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IRS

Expenditure Responsibility: A Primer

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Over the 100 years or so that the United States has had a federal income tax, Congress has, from time to time, stepped back, evaluated the existing laws, and made significant revisions to the Internal Revenue Code. The Tax Reform Act of 1969 was one such occasion of major tax law changes. For the philanthropy community, it marked the first time there was a distinction within the 501(c)(3) tax-exemption category between public charities and private foundations.

Lawmakers had become concerned that some types of 501(c)(3) organizations were open to abuse by wealthy individuals and families that formed and controlled them, often as a way to shield their assets from taxation and serve their private interests.

Before 1969, the term "private foundation" had not been defined in the Internal Revenue Code and these closely held organizations were not regulated any more than 501(c)(3) organizations generally. In the 1969 Act, Congress created a new framework, imposing on private foundations special duties and obligations as well as steep "excise" or penalty taxes for noncompliance.

"Taxable Expenditure" Excise Tax

One of the important reforms of the 1969 Act was to address the problem that private foundations were giving funds to individuals and to other private foundations without enough conditions or controls to make sure that the money was used for charitable purposes.

Section 4945 of the Internal Revenue Code describes an excise tax for a private foundation's "taxable expenditures." It's a catch-all provision, including spending money –

- For other than a "valid charitable purpose";
- To carry on propaganda or influence legislation;
- To influence an election outcome or have a voter drive;
- To make a grant to an individual for travel, study, or other similar purposes unless it satisfies strict requirements; or

- "As a 'grant' to an 'organization' unless the grant is made to certain types of public charity organizations or unless the foundation exercises expenditure responsibility." (Sec. 4945(d)(4))

An important addition to this set of rules was included in the Pension Reform Act of 2006; now, donor-advised funds – as well as private foundations – must abide by them.

As with the tax laws generally, the devil is in the details; for instance, there are explanations and definitions about what is a "grant" under this statute.

For now, we'll move on to the more precise issue of what is "expenditure responsibility" in connection with "grants" to other than certain types of public charities. (If the grant is made to a public charity or other types of organization outside the "expenditure responsibility" provisions, it must still meet the standards of Revenue Ruling 68-489. Grants to individuals are subject to a separate set of requirements under Section 4945(g) and Revenue Ruling 56-304.)

Expenditure Responsibility

Under Internal Revenue Code section 4945(h), a private foundation "is responsible to exert all reasonable efforts to establish adequate procedures (1) to see that the grant is spent solely for the purpose for which it is made, (2) to obtain full and complete reports from the grantee on how the funds are spent, and (3) to make full and detailed reports [to the IRS]."

Regulations issued by the Treasury Department interpret and give more detail about these requirements. Generally, the private foundation must:

- Conduct a pre-grant inquiry [Reg. Sec. 53.4945-5(b)(2)];
- Receive a written agreement with certain terms [Reg. Sec. 53.4945-5(b)(3)]; and
- Obtain certain reports from grantees [Reg. Sec. 53.4945-5(c)]

The foundation must also properly report the "expenditure responsibility" grants to the IRS on the annual Form 990-PF. If the report by the grantee contains certain specified information, that report may be submitted in fulfillment of the grantor's reporting requirement.

If the grantee does not comply in any way, then the private foundation is required to take action.

"Expenditure responsibility" can be viewed as consistent with standard, prudent, grantmaking procedure and practice. However, because it is statutorily mandated, it must be followed strictly. A United States Tax Court case from 1989 makes that point clear. In *Mannheimer Charitable Trust v. Commissioner,* 93 T.C. 35, a charitable trust made a "taxable expenditure" with sufficient oversight of the grantee, but without the required documentation and IRS reporting required by the statute. The excise taxes were upheld.

Conclusion

Of course, even if the grantor private foundation follows all of these rules, problems and issues can arise. The Treasury Regulations consider at least two possibilities: first, the grantee diverts the grant funds away from the stated charitable grant purposes; and second, the grantee doesn't make the required reports.

We'll discuss those issues in later posts.