

Best Practices: Expenditure Responsibility

Host: Ted Hart

Guest: Michael Durham - Caplin & Drysdale

Announcer: Welcome to the *CAF America Radio Network*, a production of the Charities Aid Foundation of America. As the leader in global giving CAF America offers more than 20 years of experience and expertise to corporations, foundations and individuals who wish to give internationally and with enhanced due diligence in the United States. Through its industry leading grants management programs and philanthropic advisory services, CAF America helps donors amplify their impact.

This show is dedicated to these donors and the charities they support. CAF America is uniquely positioned to serve as the bridge between these important partners and transforms vision into meaningful action. Guests on a *CAF America Radio Network* are leaders in their field who share tips for success and stories that inspire. Our host is Ted Hart, the CEO of the Charities Aid Foundation of America. This is a live call in show, add your voice by calling 914-338-0855, after the show you can find all of our podcasts at cafamerica.org.

Don't forget to dial 914-338-0855. Now, welcome the host of the *CAF America Radio Network* Ted Hart.

Ted: Welcome to the latest edition of the *CAF America Radio Network*. This is Ted Hart and I'm coming to you live from the national headquarters of the Charities Aid Foundation of America, also known as CAF America. Our guest here today is Michael Durham, Michael is a member of the firm Caplin & Drysdale, he has been a member there since 2011. He has advised a wide range of clients, including some of the nation's largest private foundations, large museums, hospitals, and high technology nonprofits.

A variety of newly formed organizations and donors wishing to structure their gifts to maximize tax savings. He has particular experience advising 501c3 and 501c4 organizations on running high profile advocacy campaigns. His second major area focuses international grant making and the taxation of cross border donations, both under US domestic law and under country specific treaties. This is the reason why we've invited Mr. Durham here as our guest here on the CAF America radio network.

Our topic here today is expenditure responsibility and due diligence. Welcome here to the CAF America radio network, Michael Durham.

Michael: Thanks, Ted, glad to be on the show.

Ted: It's great to have you here today. We've got so many things that we want to learn from you and make sure that our listeners here today are able to understand about the complexities of expenditure responsibility. Let's start off with where in the IRS regulations does this come from?

Michael: Ted, it all goes back to 1969 when Congress decided it needed stricter regulations for private foundation grant making, they wanted-- They recognized that many times the foundation is just making a grant to a US public charity and there's not-- they want that to be easy but when foundations made grants to other organizations that did not have IRS recognition of their exempt status or other private foundations. The IRS thought they wanted foundations to have a little bit more responsibility for making sure the money was used right.

In the regulations governing private foundations, they promulgated first statute and then treasury followed with some detailed regulations about the kinds of due diligence that these grants to nonpublic charities or to foreign organizations without public charity rulings would have to satisfy. That has really served as a model which has set the standard for due diligence more generally. [crosstalk]

Ted: That's the crux of the issue, isn't it? Is making sure that the due diligence process is done at a very high level, which is partly the reason that so many of our clients here CAF America choose to work with CAF America, because we have the most robust pre-vetting and due diligence process in the industry. What is due diligence?

Michael: One the expenditure responsibility context, there are really three different phases, I guess you could say. In the first part, due diligence means getting to know the grantee, having enough background about the grantee to be reasonably assured that the grantee will, in fact, be able to accomplish the charitable purpose of the grant. That might vary from case to case in terms of what is really required. One of the things that IRS thinks is one of the best facts to have when you go to make grant is prior experience with the grantee.

That's one thing that intermediaries like CAF America can offer because CAF America works with such a large number of institutions and has experience with working with so many different grantees. When it goes to make another grant to a grantee, it's not just having to start from scratch, but actually already has experience, knows that they've successfully used funds in the past. [crosstalk]

Ted: To the fact that the CAF America has over 20 years of experience, and currently has the largest pre-vetted list of international charities anywhere in the country, thousands of pre-vetted charities. That's key to meeting the first standard of the due diligence process is working with someone who has that experience.

Michael: Then moving on, the other standards are very specific requirements and the Treasury Department has been strict at various points in requiring perfect compliance with this. For instance, there are specific provisions that need to be in the grant agreement, these can be very technical, there are also very specific provisions for the kind of reports back that charity needs to receive. For many international grant makers, particularly they may have only-- They may be functioning with volunteer staff or for other reasons, they may just not be comfortable complying with all these procedures, which for an organization like CAF America that does this day in and day out, have really become routine.

The big problem with expenditure responsibility grant is that if you make even a foot fault, there are cases where the IRS has imposed the penalty of 20% of the grant amount, which can be a substantial liability for somebody to take on if they're not experienced in the realm of international philanthropy.

Ted: Exactly, and all the more reason to work with CAF America, because, of course, we take on that liability when we are making the grant as advised through a donor-advised fund. I want to get on to the third point here, but these regulations do apply to donor-advised funds, do they not?

Michael: That's correct, that was a change in 2006, the IRS recognized that the donor-advised funds were functioning as grant makers similar to private foundations at the time when the expenditure responsibility rules were first enacted. They extended those rules to donor-advised funds, made it very clear that-- in particular in the foreign grant making context, they expected the rules to work similarly to the way the rules have worked in the private foundation context for the last several decades.

Ted: Of course, those are assurances that working with CAF America, each of the donors who advise, gives through CAF America can count on the fact that those very technical details of the second level of due diligence are being adhered to. What is the third level?

Michael: The third level, after you've got your agreements and your reporting in place, the third level is, analyzing those reports, making sure that there are no diversions and taking proper steps if there is any indication that funds have been used improperly. It also includes keeping records for private foundations, they need to engage in quite detailed reporting to the IRS on each individual expenditure responsibility grant for donor-advised funds like CAF America there is not yet a place on the Form 990 to require that reporting to the IRS, but donor-advised funds have been asked informally to keep that material available for the IRS in their private files.

Ted: The bottom line when you look at all of those, all three levels, and each of them are absolutely required and must be done, we're talking about precision here. We're talking about an organization like CAF America providing the precise details and record keeping, but also it's the expertise of knowing the difference between what you are seeing in the documentation and in the reporting, versus someone who may not know what they're seeing.

Michael: That's right, because I would say that the general principle behind expenditure responsibility is a very practical one, that you want people with the proper expertise reviewing the materials to make sure that the funds are really going to the purposes that they were intended to go for. That's something that-- put aside IRS regulations, that's important to every donor. What then expenditure responsibility adds is a very particular way, with particular schedules for reports that you need to do that in order to be sure that you don't accrue any IRS penalties.

Ted: Now, when you're talking about reporting, that is an integral part of what CAF America provides to its donors and making sure that that third level of reporting for IRS regulations is

compliant too, what exactly are you talking about in terms of what the IRS is looking for? Is that reporting related back to the original grant?

Michael: Yes, that's right. I think that the tendency and what the expenditure responsibility rules were designed to replace, was one where there would be a certain amount of care given before the funds were distributed, but then after that the grant maker or intermediary wasn't really paying much attention to what actually happened after the grantee received a check. Expenditure responsibility includes a hefty, maybe the most important part is actually looking back, monitoring to make sure the funds were used as they were originally agreed.

If not, taking steps to assert the rights of the donor or the intermediary, to make sure that any diversions are corrected.

Ted: How can grant makers get themselves into trouble, when they're looking at the high level of scrutiny and also precision that it takes to appropriately make an international grant?

Michael: The kind of things that have been subject of court cases are instances where a grant was made, perhaps the second installment on the grant was made when report was overdue. As a result, that's just a plain violation under the regulations. The IRS wants to make sure that our reports have been received and are satisfactory before continuing payments are made. That kind of slip up, just not having the right internal procedures to track whether all the necessary reports have been received, that can lead to penalties.

You often end up in circumstances where a grant maker may just not know the ropes, so they receive information from a grantee, perhaps the grantee says, "Yes, we are a non-profit." So the grant maker doesn't realize that that's not good enough, to get out of the expenditure responsibility rules and so just does whatever they think is reasonable in terms of due diligence, but aren't looking at the specific requirements.

Another really common feature, for instance, is to have provisions missing in the core legal agreement, which honestly sometimes would be very unlikely to make a practical difference in terms of what the grantee does, but there is just a list of things that needs to be in the grant agreement. If not, the grant maker can be subject to that 20% of the grant penalty. That's one --

Ted: Of course when you're trying to maximize the impact of your philanthropic dollars, limited philanthropic dollars, you don't want to leave yourself open to having to pay a part of those funds to a penalty.

Michael: Well, that's right. This is an area where I really wish that the statute had given the IRS more room to maneuver, because you might think in other areas there is room to impose a much more minor penalty, in the case of just a minor foot fault or a little bit of delay in getting a required report. In this area, it's really kind of this 20% of the grant payment, which if it's a big grant, it can be a very large penalty for a fairly minor infraction.

Ted: Again, we come back to this notion of precision, of working with a group that like CAF America that knows how to do this, does this everyday and does it to protect the interest

donors, but also to make sure that the funds are flowing to the charity and being used appropriately. Michael, we're going to take a quick little station break and when we come back from that station break, I do want to get into why someone might use an intermediary like the CAF America, to fulfill all these requirements. We'll be right back after the break.

Announcer: Remember our podcasts and our archives are always available 24 hours a day at cafamerica.org. If you are listening today, our phone lines are open. Call in and ask a question by dialing 914-338-0855. Now, back to the *CAF America Radio Network* at our host Ted Hart.

Ted: Before we head back with Michael Durham who is our guest here on the *CAF America Radio Network*, I did want to just make a note for all of our listeners that you will be able to find and visit with CAF America at the Grant Managers Network Conference March 18th through the 20th at St. Petersburg, Florida. We will also be a vendor at the Council on Foundations Conference in Chicago April 7th through 9th. I hope that you will either give us a call here at the office, 703-549-8931 or email me directly at Ted Hart, that's T-E-D H-A-R-T. @cafamerica.org. That's C-A-F. As in Frank, America.org. If you are going to be attending one of those conferences, We certainly want to get a chance to meet you and spend time with you at either one of those conferences. Now we're going to head right back over with Michael Durham. Michael, we're back from the break here. I did want to again thank you for being on the show today and make sure that all of our listeners know it.

The announcer just reminded them that this is a call in show and you can call and ask your question at 914-338-0855. You also can join us in the chat room and I see a number of folks over in the chat room. You can type out your questions there if you would like for our guest Michael Durham. Michael, why would someone use an intermediary like CAF America to fulfill all of these requirements that the IRS has put forward?

Michael: Well, there are two different ways that you might use such an intermediary. The simplest one perhaps is to make a grant to a CAF America donor-advised fund or similar account, where the -- from the IRS' perspective the foundation is then making a grant to a US public charity, which as I mentioned earlier was always designed to be easier and was thought by the IRS to be lower risk. So that then the expenditure responsibility requirements don't apply at all to the foundation making the grant to CAF America donor-advised fund.

CAF America then shoulders the responsibility for being able to demonstrate that this is properly complied if in IRS audit of CAF America. That is the simple way that makes it so the expenditure responsibility is not the donor foundation's problem at all and the donor foundation is a -- it doesn't therefore have to get familiar with all of the complicated procedures, it doesn't have to have the internal protocols to make sure that they're complied with.

Ted: Nor are they required to keep all the paperwork that CAF America would then be keeping, to make sure that the file for that grant and the reporting for that grant is precise.

Michael: Yes, exactly. That can be a lot of paperwork and it needs to be kept in proper order, because it is something that the IRS can look at when it audits organizations periodically. The other thing, I think increasingly, we're seeing some grant makers saying, "Well, no. For whatever reason, we may not want to use a donor-advised fund. We're still going to make this grant directly, but we'd like some expert help with the due diligence process."

In that case, the organization is still responsible for reporting the grant correctly on its Form 990 and it's ultimately responsible to make sure the expenditure responsibility is complied with. Their main role, that an intermediary like CAF America is serving, is providing consultant services that make sure that the grant meets all the requirements, that the due diligence has been performed properly.

The grant maker then can rely on the fact that they have not just asked whatever set of questions they happened to think might be relevant, but they have an experienced partner who has used its general vetting process, which is quite thorough to look at this organization and has determined that it is indeed an appropriate recipient of a grant.

Ted: You're able to, in both instances, gain the experience of an organization like CAF America, which is then involved heavily and actively in international grant-making for more than 20 years. You're able to then benefit from that kind of expertise and the protocol that backs that up in the detailed precision in the grant-making process. You're able to as the donor be able to focus on what arguably you probably want to focus on and that's being philanthropic.

Michael: That's right. I also think-- I've been talking a lot about the technicalities of expenditure responsibility, which is in my experience something that many donors don't want to have to confront. I also think that that's not all that an intermediary like CAF America can add. Because certainly, sensitivity to the area, the kind of experience that comes from dealing with many different grants and projects year-round in many different places in the world. I think that you can also get valuable subsequent feedback and there are things that might not raise red flags to one observer, which might raise red flags to somebody who has looked at grants in the region for some time.

Nobody wants a situation where money has been taken and then used ineffectively or used for purposes other than were intended. To have somebody who is an experienced player in a particular jurisdiction can be really valuable.

Ted: Exactly. All the more reason to look for an organization like CAF America that has global reach and global experience because something learned in one part of the world may certainly be valuable but there may be lessons to be learned and best practices to be garnered from other parts of the world and really only a truly global perspective can you hope to really be truly successful on international grant making.

Michael: I think just as maybe a couple of examples of that. You can have specific legal challenges quite apart from the expenditure responsibility rules. For instance, we're seeing a lot of interest in giving to India and there are specific restrictions under Indian law

with grantees

receiving grant funds from outside of India. That's an example of something that an organization like CAF America has had to become familiar with. Even if you were very diligent grant maker just trying to follow all the rules propagated by the Internal Revenue Service, you might just not be aware of that and so it would be easy to make a foot fault.

Ted: Right, and a good opportunity to mention the fact that CAF America's office is part of the CAF alliance, which is in an international alliance of Charities Aid Foundations around the world. One of which, as you were just mentioning there, the particular complexities in India, but also complexities in Russia, South Africa, Australia, Singapore, and other parts of the world where we have an office in those countries, and so we're able to help streamline the process and have a greater degree of knowledge of how you can be philanthropic in those countries and make sure that, as you were just mentioning, make sure that you're in compliance with local laws in addition to the IRS regulations.

Michael: One additional layer I think is worth mentioning here. Since the time when the expenditure responsibility rules were originally enacted, we had the transformational moment of 9/11 back in 2001 and since then, the IRS and other agencies of the US government have become more and more worried, particularly about the chances of diversion to terrorism or to terrorist-related entities. They have promulgated a series of additional due diligence practices that they feel should be part of responsible grant making, recognizing that there is no one set of procedures that will work for every entity. That's another kind of thing that can be hard for a foundation that is not well established in the international grant making space to set up and be sure that they've got right.

Another place where there is a real benefit to the economies of scale that grant maker like CAF America has, which has routinized procedures for checking the names of the grantees and so forth, so that you can be sure that there's not an accidental violation where there is some connection to a person who might be on a list or might appear to be on a list of--
[crosstalk]

Ted: Exactly. It's so important here in CAF America, as you know, Michael, that everyone who serves on the board of directors and the administrative team for each and every charity to make sure that there are no violations of patriot act and terrorist watch list, but also money laundering and other important factors that would lead to good, or not well advised grant making.

Michael: I think that's so valuable. I have seen advising some particularly smaller foundations that are trying to do this on their own. It is something that when you have the right software, you can actually do it quite efficiently, but if you were just on your own trying to use the Treasury's website and check these names by hand, it can be very, very time consuming and complicated.

Ted: Michael, it's always amazing to me how fast this time goes. I can't thank you enough for being involved today. We do have an email question and I know there's an awful lot that has been written about equivalency determination being one of the IRS protocols versus

expenditure responsibility. I was wondering if you might just speak to the benefits and comparison between those two very quickly the next two minutes before we end the show.

Michael: Sure. As I mentioned, expenditure responsibility has always been the required to the procedures for organizations that are not so-called public charities. Those are certain kinds of public charities that get support from the public or are accountable to the public, universities, hospitals. Other broadly-- the Redcross, other broadly funded organizations. It is possible to look at all. Make sure that the foreign organization meets all of the legal requirements to be a US public charity, in which case, the technically precise requirements of expenditure responsibility don't apply. However, even then, you still end up needing to do a lot of it because the IRS still wants to see that the US funder is using the funds appropriately and that it is not just passing money off to be used for whatever purpose but has specifically reviewed how the foreign organization is going to use the funds.

Ted: That's the issue of equivalency determination. CAF America has created a specific website known as ngoamerica.org specifically on this topic. Michael, we hope to have you back here on the show to delve into these topics again. You've done an absolutely outstanding job, but it is my job as host to make sure that we end on time. We've been today with Michael Durham, a member of Caplin & Drysdale law firm in Washington, DC. I want to thank you for being our guest today here on the *CAF America Radio Network*.

Michael: Thanks very much, Ted.

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