants make arrangements to obtain certain basic reports of the grantee's educational pursuits.

2. §53.4945-4(c)(4) imposes reporting requirements on a private foundation that is under a duty to investigate a misused grant.

(h) If reports submitted by a grant recipient indicate that all or any part of a grant is not being used for the purposes for which the grant was made, then §53.4945-4(c)(4) imposes a duty to investigate on the grantor foundation. The foundation must withhold further payments of the grant until any delinquent reports have been submitted. A private foundation that fails to investigate and correct such abuse may be required to treat the amounts involved as taxable expenditures.

(i) A grant will not be considered a taxable expenditure even if the grantor private foundation finds that the grantee has used all or part of a grant for improper purposes, so long as the foundation:

1. takes all reasonable and appropriate steps either to recover the grant funds or to ensure the restoration of the diverted funds and the dedication of grant funds held by the grantee to the proper grant purposes; and

2. withholds any further payments to the grantee until it receives the grantee's assurances that future diversions will not occur and has required the grantee to take extraordinary precautions to prevent future diversions, and, in the case of a grantee that has previously diverted funds from a grantor foundation, until such funds are in fact recovered or restored.

(i) Educational Grants by Company Foundations: Many for-profit companies establish company foundations, which make scholarship or fellowship grants to employees and their children.

(i) As stated above, scholarship and fellowship grants are considered §4945(d)(3) taxable expenditures if they do not fall under §117(a). Section 117 excludes scholarship and fellowship grants from the recipient's gross income, but this special treatment is denied when the grants are a form of employee compensation. In such cases, the grantor foundation must treat the grants as taxable expenditures under §4945(d)(3), unless it follows the procedures outlined in Revenue Procedure 76-47, and satisfies all other applicable requirements under §4945.

(ii) Rev. Proc. 76-47: The IRS will treat educational grants by a private foundation to foundation or company employees (or their children) as scholarships or fellowships under §117(a), so that the grants may avoid taxable expenditure status by qualifying under §4945(g), if the foundation follows the procedure summarized as follows:

1. The program must not be used by the employer or private foundation as an incentive to potential or current employees.
2. Grant recipients must be selected by an independent selection committee.
3. Basic requirements for grant eligibility, which are related to the purpose of the program, must be imposed.
4. The selection of grant recipients must be based on objective standards unrelated to employment.
5. Grants already awarded may not be terminated if the employee terminates his or her employment with the company or the company foundation.
6. The courses of study for which grants are available must not be limited to those of particular benefit to the employer or the foundation.
7. The terms of the grant must meet all other requirements under §117, be consistent with a disinterested purpose of advancing the recipients' education and must not contain any conditions suggesting that the studies are undertaken for the employer or the foundation's benefit.

8. The foundation must either meet a percentage test (described in the Revenue Procedure) that caps the number of grants that may be awarded or satisfy the IRS that all of the relevant facts and circumstances indicate that the program's primary purpose is to educate the recipients, rather than to provide compensation or employment incentive.

D. §4945(d)(4): Grants to an organization that is not a public charity, unless the grantor foundation exercises "expenditure responsibility"

1. A private foundation's grant to a public charity (as defined in §509(a)(1), (2), or (3)) or to a tax-exempt operating foundation (as defined in §4940(d)(2)) is generally not a §4945(d)(4) taxable expenditure and does not require exercising "expenditure responsibility" (described below).

2. "Grant": The definition of "grant" for §4945(d)(4) is the same as for §4945(d)(3) grants to individuals, and includes loans made for charitable purposes (under §170(c)(2)(B)), "program related investments" (described below) and payments to other exempt organizations to support their exempt purposes.

   (a) The definition of "grant" includes not only a foundation's payments directly to grantees, but also payments made directly to vendors for the purpose of supporting or furthering the grantees' work.

   > **Example:** If a private foundation hires a public relations firm to publicize a grantee's activities, the amount paid to the public relations firm is considered a "grant" under §4945.

   (b) In contrast, Treas. Reg. §53.4945-4(a)(2) provides that §4945 ordinarily does not treat as "grants" payments such as salaries, consultants' fees and travel expense reimbursement made to individuals or entities that assist a foundation to plan, evaluate, or develop its own activities or projects, by providing personal services such as consulting, advising or participating in conferences.

   > **Example:** Rev. Rul. 74-125 describes a private foundation that disseminates publications and develops and conducts training programs to assist educators in improving their educational methods. The foundation hires consultants to develop model curricula and to design materials to assist educators with their performance. The IRS ruled that payments to the consultants were for their personal services in helping the foundation to plan and develop its own program activity of assisting educators to employ improved educational methods. Accordingly, such payments did not constitute "grants" for purposes of §4945.

3. Earmarked Grants: A grant made by a private foundation to a grantee organization which the grantee uses to make payments in turn to a second organization will not be considered as

made directly to the second organization so long as the foundation does not earmark the grant funds for use by the second organization and does not make an oral or written agreement enabling it to make such a designation.

(a) This rule applies even if the grantor foundation has reason to believe that certain organizations would derive benefits from the grant, provided that the original grantee organization exercises control, in fact, over the selection process and makes the selection independently of the grantor foundation.

(b) Special rules apply under §53.4945-5(a)(6)(ii) if the intermediary organization is a governmental agency.

4. Expenditure Responsibility: A private foundation must exercise expenditure responsibility over grants made to organizations other than public charities in order for the grants not to be taxable expenditures under §4945(d)(4). Expenditure responsibility, defined under §4945(h), means that a foundation must make all reasonable efforts and establish adequate procedures:

(a) to ensure that the grant funds are spent solely for the purpose for which the grant was made, which entails –

(i) conducting a pre-grant inquiry on potential grantees covering the grantee's identity, the prior history and experience of the grantee organization and its managers and other information on its management, activities and practices;

(ii) having a written grant agreement – all expenditure responsibility grants must be subject to a written agreement signed by an appropriate officer, director or trustee of the grantee organization and containing provisions:

- clearly stating the purposes of the grant;
- requiring the grantee to repay any funds not used for the purposes of the grant;
- requiring the grantee to submit annual reports on its progress and its use of the grant funds;
- requiring the grantee to maintain complete records of receipts and expenditures and to make them available to the grantor; and
- requiring the grantee organization not to use the funds in a manner inconsistent with §§ 4945(d)(1) through (5); and

(iii) retaining records of all expenditure responsibility grants (made available to the IRS on request), including a copy of each grant agreement, every report received from the grantee, and the results of audits or investigations conducted into any expenditure responsibility grants.

(b) to obtain full and complete reports from the grantee demonstrating how the funds are spent, compliance with the grant terms and the grantee's progress toward fulfilling the purposes of the grant (to be submitted by the grantee at the end of its annual accounting period and following completion of the grant); and

(c) to submit full and detailed reports describing its expenditures to the IRS when filing its annual Form 990–PF. A foundation may submit the reports received from grantee organizations. The 990-PF reports must include the following information:

- the grantee's name and address;
- the date and amount of the grant;
- the purpose of the grant;
- amounts spent by the grantee;
- whether the grantee diverted any part of the funds from the purpose of the grant;
- the dates of any reports received from the grantee; and
- the dates and results of the grantor foundation's efforts to verify grantee reports.

(d) In addition, the foundation must retain and make available to the IRS a copy of all expenditure responsibility agreements, reports made by grantees and reports made by persons hired by the grantor to investigate any expenditure responsibility grants.

5. Violations of Expenditure Responsibility Agreements: Any diversion of grant funds by the grantee for purposes other than those specified may result in the diverted portion of the grant being treated as a taxable expenditure. The rules on such diversions of grant funds are similar to the rules on diversion of individual grants. Diversions of expenditure responsibility grants fall into 3 categories:

(a) The mere use of grant funds for activities not planned in the original budget is not treated as a grant diversion. Rather, the use of the grant funds must actually be inconsistent with the original purposes or terms of the grant as described in the grant agreement. A grantor foundation will not be treated as having made a §4945(d)(4) taxable expenditure solely because a grantee has diverted grant funds, so long as the foundation:

(i) takes all reasonable and appropriate steps either to recover the grant funds or to ensure that the diverted funds are restored to their original purpose (or, if the grantee has previously diverted grant funds and some or all of the diverted funds are in fact not so recovered or restored, to recover all of the grant funds); and

(ii) withholds any future payments to the grantee organization until the foundation receives the grantee's assurances that future diversions will not occur and has required the grantee to take extraordinary precautions to prevent future diversions (and, if the grantee has previously diverted grant funds, until the funds are in fact recovered or restored).

(b) A grant will be treated as a taxable expenditure if the grantee does not submit the required report(s) to the grantor foundation, unless the foundation:

(i) has complied with the expenditure responsibility rules and reporting requirements, has made a reasonable effort to obtain the required report and withholds all future payments to the grantee until receiving the report(s).

(c) An expenditure responsibility grant is treated as a taxable expenditure if the grantor fails to conduct a proper pre-grant inquiry, to make a proper grant agreement with the grantee, to file the required reports with the IRS or to comply with the appropriate rules when making a program-related investment (described below).

6. Program-Related Investments: A program-related investment ("PRI"), as defined in §4944 and the regulations thereunder, is an investment made to accomplish one or more charitable purposes (under §170(c)(2)(B)) that does not have a significant purpose of the production of income or the appreciation of property, and no purpose of which is to influence legislation or participate in political campaigns.

> **Example:** Example (1) of Treas. Reg. §53.4944-3(b) describes a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional lenders are unwilling or unable to provide funds on economically feasible terms. A private foundation wishes to make a loan to the business bearing interest below the market rate for commercial loans of comparable risk. The foundation's primary motive is to encourage the economic development of such minority groups, and no significant purpose of the loan involves the production of income or the appreciation of property. Accordingly, the loan is a "program-related investment" even though it may produce a return for the foundation in an amount comparable to earnings from conventional portfolio investments.

(a) The expenditure responsibility rules for PRIs require the grantor foundation to make a written agreement, signed by an officer, director or trustee of the grantee organization, specifying the investment's purpose and requiring the PRI recipient:

(i) to use the funds only for the stated purposes and to repay any portion not used for such purposes;
(ii) to submit, at least once a year, full and complete financial reports and a statement that it has complied with the terms of the investment;
(iii) to maintain adequate books and records, made available to the foundation; and
(iv) not to use any of the funds for uses described in §§ 4945(d)(1) and (2) or, with respect to any PRI recipients that are private foundations, not to make any grant that does not comply with §§ 4945(d)(3) or (4).

(b) A PRI recipient must also agree not to use grant funds for the following activities:

(i) to carry on propaganda or otherwise to attempt to influence legislation within the meaning of §4945(d)(1);

(ii) to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive within the meaning of §4945(d)(2); and

(iii) in the case of a recipient which is a private foundation, to make any grant which does not comply with §4945(d)(3) or (4).

E. §4945(d)(5): Expenditures for non-charitable purposes

1. §4945(d)(5) serves as a "catch-all" prohibition by including in the definition of "taxable expenditure" any amount paid or incurred by a private foundation for any purpose other than one described in §170(c)(2)(B) (i.e., charitable purposes). Improper purposes include wrongful distributions, excessive compensation arrangements and unreasonable payments for goods and services.

2. Treas. Reg. 53.4945–6(b)(1) describes several expenditures that are not treated as taxable expenditures under §4945(d)(5), including taxes; investment-related expenditures; expenses that qualify as deductions for purposes determining §511 unrelated business income tax; payments constituting allowable deductions under §4940 or qualifying distributions under §4942(g); reasonable expenditures related to program-related investments; and business expenditures made by PRI recipients.

3. Expenditures for unreasonable administrative expenses, including compensation, consultant fees and other fees for services are considered taxable expenditures under §4945(d)(5) unless the foundation can demonstrate that the expenses were made in the good faith belief that they were reasonable and consistent with ordinary business care and prudence.

4. Since private foundations may not make expenditures for non-charitable purposes, a private foundation may not make grants to organizations other than §501(c)(3) public charities unless:

   (a) the grant qualifies as a PRI;

   (b) giving the grant itself constitutes a direct charitable act; or

   (c) the foundation is "reasonably assured" that the grant will be used exclusively for charitable purposes (as defined in §170(c)(2)(B)) by exercising expenditure responsibility and having the grantee organization agree to maintain the grant funds in a separate fund dedicated to charitable purposes.

5. Unlike §501(c)(3), which requires expenditures for non-exempt purposes to be more than insubstantial before loss of exemption occurs, §4945 imposes excise tax liability on all expenditures for non-exempt purposes, whether substantial or not. A private foundation could, therefore, have a tax liability under §4945(d)(5) for engaging in an activity that did not further an exempt purpose and yet retain its exempt status under §501(c)(3) because the activity was insubstantial.

III. Penalties for Violations

A. Section 4945 imposes excise tax penalties on private foundations that make taxable expenditures and on private foundation managers who approve the making of such expenditures knowing them to be taxable expenditures.

B. "First-tier" taxes: Section 4945 imposes an initial tax on a private foundation and, in some cases, on foundation managers for making a taxable expenditure.

1. An initial tax of 10% of the amount of the taxable expenditure is imposed on the private foundation.

2. An initial tax of 2.5% of the amount involved is imposed on private foundation managers who knowingly approve the making of such expenditure, where such action is willful and not due to reasonable cause.

C. "Second-tier" taxes: Where an initial tax is imposed and the taxable expenditure is not "corrected" in the proper time frame, an additional tax is imposed.

1. The second-tier tax on the private foundation is 100% of the amount involved.

2. The second-tier tax on foundation managers is 50% of the amount involved, up to $10,000, and is imposed on foundation managers who refuse to agree with the correction.

D. "Correction" of a taxable expenditure:

1. "Correction" of a taxable expenditure means recovering the expenditure to the extent possible and, where full recovery is not possible, taking additional corrective action that may be prescribed by the IRS.

2. If the expenditure is taxable only because of inadequate reporting (in violation of §4945(h)(2) or §4945(h)(3)), correction may be accomplished by obtaining the required report.

E. Abatement of penalties:

1. Section 4962 allows the IRS to abate the first-tier tax under §4945 where the foundation can establish that the expenditure was corrected and that the making of the expenditure was due to reasonable cause and not to willful neglect.