Confirming Section 501(c)(3) Status is Not Enough: Determining Grantee Status for Grants from Donor Advised Funds After the Pension Protection Act of 2006

The Pension Protection Act of 2006 (PPA) created new requirements and restrictions on grants from donor advised funds. While the Internal Revenue Service (IRS) is expected to issue guidance at some point in the future clarifying some ambiguities in the law, community foundations should act now to review and update policies to ensure that grant processing procedures are in place to properly consider grant recommendations and avoid potential IRS penalty taxes. Such a review and update of policies is necessary even if the community foundation only permits grants to Section 501(c)(3) organizations. As is detailed below, checking Section 501(c)(3) status alone is no longer sufficient to comply with the law.

While there are many questions involved in determining whether a community foundation should make a grant from a donor advised fund, one key determination is the grantee’s status under tax law. For example, is the potential grantee an individual, for-profit organization, private foundation, or public charity? The answer will dictate whether and how a grant can be made. One way to understand the importance of grantee status under the new PPA’s rules on grants from donor advised funds is to break the types of potential grants into three categories: prohibited grants, expenditure responsibility grants, and permissible grants.

Prohibited Grants

The PPA specifically prohibits several types of grants from donor advised funds:

- Grants to individuals

  Note that prohibited grants to individuals include both grants made directly to an individual and grants made to an organization, such as a school, for the benefit of a specified individual.

- Grants to donor, advisors, or related parties

  This includes a prohibition against grants to donors that are not individuals. It is currently unclear if a donor advised fund could make a grant back to the donor if the donor is a public charity.

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1 For the text of the statute and background information on the other provisions of the Pension Protection Act that define and regulate donor advised funds, see www.cof.org/ppa.

2 The PPA uses the term “distributions.” This article is focused only on gratuitous transfers of money and property and uses the term “grants” to describe those transfers.

3 For more information on the rules against these and similar payments to donors, advisors, or related parties, see Changes in Intermediate Sanctions for Donor Advised Funds and Sponsoring Organizations.
Grants for non-charitable purposes

To implement these provisions, community foundations should consider both how to communicate the information about prohibited grants to fund advisors and what additional donor advised fund grant recommendation review processes the community foundation should institute. The National Standards for U.S. Community Foundations require that prohibitions against grants to individuals and to donors, advisors, or related parties appear in either donor advised fund agreements or donor advised fund guidelines. Community foundations should also consider going further to include the prohibitions in its internal grants processing procedures to avoid making a prohibited grant.

Expenditure Responsibility Grants

Certain grants from donor advised funds are taxable unless the community foundation follows a due diligence process called “expenditure responsibility.” Briefly, expenditure responsibility is designed to ensure that a grant is used for charitable purposes and that the community foundation maintains appropriate oversight and documentation of certain grants from donor advised funds. While the IRS has not issued guidance to define the expenditure responsibility steps for grants from donor advised funds, the private foundation rules provide some guidance. Specifically, the private foundation rules define expenditure responsibility as a five-step process that includes:

1. Conducting a pre-grant inquiry including a reasonable investigation of the grantee to ensure that the proposed activity is charitable and that the grantee is able to perform the proposed activity.

2. Executing a written agreement with the grantee that specifies the charitable purposes of the grant and includes provisions that prohibit use of the funds for lobbying activities and require the grantee to return any funds not used for the designated purposes.

3. Requiring the grantee to maintain the grant funds in a separate fund so that charitable funds are segregated from non-charitable funds.

4. Requiring the grantee to provide regular reports on the use of the funds and the charitable activity supported by the grant.

5. Including a report on Form 990-PF about the grant including a brief description of the grant, the amount, the charitable purpose, and the current status of the grant. Note that the current and revised Form 990 for public charities does not have instructions indicating that such information should be reported on the Form, so the application of this requirement to public charities with donor advised funds is unclear at this time.

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4 More details about the expenditure responsibility process and sample forms can be found in Expenditure Responsibility Step by Step by John Edie.
The largest source of confusion for community foundations is that grants to certain supporting organizations require expenditure responsibility even though these supporting organizations are Section 501(c)(3) public charities. Consequently, even if the foundation’s policies limit grants to Section 501(c)(3) public charities, the foundation will need to determine if the potential grantee is a supporting organization—a type of public charity—to determine if expenditure responsibility will be required. For this reason, it is prudent for a community foundation to establish procedures to determine whether grants require the expenditure responsibility process. The National Standards for U.S. Community Foundations require that a community foundation have due diligence policies that include such procedures.

Grants to the following organizations require expenditure responsibility:

- Organizations **not** described in Section 170(b)(1)(A) of the Internal Revenue Code

  Common examples of such grants include:
  - Grants to non-charities
  - Grants to international organizations unless equivalency determination is followed
  - Grants to private non-operating foundations

Community foundations should already have procedures in place to determine whether a grantee is a public charity. However, a community foundation may choose to combine the determination of whether the grantee is a public charity with the next step described below of determining whether a public charity is a supporting organization.

- Grants to certain supporting organizations (Section 509(a)(3) public charities)

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5 The legislative history makes clear that a donor advised fund has two choices in making such distributions. It may either make a good faith determination that the organization is equivalent to a domestic charity (equivalency determination) or it must exercise expenditure responsibility. For more information on expenditure responsibility and equivalency determination in the context of international grantmaking, visit [http://www.usig.org/legal/er-ed.asp](http://www.usig.org/legal/er-ed.asp).

6 The Council on Foundations continues to recommend against grants to private non-operating foundations from donor advised funds even if expenditure responsibility is exercised. Under the new law, a donor advised fund may make a distribution to any organization (including a private foundation) as long as it follows expenditure responsibility. However, under existing law, the IRS has held that a grant from a donor advised fund is evidence of excessive donor control and a material restriction. Further, any attempt to funnel money through a donor advised fund to circumvent the deduction limits that otherwise apply to gifts to private foundations may expose the sponsoring charity to liability for participation in a tax fraud. While there are situations where it may be appropriate to make a grant from a donor advised fund to a private foundation, you should only do so after consulting with your tax advisor to evaluate these risks.

7 Determining the public charity status of religious entities and organization subject to group rulings may require special attention. For information about determining status of these organizations, see [Unusual Grants: An Online Legal Guide for Public Charities](http://www.usig.org/legal/er-ed.asp).
As mentioned above, a supporting organization is a type of public charity. A supporting organization receives a determination of public charity rather than private foundation status from the IRS because the organization has a particular relationship with another publicly supported charity or government unit. Based on the relationship, a supporting organization is defined as Type I, Type II, or Type III. Type III supporting organizations are further broken down into functionally integrated or non-functionally integrated. Descriptions of supporting organizations can be found following this article in “Supporting Organizations Definitions.”

Grants to the following supporting organizations require expenditure responsibility:

- Type III supporting organizations that are not “functionally integrated”
- Any type of supporting organization (even a functionally integrated Type III) if the organization that is being supported is controlled directly or indirectly by either the donor, donor advisor, or related party

**Determining Supporting Organization Status and Type**

The IRS issued guidance (Notice 2006-109) to help organizations with donor advised funds determine whether an organization is a supporting organization and, if the organization is a supporting organization, how to determine the type of supporting organization. This guidance, broken down into steps below, should help community foundations develop procedures to determine whether expenditure responsibility is required.

**Step 1: Determining Whether a Public Charity Is a Supporting Organization**

IRS guidance states that donor advised fund grantmakers may rely on information from either of the following sources to determine whether a public charity is a supporting organization:

- the IRS Business Master File (BMF)\(^8\);
- the potential grantee’s IRS determination letter; or
- a report from a third party that includes the following:
  - the grantee’s name, Employer Identification Number, and public charity classification under Section 509(a)(1), (2), or (3)
  - a statement that the information is from the most currently available IRS monthly update to the BMF, along with the IRS BMF revision date
  - the date and time of the grantmaker’s search

The grantmaker must retain the report in electronic or hard-copy form.

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\(^8\) Note that the Business Master File is not the same as IRS Publication 78 referenced above. The Business Master File includes significantly more details about charities than Publication 78 including how the organization qualifies for its status as a public charity. Publication 78 does not currently contain sufficient information to use to determine whether an organization is a supporting organization.
Step 2: Determining the Type of Supporting Organization

If an organization is a supporting organization, grantmakers must next determine its type. The IRS guidance prescribes one process for organizations with Type I or Type II status and a more complex one for those that are Type III. In all cases, the grantmaker must first verify that the organization is a public charity by checking either the organization’s determination letter or its status in IRS Publication 78.

**Basis for Determining that an Organization Is a Type I or II Supporting Organization:** Grantmakers may rely on a written representation signed by an officer, director, or trustee of the grantee if both of the following are true:

- The representation describes the process used for selecting the grantee’s officers, directors, or trustees and references the pertinent provisions of the grantee’s organizing documents that establish the grantee’s relationship to its supported organizations.
- The grantmaker collects and reviews copies of the grantee’s governing documents. If the grantee’s organizing documents are not sufficient to establish the relationship, the grantmaker must also collect organizing documents from the supported organization.

**Basis for Determining that an Organization is a Functionally Integrated Type III Supporting Organization:**

- The grantee’s written representation identifies the organizations it supports.
- The grantmaker collects and reviews the grantee’s organizing documents (and those of the supported organizations if necessary).
- The grantmaker collects a written representation signed by an officer, director, or trustee of each supported organization stating that the supporting organization is functionally integrated and that but for the involvement of the supporting organization, the supported organization normally would engage in those activities itself.

**Alternative:** Grantmakers may also rely on a reasoned written opinion of counsel of either the grantee or the grantmaker in making the determination that a supporting organization is a Type I, Type II, or functionally integrated Type III supporting organization.

Step 3: Determining Whether a Supported Organization is Controlled by a Donor, Advisor, or Related Party

If the foundation has determined that the potential grantee is a supporting organization and determined that the supporting organization is not a Type III non-functionally integrated supporting organization (where expenditure responsibility is automatically
required), the community foundation will need to determine whether the donor, donor advisor, or related parties control the supported organization. This final step is required to make a determination about whether expenditure responsibility is required.

While guidance from the IRS on this subject is still anticipated, the current guidance states that a supported organization is controlled by a donor, donor advisor, or related party if “any such persons may, by aggregating their votes or positions of authority, require a supported organization to make an expenditure, or prevent a supported organization from making an expenditure.” For example, if a member of the donor’s family is the executive director of the supported organization of a Type I supporting organization, the supported organization would likely be considered controlled by the donor, donor advisor, or related party. In this case, expenditure responsibility would be required for the grant even though the grantee is a Type I supporting organization.

The available guidance (Notice 2006-109) also suggests one method for determining whether control is present. Specifically, if the community foundation is considering a grant from a donor advised fund to a Type I, Type II, or functionally integrated Type III supporting organization, the community foundation may need to request a list of the organizations that the potential grantee supports. Then the community foundation would likely need to work with the donor(s) and advisors to determine whether any of those supported organizations are controlled by the donor, advisor, or related party. For example, the community foundation may seek a certification from the donor or advisor regarding whether they control a supported organization directly or indirectly. Other foundations may choose to seek a certification directly from the supported organization directly indicating that the donor, advisor, or related parties do not control the supported organization. In either case, the community foundation will need to work with the donors and donor advisors to determine the class of individuals and entities that qualify as donors, donor advisors, and related parties. At some point, the IRS may issue guidance to make the steps clear. However, until that time, a community foundation should work with its local counsel to determine policies and procedures that adhere to the law.

A community foundation may find that only a few grants are affected by these new rules. However, the key is having a process in place to identify those grants. While the IRS has yet to issue significant guidance in this area, the available guidance does provide a road map for establishing appropriate processes for making the determination if expenditure responsibility is required. At the end of this article, you will find a chart that addresses which grants to Section 501(c)(3) organizations from donor advised funds require expenditure responsibility. In addition, an accompanying flow chart summarizes one method to answering the question of whether expenditure responsibility is required for a particular grant.

Other Permissible Grants
Grants to all other organizations including government units, Section 509(a)(1) or 509(a)(2) public charities, private operating foundations, and Type I and II supporting organizations where there is no control by a donor, advisor, or related party do not require any special processes. In addition, grants may be made from one donor advised fund to the charity that holds the donor advised fund or to other donor advised funds. The key for a community foundation is to determine which grants are prohibited or require special procedures. All other grants serving charitable purposes are permitted from donor advised funds with standard due diligence procedures.

**Final Considerations**

A community foundation should work to develop policies and procedures to address the new rules for grants from donor advised funds that will guide staff in following the law. At minimum, these policies should include provisions for determining whether potential grantees are non-charities, private foundations, or supporting organizations. Beyond those steps, policies may vary among community foundations. For example, some community foundations may determine that the foundation makes so few grants to supporting organizations that it will exercise expenditure responsibility with regard to all such grants rather than proceeding through an inquiry about supporting organization type or control relationships. Others will develop processes that walk through all the steps to determine if expenditure responsibility is required and only exercise expenditure responsibility in cases where absolutely required by law. Still others may choose to make a grant directly to a supported organization rather than exercise expenditure responsibility over a grant to an affected supporting organization. Regardless of the foundation’s policy, each community foundation should review their donor advised fund policies and procedures to ensure that the policy is designed to ask all of the necessary questions about the grantee’s charitable status.

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The information provided here is based on our continuing analysis of the Pension Protection Act. Every effort has been made to ensure accuracy of these documents. Please understand, however, that due to the complexity of the law and the fact that many of these provisions introduce issues that are new to the Internal Revenue Code, this information is subject to change. The information is not a substitute for expert legal, tax or other professional advice and we strongly encourage grantmakers and donors to work with their counsel to determine the impact of this legislation on their particular situations. This information may not be relied upon for the purposes of avoiding any penalties that may be imposed under the Internal Revenue Code.
Supporting Organizations Definitions

What is a supporting organization? To oversimplify, a supporting organization is a Section 501(c)(3) organization that qualifies as a public charity (and not a private foundation) because it has a close relationship with another publicly supported Section 501(c)(3) organization. Usually, in order to qualify as a public charity, an organization must receive at least one-third (or in special cases as little as ten percent) of its support each year from gifts, grants, and contributions from a variety of sources. A “supporting organization” is not required to meet this “public support test” on its own if it provides meaningful support (financial, programmatic, or both) and gives some degree of structural and operational control to another organization that is already classified as a public charity, rather than a private foundation. Based upon the relationship of the supporting organization to the public charity it supports, a supporting organization will be classified as a type I, II, or III. A supporting organization may not be controlled by someone who is a disqualified person with respect to the supporting organization.

What are the different classifications of supporting organization? As a general overview, supporting organizations fall into three categories: type I, type II, and type III. The type refers to the nature of the relationship between the supporting organization and the charity being supported.

- **Type I:** By far the most common, this type is often described as a parent-subsidiary relationship and generally involves the charity appointing a majority of the board of the supporting organization.
- **Type II:** The least common of the three, this type usually involves an overlapping board relationship where at least a majority of the members of the supporting organization board are also members of the supported charity’s board.
- **Type III:** This type operates with a greater degree of independence from the organization it supports. Typically the supported organization appoints one member of the governing board of the supporting organization and institutes other procedures designed to ensure that the supporting organization is responsive to it. Type III supporting organizations may provide financial support to their supported organization or they may directly carry out a program or function for it.

What is a supported organization?

A supported organization is the Section 509(a)(1) or 509(a)(2) organization that the supporting organization is designed to support. A supporting organization may have one or many supporting organizations. In some cases, a supporting organization may have a class of supported organizations such as all public universities in a particular state.
Which grants from donor advised funds to Section 501(c)(3) organizations require expenditure responsibility?

Section 501(c)(3)

Public Charity

Private Foundation

Operating

Non-operating

Section 509(a)(1)
Traditional Organizations

170(b)(1)(A)(i) Churches
170(b)(1)(A)(ii) Schools
170(b)(1)(A)(iii) Hospitals
170(b)(1)(A)(iv) Support organizations to schools
170(b)(1)(A)(v) Governmental units
170(b)(1)(A)(vi) Publicly supported organizations (including community foundations)

Section 509(a)(2)
Gross Receipts Organizations

Section 509(a)(3)
Supporting Organizations

Section 509(a)(4)
Public Safety Organizations

Type I
Type II
Type III

Key

- Expenditure responsibility required. Includes distributions from donor advised funds to:
  - Private non-operating foundations
  - Section 509(a)(4) organizations
  - Non-functionally integrated Type III supporting organizations (SO)
  - Non-charities (including grants to for-profit and other 501(c) organizations)

- Expenditure responsibility only required for distributions from donor advised funds to these Section 509(a)(3) supporting organizations where the charity that the SO supports is controlled by the donor, advisor or related parties.

- Expenditure responsibility not required for distributions from donor advised funds to these organizations.