



Due Diligence

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PRINCIPLE 1
Take a fresh look at information requirements

PRINCIPLE 2
Right-size grant expectations

PRINCIPLE 3
Relieve the burden on grantees

PRINCIPLE 4
Make communications clear and straightforward

A collaborative initiative of the



In partnership with

Association of Fundraising Professionals
Association of Small Foundations
Council on Foundations
Forum of Regional Associations of Grantmakers
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Project Streamline is an effort of funders and nonprofits to improve grant application, monitoring and reporting practices. It is a collaborative initiative of the Grants Managers Network, in partnership with the Association of Fundraising Professionals, the Association of Small Foundations, the Council on Foundations, the Forum of Regional Associations of Grantmakers, the Foundation Center, Grantmakers for Effective Organizations, and the National Council of Nonprofits. For more information, go to www.projectstreamline.org.

The Grants Managers Network (GMN) improves grant-making by advancing the knowledge, skills and abilities of grants management professionals and leading grant-makers to adopt and incorporate effective practices that benefit the philanthropic community. GMN has more than 1,700 members from 1,000+ grantmaking organizations who represent the breadth of the philanthropic community including small family foundations, prominent national foundations, grantmaking public charities, and socially responsible corporations. For more information, go to www.gmnetwork.org.

Project Streamline At A Glance

What can funders do to improve their grant application and reporting processes, reduce the burden on nonprofits, and free up more time for mission-critical activities? How can grantseekers support these efforts?

Project Streamline has worked with leaders in grantmaking and nonprofit organizations to identify challenges, propose solutions and develop resources to help you streamline.

Streamlining Challenges

Drowning in Paperwork, Distracted from Purpose, a Project Streamline study, found ten flaws in the current system of grant application and reporting:

1. Enormous Variability
2. Requirements Aren't "Right-Sized"
3. Insufficient Net Grants
4. Outsourced Burdens
5. Trust Undermined
6. Reports on a Shelf
7. Fundraising Gymnastics
8. Due-Diligence Redundancy
9. Double-Edged Swords
10. Time Drain for Grantmakers, Too

Streamlining Solutions

Our research suggests four core principles that grantmakers can adopt into practice to make things easier on nonprofits.

Principle 1: Take a fresh look at information requirements. Begin with a rigorous assessment of what kind of information you really need to make a responsible grant.

Principle 2: Right-size grant expectations. Ensure that the effort that grantseekers expend to get a grant is proportionate to the size of the grant, is appropriate to the type of grant, and takes into consideration any existing relationship with the grantee.

Principle 3: Relieve the burden on grantees. There are many ways that funders can reduce the burden that grant-seeking places on grantees. By minimizing the amount of time, effort, and money that nonprofits spend getting and administering grants, funders increase the amount of time, effort, and money devoted to mission-based activities.

Principle 4: Make communications clear and straightforward. Good communication is critical to a streamlined process and essential for fostering a mutually respectful relationship between grantmakers and grantseekers.

Streamlining Resources

We provide resources to help you streamline.

Guide to Streamlining Series

Guides on:

- Due Diligence
- Right-Sizing
- Grant Budgets and Financial Reports
- Online Applications and Reporting
- Communications

Making Streamlining Stick

Explores four steps to develop your organization's strategy:

1. Take stock
2. Make the case
3. Plan changes
4. Implement and refine

Online Self Assessment

Tool to assess your current practice

Workshops

Interactive sessions for grantmakers

Website

Resources, events, ideas

Newsletter

Stories, voices, research

Guide Snapshot

Streamlining Due Diligence

Due diligence—the process by which a funder assesses an organization before deciding to invest—can cause anxiety for grantmakers and grantseekers alike. In part, this is because it's poorly understood. In this guide, we dispel five myths, distinguish between legal compliance and the rest of the due diligence process, and clarify legal requirements.

The Bottom Line for Funders

Contrary to prevailing perceptions, the tax code allows private foundations, public charities, and other grantmakers to make grants to virtually any type of organization in the world for charitable purposes. This includes grants to public charities, private foundations, other tax exempt organizations, governmental agencies, foreign organizations, and even for-profit entities. Surprised? Most funders are when they hear that there are so few actual legal prohibitions. In fact...

- There is no process that must be followed in order to make a grant to most domestic public charities.
- The tax code imposes no penalties solely because you failed to confirm or document an organization's status.
- The key due diligence question for grantmakers is not whether a given grant can be made, but what procedures should be followed as the grant is made.

In this guide, we recommend three basic guidelines for grantmakers seeking to streamline their due diligence:

1. Steer clear of long-standing due diligence myths that might prompt your organization to ask for more information than it really needs.
2. Know the difference between the legal requirements that you *must* fulfill and the due diligence that you *choose* to do.
3. Understand the different types of grantseeking organizations, the documentation required to make grants to them, and the procedures for getting the information you need.

Tips for Nonprofits

Grantseekers of all sorts can help grantmakers conduct due diligence in the following ways:

- Know your IRS designation and your Federal Tax Number (EIN). Are you a supporting organization? What type? A government instrumentality? A 501(c)(3) organization classified as a type 509(a)(1) or (2)? A public charity or private foundation? If you know your designation and have the proper paperwork to prove your good standing, your grantseeking process will be much easier.
- Keep critical information on file and at the ready when applying for grants. This pertains particularly to grantseekers that fall outside of public charity 501(c)(3) status and have more complex requirements.
- Understand the purpose and value of due diligence. Grantmakers must follow specific legal and regulatory rules to make some grants. Other due diligence processes may assure them that they aren't taking undue risk with the money under their stewardship.

Principles in Action

The *Guide to Due Diligence* responds to Project Streamline's Principle 1: Take a fresh look at information requirements. Every organization needs to determine its own tolerance for institutional risk and be responsible for thoroughly understanding the legal rules for grantmaking. Beyond that, we recommend imposing additional due diligence requirements with care.

Busting Myths About Due Diligence

The term “due diligence,” common in the business world since the Securities Act of 1933, has been broadly defined as the process by which a potential investor assesses the financial health, legal legitimacy, and overall goals, capacity, and values of an organization before deciding whether to invest.

The passage of the Tax Reform Act of 1969 sparked a major expansion of due diligence in grantmaking. New regulations required due diligence to protect the funder from liability for making a grant that might later be found by the IRS to violate new rules and regulations. Grantmaking suddenly felt more complicated, especially when funding new or foreign organizations or making grants for policy and advocacy work, which might now require taking “expenditure responsibility” or following other special procedures. While funders were accustomed to vetting proposals carefully, they weren’t used to managing multi-layered legal and regulatory requirements, with the threat of fines if they slipped up. Many larger foundations added the position of grants manager to ensure that they followed proper procedures when making grants.

Over time, due diligence practices have become—in many foundations—quite elaborate. And while much of this serves an important purpose, some practices are rooted in misunderstandings about what is required. So, before we go any further, we’d like to dispel five common myths about due diligence.

Myth 1

“We must get the same due diligence materials from each grantee.” (a.k.a. one size fits all)

Reality: The one-size-fits-all myth is a common one. Many funders take a formulaic approach to due diligence—getting the same materials from every grantee, regardless of the situation. This isn’t necessary. For many organizations—especially 501(c)(3) grantseekers that you have funded previously or know well—a more limited set of materials might well suffice. See Project Streamlining’s Guide to Right Sizing the Grantmaking Process for more ideas.

Myth 2

“We must complete all due diligence at the beginning of the grantmaking process.”

Reality: Many funders require a full set of due diligence materials with every application. In these cases, even organizations unlikely to be selected for funding still must send their IRS Letters of Determination, board lists and minutes, detailed financial statements, and whatever other due diligence documentation a grantmaker requires. While these documents may be readily available, it still takes grantseekers time to gather and submit them to funders—time that can really add up when an organization has multiple funders.

We think there’s a better way. Staging requirements so that grantseekers have to send additional documentation only after the grantmaking organization determines that they are otherwise a good fit for funding saves everyone time and effort. Of course, by the time you make a final grant decision, you will have completed a thorough internal assessment of the grantee and its proposal. But don’t forget that many of the legally required due diligence procedures do not take place until the grant is actually made. The practice of asking all applicants early on for all materials that might possibly be used either in internal review of the proposed request or for IRS compliance before it has been established that such information is needed causes unnecessary work for grantseekers—and for grantmakers.

Myth 3

“We need to have a copy of grantseekers’ IRS determination letter and Form 990 in every file.”

Reality: No, you don’t.

In fact, a photocopy of the IRS letter of determination only tells you that the grantee was at some point granted a specific tax-exempt status. These things can change over time, and the original letter of determination may have been rescinded or modified. The best practice, if you have doubts about a potential grantee’s tax status, is to check it online using the IRS’s free Exempt Organizations search or a third-party source. Then you can note the date of the verification in your database or, if necessary, file a printout or screen image as documentation that the status is current. If the organization has anything other than public charity tax status, you may need to follow special due diligence procedures in making a grant.

We know that many grantmakers adhere to an IRS letter requirement at the advice of their auditors or legal advisors. The IRS’s description of “Reliance Criteria for Private Foundations and Sponsoring Organizations,¹” may be useful in establishing why this is not a “must do.”

Myth 4

“We’re required as grantmakers to make sure our grant doesn’t ‘tip’ our grantee into being a private foundation.”

Reality: It’s a conscientious gesture to ensure you aren’t “tipping” your grantee with a grant that dominates their budget. But it’s not your job. The Council on Foundations obtained a ruling for the field in 1989 that clarified that this is the grantee’s responsibility.

Before this ruling (Rev. Proc. 89-23), Treasury regulations stated that a private foundation could be held responsible if its grant to a public charity transformed a public charity into a private foundation by virtue of the grant’s size relative to the organization’s other contributions. To avoid tipping a public charity, foundation financial officers and outside counsel reviewed grantees’ finances and public support calculations. If the public charity was “tipped,” the private foundation would be required to treat the tipping grant as a grant to another private foundation, exercise expenditure responsibility, and make sure that all other rules were satisfied.

This is no longer the case. The ruling (Rev. Proc. 89-23) states that a foundation can’t be penalized for tipping a grantee as long as: (1) the grantee has a valid IRS determination of public charity status at the time the grant is made; (2) the IRS has not revoked the status and the foundation is not aware of imminent action by the IRS to do so; and (3) the foundation does not control the grantee.

Information about this ruling can be found on the IRS website (www.irs.gov).² It’s not easy reading, but will help your financial or legal advisors better understand the requirements and support a change to your practices, if needed.

1. Found at <http://www.irs.gov/pub/irs-drop/rp-09-32.pdf>

2. <http://www.irs.gov/pub/irs-tege/rp1989-23.pdf>

Myth 5

More is better.

Reality: As with everything in grantmaking, there's always more you could do. But is it necessary? Due diligence can be right-sized³. In addition to requiring less, grantmakers can also stage requirements so that only grantseekers with a very good chance of being funded are asked to provide full due diligence information. It takes your staff resources to ask for, follow up on, file, and handle all of these documents. Asking for unnecessary paperwork drains resources not only from your grantseekers, but also from your own grantmaking organization. As you take a fresh look at your information requirements, we suggest applying the following questions to your due diligence practices:

1. Do we need this information to be legally compliant, or do we want it to help us determine whether this would be a prudent grant for us to make?
2. In either case, is this information necessary at this point in the grantmaking process, or can it wait until we are closer to making a grant?
3. Can we get the information ourselves or do we need to request it from the grantseeker?

To benchmark your grantmaking practice against that of your peer organizations, use Project Streamline's free online Grantmaker Assessment Tool, found at <http://www.projectstreamline.org/tools>

3. See Project Streamline's Right-sizing Guide at www.projectstreamline.org for more tips on right-sizing grant application and reporting practices.

Two Types: “Must Do” and “Choose to Do”

Today, most grantmakers complete two types of due diligence:

- 1. What *must* you do?** This is the imperative information that you must have to protect your organization from legal liability for having made a particular grant.
- 2. What else might you *choose* to do?** This is additional due diligence that your organization can conduct to satisfy itself that this is a grantseeker with which it wants to be associated and that the grant requested will prove a good investment.

Over time, the distinction between these two types of due diligence has become blurred.

Question #1 relates to legal compliance and is the focus of this Guide. The law is the law. By clarifying the baseline of what is needed to make a grant, we hope to help funders adjust their requirements when additional due diligence is unnecessary and to eliminate certain practices that aren't legally required or used to good purpose in grant decision making.

Question #2, however, is more subjective. Once you've done the minimum that is required, what else might be prudent in a particular case? What else will enable you as a grantmaker to have as much confidence in the potential grantee as you feel you need and as much assurance as possible that your grant funds will be well used?

Because each grantmaking organization needs to establish its own tolerance for risk in its investments, Question #2 is hard to answer categorically. Grantmakers for Effective Organizations (GEO) provides a nuanced treatment of this question in their guide, *Due Diligence Done Well: A Guide for Grantmakers*.⁴ That tool helps grantmakers determine the “fit” of the grantseeker to a grantmaker's mission, assess the strengths and weaknesses of an applicant, and understand potential red flags. In this guide, Project Streamline takes a narrower focus and is concerned primarily with Question #1, the “must do.”

“Must Do” Due Diligence

So what is really required to make a grant? The answer may surprise you. *For most grantmaking by funders in the U.S., very little is legally required in terms of due diligence.* There is no required paperwork, no process that must be followed, and no post-grant reporting required to make a grant to most domestic public charities. For example, of the 504,759 organizations that filed a 990 or 990EZ in (2009-2010), 325,444 of them fit the criteria of being a 501(c)(3) organization, with a 509(a)(1) or (a)(2) designation. For these organizations, a grantmaker could simply sit down with a checkbook, pen, envelopes, and stamps and be in perfect compliance with the tax code.

The tax code also allows private foundations and public charities alike to make grants to other types of domestic organizations and organizations, governments, and entities around the world. However, special procedures must be followed when making grants to organizations with certain tax designations or for certain kinds of grants. Tax status affects what's required before, during, and after a grant term. The question is rarely whether the grant can be made, but rather what procedures should be followed as the grant is made.

The remainder of the Guide will show you how to determine the tax status of a potential grantee and what, if any, special procedures must be followed to fund that type of organization.

4. <http://www.geofunders.org/publications.aspx>

Three options for determining a 501(c)(3)'s specific IRS designation⁵

The IRS currently identifies the following three options for identifying a potential grantee organization's 501(c)(3) type:

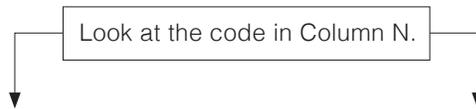
Option 1: Visit the IRS website

You can verify a potential grantee's status by following these steps:

STEP 1 Go to the **Exempt Organization Master File (EOMF)**⁶ on the IRS Web site.

STEP 2 Scroll down to select the state and alphabetic range where the grantee is listed, and open the **Excel spreadsheet** link for that state and alphabetic range. (NOTE: Do not attempt to open the unformatted data.)

In the **Excel spreadsheet**, find the listing for the organization. Highlight the name and scroll across to column N, which shows the "Foundation Code."



If it is **10, 11, 12, 13, 14, 15 or 16**, then you know that the prospective grantee is designated as a 509(a)(1) or 509(a)(2) organization. **These are organizations your foundation may fund with no additional documentation.**

If the code is one of those below, you need to follow special due diligence procedures.
2, 3 or 4: a grant to this grantee requires expenditure responsibility. These numbers signify that the prospective grantee is another private foundation. Read more about how to make grants to other private foundations in this guide (pages 16-17)
17: this organization is a 509(a)(3) supporting organization. Read about how to make grants to 509(a)(3) supporting organizations in this guide (pages 14-16)
0 or 9: then you must exercise expenditure responsibility and ensure that the grant is used exclusively for charitable purposes in order to make a grant.

STEP 3 If you'd like to keep this record, simply save and store the pages electronically that show the organization name and column N to document the applicant's status.

CHARITIES NOT LISTED IN PUB 78

Some charities that are exempt under section 509(a)(1) and 509(a)(2) may not be listed in publication 78 and may not have a determination letter. They include:

- Religious organizations
- Tiny charities
- Organizations covered by a group ruling letter
- Organizations based outside the U.S. that have obtained a ruling

For each of these charities, the required due diligence is the same as any other 509(a)(1) or 509(a)(2) organization, but determining exempt status may be more difficult. If in doubt, contact the grantee to see what they've used to prove their exempt status in the past. As always, consult with your legal advisor if you have questions.

5. This information has been adapted from DETERMINING A GRANTEE'S STATUS: How to Meet IRS Requirements, from the Association of Small Foundations.
6. For more information, see the current Instruction Booklet on the IRS Exempt Organizations Master File Data page: <http://www.irs.gov/taxstats/charitablestats/article/0,,id=97186,00.html>

Option 2: Use a Third-Party Database to Check Status

On June 30, 2009, the Internal Revenue Service (IRS) issued an official revenue procedure stating that private foundations, as well as sponsoring organizations that maintain donor-advised funds, may rely on third parties—such as GuideStar’s Charity Check, a fee-based service that is more accessible than the IRS’s EOMF—for determining whether a 501(c)(3) organization is further classified under section 509(a)(1), (2), or (3) under the Internal Revenue Code.

Simply store the following information electronically:

- Prospective Grantee’s name
- Employer Identification Number
- Public charity classification under section 509(a)(1), (2), or (3)
- Statement that the information is from the most currently available IRS monthly update to the Business Master File (BMF), along with the IRS BMF revision date
- Date and time of your search

Most grants management programs have standard fields for capturing this information and some can even perform this check and documentation automatically.

Option 3: Call the IRS

You may also call the IRS directly at 1-877-829-5500 to check on a U.S. organization’s tax status. If you do so, document the call in your database.

Understanding Tax Exempt Status

There are four questions to answer when verifying the tax exempt status of a U.S. organization. Grants to non-US based organizations have different requirements. See page 19. This decision tree assumes that the grantmaker is a private foundation.

1. Is the organization determined to be an exempt organization under section 501(c) of the Internal Revenue Code?

NO

If the organization is not exempt or its application for exemption is pending, then a private foundation must exercise expenditure responsibility when making a grant to that organization.

YES

Move to next question.



2. Is the organization exempt under subsection 3 (a 501(c)(3) organization)? **NO**

If the organization is exempt under a section other than 501(c)(3), then a private foundation must exercise expenditure responsibility when making a grant to that organization.

 YES

Move to next question.

**3. Is the organization a public charity (a 509(a)(1) or 509(a)(2) organization)?** **NO**

If the organization is a private foundation, and so are you, then you must exercise expenditure responsibility when making a grant to that organization. If the organization is a supporting organization under 509(a)(3), a private foundation may also be required to exercise expenditure responsibility. Move to the next question.

 **YES**

You may fund the organization with no further restrictions or requirements.

4. Is the organization a Type III non-functionally integrated 509(a)(3) supporting organization? **NO**

The organization is a Type I, Type II, or Type III functionally integrated supporting organization. A private foundation may fund the organization with no special contingencies or procedures, provided the private foundation does not control the supporting organization.

 YES

A private foundation may fund the organization using expenditure responsibility, but the grant will not count toward the foundation's minimum distribution ("payout") requirement. See the next section of this report for detailed information about this.

Basic Legal Due Diligence Requirements⁷

This section lays out the basic legal requirements governing grantmaking by private foundations to six types of organizations within the United States and organizations outside the U.S. (We focus here on private foundations because the legal requirements governing grantmaking by public charities and corporate giving programs are minimal in comparison.) For more information, please subscribe to the *GM Guide*. It can be accessed on the Grants Managers Network website at www.gmnetwork.org.

MAKING GRANTS TO U.S. ORGANIZATIONS

1. U.S. public charities
2. U.S. government entities and instrumentalities
3. Supporting organizations
4. Private foundations and private operating foundations
5. Domestic non-charities
6. New entities pending an IRS ruling

1. U.S. Public Charities

Public Charities: 501(c)(3)—types 509(a)(1) and 509(a)(2)

Bottom Line on Due Diligence Required for U.S. Publicly Supported 501(c)(3) Charities

⇒ Verify current ruling under section 509(a)(1) or 509(a)(2)

Much of U.S. foundation grantmaking is to 501(c)(3) public charities, including universities and other educational institutions. Minimal due diligence is required. In fact, a funder may make a grant to an organization without doing any due diligence beyond determining if it has a ruling under Section 501(c)(3) and is further classified as one of two types of 501(c)(3) organizations:

- 509(a)(1): schools, hospitals, churches, and other organizations that receive their public support primarily from gifts, grants and contributions from a broad group of people.
- 509(a)(2): organizations that receive their support from a combination of gifts, grants and contributions and fees for their exempt services (e.g., museums, symphonies, etc.).

Both supporting organizations and private foundations are also included under section 501(c)(3). Because the due diligence for grants to these types of charities is more complex, each is covered separately in a later section.

Once you have verified that an organization has a current ruling under Section 501(c)(3) and Section 509(a)(1) or (2), the IRS doesn't require any special due diligence, and you may make general support grants with no restrictions. Again, nothing specific is required here, so we recommend obtaining only as much information as you need to feel comfortable that the grantee is in fact a public charity.

IRS DETERMINATION LETTERS

An IRS letter can be used to confirm exempt status, but only if it hasn't been revoked. You'll need to determine if the letter is still valid. To avoid multiple steps, skip the letter altogether and go straight to the IRS publication 78 or a third-party site that is kept up-to-date.

7. Please note this information is not a substitute for expert legal, tax, or other professional advice and may not be relied upon as legal or tax advice.

Depending on the grantee, however, additional due diligence may be prudent to guard against the risk of diversion of your funds to support terrorism. See information about Anti-Terrorist Financing Laws on page 22. Further, grants for specific projects that include lobbying or other regulated activity require additional due diligence and grant restrictions.

If your organization's grantmaking is limited to general support grants to either 509(a)(1) or (2) organizations, then you don't need to read any further. If your grantmaking extends to other types of grants or organizations, such as for specific projects or to U.S. non-charities or outside the U.S., then read on.

2. U.S. Government Entities and Instrumentalities

Bottom Line on Due Diligence Required for U.S. Government Entities or Instrumentalities

- ⇒ Verify status as government entity/instrumentality through
 - government affirmation letter,
 - review of legislative act creating the entity, or
 - letter from authorized government official.
- ⇒ Confirm that grant will be used for charitable and "exclusively public" purposes.

A government entity or instrumentality is defined as a state, a possession of the United States, or a political subdivision of either, or the United States itself, or the District of Columbia.

Government entities and instrumentalities are classified under Section 509(a)(1) and 170(b)(1)(A)(v) of the Code. Unlike public charities, they generally don't receive rulings from the IRS as to their status, and they are not listed in Publication 78.

As a grantmaker, you are not required to receive or include in your files any specific documentation regarding an entity's status as a government entity or instrumentality. In some cases, it may be so obvious that no documentation is needed. For example, if you were to fund a city's health department for a project on child immunization, you'd have very little question about the status of your grantee. In other cases, it's harder to tell if the organization is really a government entity. In those cases, to be certain that you are funding the entity properly, you will want to verify its status.

The grantseeker may seek—or may already have on file—a "government affirmation letter" from the IRS. In the absence of such a letter, and if you don't wish to ask the prospective grantee to obtain one, you could review the legislative act creating the entity or ask for a letter from an authorized government official confirming its status. *Again, nothing specific is required here, so we recommend obtaining only as much information as you need to feel comfortable that the grantee is in fact a government entity or instrumentality.*

Having confirmed the proper grant recipient and its status, remember that the grant must be given for charitable and "exclusively public purposes." These purposes include things like promoting economic development, constructing a public parking lot, or furnishing new facilities to railroads⁸. Most grants to governmental units will qualify as being for charitable (as well as public) purposes."⁹

3. 509(a)(3) “Supporting Organizations”

Bottom Line on Due Diligence Required for U.S. Government Entities or Instrumentalities

- ⇒ Step 1: Verify current ruling under section 509(a)(3)
- ⇒ Step 2: Determine type of supporting organization
 - Type I
 - Type II
 - Type III functionally integrated
 - Type III non-functionally integrated (these grants can't be a qualifying distribution and require expenditure responsibility to avoid being a taxable expenditure)
- ⇒ Step 3: Verify that neither the grantee nor its supported organization(s) are controlled, directly or indirectly, by disqualified persons (other than foundation managers) with respect to the grantee

Once upon a time, supporting organizations were treated like any other public charity. The Pension Protection Act of 2006 changed that, adding a set of restrictions that require an additional layer of due diligence for some supporting organizations.

A supporting organization is a 501(c)(3) organization that gets its public charity status by virtue of its support of another public charity. More specifically, a supporting organization is one that 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. Examples include certain hospital foundations, university foundations, and “Friends of..” organizations. Based on the relationship of the supporting organization to the public charity it supports, a supporting organization will be classified as Type I, II or III. Type III supporting organizations are further classified as “functionally integrated” or “non-functionally integrated.”

All this is important to grantmakers because your legal responsibilities depend on the type of supporting organization you're funding. Accordingly, you must follow three steps just to determine whether or not the supporting organization is covered by the Pension Protection Act rules:

1. Confirm the organization's status as a 509(a)(3) supporting organization
2. Determine what type of supporting organization the grantseeker is
3. Verify that certain insiders of the grantseeker don't improperly control the charity that the organization supports

Each of these steps is described in detail below.

Step 1: Confirm the organization's status as a 509(a)(3) supporting organization. First, you need to understand if you're dealing with a supporting organization. In Notice 2006-109,¹⁰ the IRS issued guidance on how to identify public charities that are supporting organizations. To determine whether a public charity is a supporting organization, you may rely on information from either of these sources:

- the IRS's Business Master File (BMF)
- the grantee's IRS determination letter

In a subsequent notice,¹¹ the IRS clarified that you may instead use a third party to obtain information from the IRS's BMF to determine whether or not a charity is a supporting organization, provided that the report includes all of 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 funder's search.

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

Step 2: Determine what type of supporting organization the grantseeker is. IRS guidance permits you to rely on a reasoned written opinion of your own or the grantee's counsel to determine that a supporting organization is a Type I, Type II, or functionally integrated Type III supporting organization. Many supporting organizations are familiar with these procedures, so ask the grantseeker if it already has such an opinion on file and, if so, confirm that it remains accurate.

Types of Supporting Organizations

A **Type I** supporting organization is one that is operated, supervised, or controlled by one or more section 509(a)(1) or 509(a)(2) organizations. It is generally described as being in a parent-child relationship with its supported organization(s).

A **Type II** supporting organization is one that is supervised or controlled in connection with one or more section 509(a)(1) or 509(a)(2) organizations. It is generally described as being in a brother-sister relationship, and it typically has 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.

A **Type III** supporting organization is one that is operated in connection with one or more section 509(a)(1) or 509(a)(2) organizations. It generally operates more independently from its supported organization(s) than the other types of supporting organization. A "functionally integrated" Type III supporting organization is one that is not required under the regulations governing supporting organizations to make payments to its supported organization(s), because the activities of the organization are related to performing the functions, or carrying out the purposes, of such supported organizations.

In the absence of an existing opinion of legal counsel, and if you prefer not to incur the costs of obtaining one or asking the grantseeker to obtain one, you may follow these procedures, summarized from IRS Notice 2006-109:

To determine that an organization is a Type I or II supporting organization, you may rely on a written representation signed by an officer, director, or trustee of the grantee, if

- 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; and
- you collect and review copies of the grantee's governing documents. If the grantee's organizing documents are not sufficient to establish the relationship, you must also collect organizing documents from the supported organization.

11. March 27, 2007

To determine that an organization is a Type III functionally integrated supporting organization, you may rely on a written representation signed by an officer, director, or trustee of the grantee, if

- the written representation identifies the organizations it supports;
- you collect and review the grantee's organizing documents (and those of the supported organizations, if necessary) to confirm what is in the written representation; and
- you also collect and review 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.

If you can't determine to your satisfaction that the grantee is a Type I, Type II, or Type III functionally integrated supporting organization, you should treat it as Type III non-functionally integrated supporting organization. Grants to such entities are not qualifying distributions. If you choose to make the grant even though it's not a qualifying distribution, you must exercise expenditure responsibility so that it will not be a taxable expenditure¹².

Step 3: Verify that disqualified persons of the grantseeker organization do not improperly control the charity that it supports. To do this, you should obtain a list of the organizations that are supported by your prospective grantee. An organization is controlled if disqualified persons can, by aggregating their votes or positions of authority, require the supported organization to make, or refrain from making, an expenditure.

4. Private Foundations and Private Operating Foundations

Bottom Line on Due Diligence Required for Private Foundations and Private Operating Foundations

- ⇒ Verify current ruling under section 509(a)(3)
- ⇒ Follow the expenditure responsibility (E/R) Requirements (see page 17)
- ⇒ Observe the "out of corpus" rules if counting the grant toward payout

Funding charities beyond public charities—private operating foundations and private foundations, for example—requires more due diligence and documentation than funding a public charity.

1. You must verify that the organization has a current ruling under Internal Revenue Code Section 501(c)(3) and determine its status. As with public charities (see page 12), this information can be found in Publication 78, from an authorized secondary site, or from the organization's determination letter, unless you have knowledge that the prospective grantee's ruling has been revoked or that a revocation is imminent.
2. To fund a private operating foundation¹³ or a private (non-operating) foundation¹⁴, you are required to exercise "expenditure responsibility" or "E/R" for the grant. (See page 17 for a list of basic steps.)

12. IRS uses the definition of control found in the regulations under Section 4942 in deciding whether a private foundation disqualified person or a donor advisor (and related parties) controls a supporting organization or an organization that a supporting organization supports.

13. Defined in Section 4942(d)(2) of the Code. Generally a foundation that primarily conducts its own activities rather than making grants to others. It must spend at least 85% of its investment income directly for conducting its own programs.

14. Defined in Section 509 of the Code. The bulk of its expenditures are in the form of grants to other organizations; it does not exist primarily to operate its own programs.

3. To fund a private (non-operating) foundation, if you wish to have your grant funds count as a qualifying distribution, the grant must also satisfy the “out-of-corporus” requirement. Simply put, this means that your private foundation grantee must have met its own minimum distribution requirement and distributed the full amount of your grant funds within a specified period of time.

5. Domestic Non-Charities

Bottom Line on Due Diligence Required for Other U.S. Entities (Expenditure Responsibility)

- ⇒ Verify legal existence of entity (and exempt status if applicable)
- ⇒ Determine that project being funded is charitable
- ⇒ Follow the Expenditure Responsibility (E/R) Requirements (See below).

Believe it or not, a private foundation can give a grant to an organization that is not a charity. The grant must be for a discrete charitable project, and all funds must be used for that project. To ensure that charitable funds are used exactly the way they’re supposed to, the foundation making such a grant must exercise expenditure responsibility (E/R). Rules for expenditure responsibility are essentially the same whether the grantee is a non-profit or a for-profit.

Expenditure Responsibility (E/R)

As there are many excellent publications available on what it means to exercise E/R, this document will not cover expenditure responsibility in detail. E/R includes five basic steps:

- 1) Pre-grant inquiry
- 2) Written grant agreement
- 3) Grantee segregation of funds
- 4) Periodic reporting by grantee
- 5) 990-PF reporting

For each of these steps, the Treasury regulations specify the type of information the grantmaker should consider in determining whether the grant is an appropriate one to make and, if so, the documents needed to enter into and then oversee the grant agreement.

Conducting a pre-grant inquiry requires that you make a reasonable investigation of the grantee to ensure that it is capable of performing the charitable activity being funded. The pre-grant inquiry determines that the grant activities being funded qualify as a discrete charitable project and that funds won’t be used to support any non-charitable activities of the grantee. Some funders choose to have their counsel—internal or external—make a

determination of the charitable value of the proposed project by reviewing the proposal and budget. Many excellent publications and websites (such as *Expenditure Responsibility Step by Step*, by John Edie) go into great detail about the pre-grant inquiry, offering suggested templates and questionnaires. It’s worth noting, however, that many organizations go much further than is necessary in conducting a pre-grant inquiry. The standard is this:

[T]he foundation should conduct a *limited inquiry* concerning the potential grantee before the grant is made. The inquiry should deal with matters such as the identity, past history and experience, management, activities, and practices of the grantee organization, and *should be complete enough to give reasonable assurance that the grantee will use the grant for the purposes for which it is made*. The scope of the inquiry might be expected to vary from case to case depending on the size and purpose of the grant, the period over which it is to be paid, and the prior experience which the grantor has had with respect to the grantee.¹⁵ (Emphasis added.)

As the regulations note, the inquiry required will depend on the size, purpose, period, and entity receiving the grant.

15. <http://www.irs.gov/charities/foundations/article/0,,id=137614,00.html>

6. New Entities Pending IRS Ruling

This is one example where requesting a copy of an organization's determination letter may be appropriate. New entities not yet designated by the IRS will receive an exemption letter if they are eligible—and that letter may well be retroactive to a date before you made a grant—but it will take some time for the determination to be published on the IRS's Publication 78 or on an outside service. However, you should treat all “pending” charities as if they are not charities until they have a determination letter to share with you, or you've otherwise verified their exempt status. Accordingly, perform expenditure responsibility as you would for any other grant to a non-charity.

Making Grants Outside the U.S.

So far, the grantees discussed in this guide have all been organizations based in the United States. But some non-U.S. grantseekers are actually quite simple to fund.

1. Non-U.S. Organization with 501(c)(3) Ruling
2. International Organizations by Executive Order
3. Non-U.S. Government Entities or Instrumentalities
4. Other non-U.S. Entities

We encourage grantmakers funding organizations outside the U.S. to review Internal Revenue Code section 1441 and the regulations it encompasses if their non-U.S. grantees conduct some or all of their activities within the U.S. You can find an excellent summary of the topic at <http://www.usig.org/legal/1441.asp>.

1. Non-U.S. Organization with 501(c)(3) Ruling

Summary of Required Due Diligence: Non-U.S. Publicly-Supported 501(c)(3) Charities

⇒ Verify current ruling under section 509(a)(1) or 509(a)(2)

Organizations outside the U.S. may seek an IRS ruling as a 501(c)(3) charity. These organizations will not be in Publication 78, but you can verify their status through the IRS's Business Master File, or by receiving a copy of the organization's determination letter, provided that you have no reason to believe it has been revoked. *If the organization is classified as a public charity under Section 501(c)(3), organized under section 509(a)(1) or 509(a)(2), no further documentation or due diligence is required.*

2. International Organizations by Executive Order

Summary of Required Due Diligence: International Organizations by Executive Order

⇒ Verify that organization is on the list of such organizations

In 1946, President Harry S. Truman issued Executive Order 9698, in which he designated five entities to be "public international organizations entitled to enjoy the privileges, exemptions, and immunities conferred by the International Organizations Immunities Act." At the time, these entities were the Food and Agriculture Organization, the International Labor Organization, the Pan American Union, the United Nations, and the United National Relief and Rehabilitation Administration. (The status was later revoked for the Pan American Union and the UN Relief and Rehabilitation Administration.) He further charged the Secretary of State with considering potential additional entities to be given this status and submitting recommendations to the President. Since that time, many additional organizations have been added to the list.

As a funder, the only required due diligence with respect to these organizations is to verify that they are on the list of designated international organizations, which is maintained on the Federal Register site of the National Archives.¹⁶ Once that is done, no restrictions need to be placed on the grant, and no additional documentation is required.

16. <http://www.archives.gov/federal-register/codification/executive-order/09698.html>

3. Non-U.S. Government Entities or Instrumentalities

Summary of Required Due Diligence: Non-U.S. Government Entities

- ⇒ File correspondence or materials used to verify that the entity is a government entity or instrumentality.

Funders may fund non-U.S. government entities and instrumentalities. Government entities have “sovereign powers,” including the power to tax, the power of eminent domain, or police powers. Verifying an organization’s status as a government entity may be a relatively simple matter—it is not in question that the Ministry of Health of Tanzania is a part of the Tanzanian government. In that case, no documentation is required by the IRS. However, often an entity is not obviously a government entity. You need to be able to demonstrate the basis on which you determined the organization’s status by keeping a copy of your correspondence with the entity in your files.

Instrumentalities (e.g., government agencies such as transportation departments or government-operated research institutes) may be more difficult. While the tax code and regulations are silent about specific requirements, you should request and collect the information and documentation that you need to feel confident that they qualify, as you would with instrumentalities of domestic government. Whether the organization is in fact an instrumentality of a government depends on various factors, such as whether it:

- Is used for governmental purposes and performs government functions
- Functions on behalf of one or more political subdivisions
- Does not involve private interests in its operations
- Is controlled and supervised by a government entity
- Was created pursuant to a government entity’s exercise of statutory authority
- Is substantially supported by government funds

As with grants to domestic government entities, a grant to a government entity outside the U.S. must be for exclusively public purposes. If you collected materials to make this determination, keep a file of copies to document the basis on which you made your determination.

4. Other Non-U.S. Entities

If the entity does not have an IRS ruling or the status of an international organization, and is not a government entity or instrumentality, then what is it? As a funder faced with this type of mystery, you may proceed down one of two paths: make an equivalency determination (and treat the organization as the equivalent of a university, nonprofit, or other entity) or fund a discrete charitable project and exercise expenditure responsibility over the grant (in which case, type of entity does not matter).

Conducting an Equivalency Determination

Summary of Required Due Diligence: Other Non-U.S. Entities (Equivalency Determination)

- ⇒ Obtain equivalency affidavit and all required back-up documentation, and review—or use NGOsourceto establish equivalency (<http://www.techsoupglobal.org/ngosource>).
- ⇒ If a private foundation or private operating foundation equivalent, conduct pre-grant inquiry in accordance with E/R requirements

If you decide to conduct an equivalency determination—that is, to make a “good faith determination” that your prospective grantee is the equivalent of a 501(c)(3) organization—you will conduct a specific inquiry as part of your due diligence. The inquiry generally requires seeking an affidavit and supporting documentation from the grantee (all grantee documents must be in English), to determine whether the grantee has the same traits as a charity, as follows: it is organized and operated exclusively for charitable purposes; it conducts no more than an insubstantial amount of lobbying; its activities do not include intervening in political campaigns; there is no private inurement (other than reasonable compensation); it has no shareholders or proprietary interests; and its assets would be distributed to another charity on dissolution.

A repository of equivalency determinations, called NGOSource, has been developed. Information about this resource can be found at <http://www.techsoupglobal.org/ngosource>.

The IRS has provided a safe harbor for obtaining a satisfactory affidavit in Revenue Procedure 92-94.¹⁷ Due diligence includes, in this case, obtaining from the grantee and reviewing the documents required for the equivalency determination. This will include a support schedule (five years of financials) to calculate if the entity meets the public support test—meaning that it receives substantial support from the general public.¹⁸ On the basis of the documentation, you may find the grantee to be the equivalent of a public charity, a private operating foundation, or a private (non-operating) foundation, each requiring the same restrictions outlined above.

Expenditure Responsibility – Providing a Project Grant

Summary of Required Due Diligence: Other Non-U.S. Entities (E/R Project Grant)

- ⇒ Verify legal existence of entity
- ⇒ Determine that project being funded is charitable
- ⇒ Follow the Expenditure Responsibility (E/R) Requirements (see page 17)

As with a grant to a U.S. non-charity, the primary inquiries in this case are (1) to ensure that the specific project being funded is charitable, and (2) to conduct a pre-grant inquiry in accordance with the requirements of making an E/R grant. See the box on page 17 for a brief description of the requirements for exercising expenditure responsibility.

To ensure that you are funding a legal entity and contracting with the right organization, you’ll want to confirm the organization’s legal existence through a copy of its registration or articles of incorporation.

17. Rev. Proc. 92-94, 1992-1 C.B. 507

18. See The Foundation Center’s description of public support test at http://foundationcenter.org/getstarted/faqs/html/pub_sup_test.html

A Word on Due Diligence to Comply with Anti-Terrorist Financing Laws

Executive Order 13224 and the Global Terrorism Sanctions Regulations prohibit transactions by U.S. persons with persons who commit, threaten to commit, or support terrorism. A list of known or suspected terrorists under the Executive Order, known as the Specially Designated Nationals (SDN) List, is available at the Office of Foreign Assets Control's website.¹⁹

This rule is not unique to grantmakers, as it applies equally to all U.S. persons. It also applies to all kinds of support, including financial, technical, or humanitarian assistance through charitable activities.

This set of rules prompted considerable speculation among charities about what due diligence is required. In response, the Treasury Department issued voluntary guidelines²⁰ which, as their name states, are not mandatory, nor do they provide a safe harbor. The philanthropic sector, in turn, responded to the

guidelines and published the Principles of International Charity in March 2005. The Principles were drawn up by representatives of more than 40 charitable sector organizations, including the Council on Foundations (the working group coordinator), Independent Sector, InterAction, and Grantmakers Without Borders, as an alternative to the U.S. Treasury Department's Voluntary Anti-Terrorist Guidelines.

The only way to avoid giving to someone on the SDN list is to verify that anyone you make payment to is not on the SDN list. During your pre-grant inquiry, and again before making further payments, verify that your payees are not on the SDN list and monitor the progress of your grants with reasonable frequency (generally annually). You should have enough information to reasonably expect that your prospective grantee will carry out the charitable purpose for which the funds are intended.

19. <http://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx>

20. <http://www.treasury.gov/resource-center/terrorist-illicit-finance/Pages/protecting-charities-intro.aspx>

Selected Resources on Conducting Due Diligence

General:

GM Guide. This comprehensive grants management resources developed by the Grants Managers' Network is available online with a subscription at www.gmnetwork.org.

The Due Diligence Tool, Grantmakers for Effective Organizations.

<http://www.geofunders.org/publications.aspx>

GuideStar's Charity Check – a resource for determining 501(c)(3) tax status: www.guidestar.org

Expenditure Responsibility:

Expenditure Responsibility Step by Step, by John A. Edie, The Council on Foundations, 2002.

International grantmaking:

Equivalency or Expenditure Responsibility? A Guide in Plain English By Betsy Buchalter Adler and Stephanie L. Petit. International Dateline, Issue 73, 2005. A publication of the Council on Foundations. http://www.adlercolvin.com/pdf/private_foundations/Equivalency.pdf.

Beyond Our Borders, A Guide to Making Grants Outside the United States, by John A. Edie and Jane C. Nober, The Council on Foundations, 2002

United States International Grantmaking (USIG) is a project of the [Council on Foundations](http://www.cofoundations.org) in partnership with the [International Center for Not-For-Profit Law](http://www.icnl.org). The USIG project facilitates effective and responsible international grantmaking by U.S. foundations. www.usig.org

The International Center for Not-for-Profit Law: ICNL is the leading source for information on the legal environment for civil society and public participation. Since 1992, ICNL has served as a resource to civil society leaders, government officials, and the donor community in over 100 countries. www.icnl.org

NGOsource: an Equivalency Determination repository. NGOsource, a project of the Council on Foundations and TechSoup Global, has been designed to be an equivalency determination information repository (EDIR) service to help U.S. grantmakers streamline their international grantmaking procedures. <http://www.techsoupglobal.org/ngosource>



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