

How Grant-Making Private Nonoperating Foundations Avoid Taxable Expenditures

This article assists private foundations making grants to charitable organizations with complying with the Internal Revenue Code (“Code”) taxable expenditure rules. We first provide background on taxable expenditures, introducing the importance of understanding the potential grantee’s organization type. Next, we review the common types of organizations to which private foundations make grants and the significance of each. We then provide three methods that private foundations may use to determine the potential grantee’s organization type.

BACKGROUND—TAXABLE EXPENDITURES AND ORGANIZATION TYPE

The Code imposes an excise tax on taxable expenditures. A “taxable expenditure” is any grant from a private foundation if the private foundation does not comply with Code rules governing the grant. The Internal Revenue Service (“IRS”) can impose the excise tax on both the foundation and the management for failure to comply with the Code rules. The excise tax imposed on a foundation can be as high as 100 percent of the amount of the expenditure and 50 percent of the amount of the expenditure upon the management.

A private foundation can make a grant to an organization without the grant being a taxable expenditure if either (i) the private foundation exercises expenditure responsibility as to the grant or (ii) the grantee organization is one of three specific types of organizations noted below. Exercising expenditure responsibility can be detailed and time-consuming work. Therefore, a private foundation considering making a grant to an organization should first determine whether the potential grantee is one of the following three specific types of organizations.

ORGANIZATION TYPES

The first type of organization to which a private foundation can make a grant without the grant being a taxable expenditure is described in Code sections 509(a)(1) or (2). As a practical matter, most charitable organizations that private foundations make grants to will be either section 509(a)(1) or (2) organizations. The section 509(a)(1) organizations include public charities with a public policy favored purpose such as schools, churches, and

hospitals. The section 509(a)(2) organizations are public charities with substantial funding from the public.

The second type of organization to which a private foundation can make a grant without the grant being a taxable expenditure is certain section 509(a)(3) public charities referred to as functionally integrated Type III supporting organizations. If the potential grantee is a section 509(a)(3) organization, the private foundation must follow a detailed procedure to determine whether the grantee is a functionally integrated Type III supporting organization. A private foundation cannot make a grant to a 509(a)(3) organization other than functionally integrated Type III supporting organizations without exercising expenditure responsibility. Fortunately, grants to section 509(a)(3) organizations are relatively rare; and we'll explain how to spot a section 509(a)(3) organization below.

The third type of organization to which a private foundation can make a grant without the grant being a taxable expenditure is the private operating foundation. Because most private foundations are not private operating foundations, *grants to most private foundations require expenditure responsibility*. The procedure for exercising expenditure responsibility is beyond the scope of this memorandum. Please contact us should you have questions about how to exercise expenditure responsibility.

HOW TO DETERMINE ORGANIZATION TYPES TO AVOID TAXABLE EXPENDITURES

To avoid the excise tax the Code imposes upon a private foundation for taxable expenditures, the private foundation must determine the grantee organization's section 509(a) status. The IRS sanctions three different methods to determine whether a potential grantee is one of the three organizations described above. One method is to request (if not available on the grantee's web site) the potential grantee's current IRS determination letter, which recognizes an organization as exempt from federal income tax. The letter indicates the potential grantee's section 509(a)(1), (2), or (3) tax exempt classification.

The second method a private foundation can use to determine an organization's section 509(a) status is to use the Business Master File ("BMF"). The IRS maintains on its web site a repository of tax-exempt organization information, including 509(a) status, which is called the BMF. To rely upon the BMF, a private foundation must download and store the potential grantee's BMF information. To access the BMF, follow the instructions on the IRS's web site at: <http://www.irs.gov/charities/article/0,,id=169840,00.html>, which can be accessed through the IRS's home page by clicking "Charities & Non-Profits" at the top of the page, clicking the "More Topics" link in the sidebar on the top, left part of the page, clicking the link "Statistical Information About Tax-Exempt Organizations," and finally clicking on the link to the instructions at the bottom of the text.

To determine the organization's section, use the field in the BMF called "Foundation Code." The explanation of the Foundation Code that is found in the BMF instructions will state whether the organization is described in sections 509(a)(2) or 509(a)(3) (codes 16 or 17, respectively) and whether the organization is a private operating or nonoperating foundation (codes 03 or 04, respectively). No Foundation Code explicitly refers to section 509(a)(1) organizations, but all 509(a)(1) organizations will have a code description that references section 170 (codes 10 through 15).

The third method of verifying section 509(a) status is through a third party. A private foundation meets the IRS standards for relying on a third-party provider only if: **(A)** the third party provides a report which contains (i) the potential grantee's name, EIN, and section 509(a) status; and (ii) a statement that the information is from the most current update of the BMF and the BMF revision date; and **(B)** the report is in a form that the grantor can store in hard copy or electronically.

Relying on a grantee's Form 990 to determine whether the organization is classified under section 509(a)(1), (2), or (3) is not one of the three methods the IRS sanctions. Guidestar's basic service is also not compliant with IRS requirements. Guidestar does offer an additional service (called GuideStar CharityCheck) that it claims is compliant. Use of GuideStar CharityCheck does not, however, provide the documentation that the IRS requires to determine that a section 509(a)(3) organization is a functionally integrated Type III supporting organization. We suggest, therefore, that you contact us if you determine that a potential grantee is a 509(a)(3) organization.

SUMMARY

If you determine that a potential grantee organization is a private operating foundation or that the organization is described in section 509(a)(1) or (a)(2), you do not need to exercise expenditure responsibility with respect to a grant. If you determine that the organization is a private nonoperating foundation or is described in section 509(a)(3), please contact us to discuss expenditure responsibility.

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

If you have any questions, please contact us at 410.771.0001 or via email at contactus@arthurbellcpas.com.