APPENDIX XIV

Guidance on Expenditure Responsibility: Council on Foundations Letter to Treasury

December 27, 2001

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Tax Legislative Counsel
Department of the Treasury
Room 1313-A MT
1500 Pennsylvania Avenue, NW
Washington, DC 20020

Dear Susan:

I am writing to outline the advice that we propose to provide to private foundations making international grants. This advice clarifies certain points not discussed in the IRS's excellent and helpful General Information Letter on expenditure responsibility of April 18, 2001. In particular, our advice will recommend reasonable approaches to the following issues:

1. Grants for Capital Equipment
2. Grants for Endowments
3. Reasonable Efforts to Obtain Grantee Reports

Background: Expenditure Responsibility Grants

Pursuant to Section 4945 of the Tax Code, the accompanying Treasury Regulations and the General Information Letter of April 18, 2001, it is clear that private foundations making international grants may presume that non-U.S. grantees are not section 501(c)(3) charitable organizations. By exercising expenditure responsibility in connection with a grant to a foreign grantee, a private foundation may generally ensure that such a grant will be a qualifying distribution for the purposes of meeting its 5 percent minimum distribution requirement (Section 4942) and will not be a taxable expenditure under Section 4945.

The regulations under section 4945 require that recipients of expenditure responsibility grants provide reports on "the use of the funds, compliance with the terms of the grant, and the progress made by the grantee toward achieving the purposes for which the grant was made," Treas. Reg. §53.4945-5(c)(1). Existing IRS guidance on expenditure responsibility does not provide clear answers on various aspects of the reporting requirement, however, including the length of time that reports must be obtained for grants made for the purchase of capital equipment or endowment purposes and the minimum required efforts that a private foundation should make to secure reports from grantees. In the absence of clear guidance on these issues, we intend to recommend reasonable solutions that will, we hope, reassure grantmakers and their advisors and thus promote this vital form of philanthropy.

Grants for Capital Equipment

As you know, the regulations under section 4945 acknowledge that three years of expenditure responsibility reporting are sufficient for a grant made for capital equipment purposes that goes to another private foundation. If it is reasonably apparent to the grantor that (before the end of the second year following the year in which the grant was made) the equipment purchased with the grant funds has not been used for any noncharitable purposes outside the limitations of the written grant agreement, reporting may end. Unfortunately, the same regulations give no guidance as to how long reports must be collected from the grantee and reported to the IRS for this type of grant when made to an organization that is not a private foundation. Such grants are specifically noted and permitted but no guidance is provided for how long reports must be submitted, Treas. Reg. §53.4945-5(b)(3).

We will recommend that reports should be required to be submitted and reported to the IRS for the duration of the "useful life" of the equipment, using generally recognized accounting principles and current U.S. law regarding how long such equipment must be depreciated. If, by the close of the year in which the useful life of the capital equipment ends, it is reasonably apparent that the equipment has been used only for charitable purposes consistent with the written grant agreement, reporting may end. We believe that this useful life approach provides the grantmaking private foundation ample opportunity to confirm that its funds have not been used for noncharitable purposes without burdening either the grantmaker or grantee with perpetual reporting requirements.

Grants for Endowment

As with grants for capital equipment, the Treasury Regulations provide guidance on the duration of required reporting where endowment grants are made to private foundations but not where they are made to organizations other than private foundations. Where an expenditure responsibility endowment grant is made to a private foundation and it is reasonably apparent to the grantor that (before the end of the second year following the year in which the grant was made) neither the income nor principal of the grant has been used for any noncharitable purposes outside the limitations of the written grant agreement, reporting may end. Since private foundations are by definition charitable under Section 501(c)(3) and must be organized and operated for charitable purposes in perpetuity, there seems to be little risk that grant funds will be used for noncharitable purposes.

No such assurance is available when endowment grants are made to noncharitable entities. Because the recipient's assets may not be wholly or permanently dedicated to charitable purposes, the grantmaker cannot assume that the income and principal of its grant will always be used for the charitable purposes described in the written grant agreement. A never-ending reporting requirement might ensure that the funds are used appropriately but is unduly burdensome on both the grantor and the grantee.

Accordingly, we will recommend that private foundations wishing to make grants for endowments to foreign organizations not make such grants under the expenditure responsibility rules. We will recommend that private foundations first determine that these entities are the equivalents of U.S. charities before making such grants. Revenue Procedure 92-94 provides guidance on the issues to be analyzed by the grantmaker and its legal advisor in making this determination. If the entity is the equivalent of a U.S. public charity, the grant may be made without further documentation. If it is the equivalent of a U.S. private foundation, the three-year reporting requirement will apply.

Reasonable Efforts to Secure Reports from Grantees

It is occasionally the fact that some grantees do not provide required reports to grantors—at least not in a timely fashion. The Treasury Regulations make it clear that failure by the grantee to make such reports will result in the grant being treated as a taxable expenditure unless the grantor foundation has otherwise completed the requirements for expenditure responsibility; has made the required reports to the IRS; makes a reasonable effort to obtain the required report, and withholds all future payments on the grant and on any other grant to the same grantee until the report is furnished, Treas. Reg. §53.4945-5(e)(2). The issue here is defining a reasonable effort.

We will recommend that a private foundation that has made at least two good-faith attempts to contact the grantee and request the required report be considered to have made a reasonable effort. The contacts may be made by any means of communication that the foundation reasonably believes likely to reach the grantee (including letter, facsimile, electronic mail), and the foundation should document these efforts. We believe that this standard will encourage compliance with the reporting rules.

The foundation community greatly appreciates the efforts of IRS and Treasury to provide guidance in the area of international grantmaking. If you have any questions or concerns with regard to the advice we have outlined above, we would appreciate hearing from you.

Sincerely,

John A. Edie
Senior Vice President and
General Counsel