The IRS issued final regulations regarding the standards to be followed for making a good faith determination that a foreign organization grantee operates and is the equivalent to a U.S. publicly funded charitable organization that is not a private foundation, which allows grants made by U.S. private foundations to such foreign organization grantees to be treated as qualifying distributions and not taxable expenditures. By providing these rules, the government has provided the private foundation community opportunities to lower internal compliance costs and free up valuable personnel resource time focused on expenditure responsibility tasks.

Background
To avoid certain excise taxes under chapter 42 of the Internal Revenue Code (“Code”), a private foundation (referred to in this white paper as a foundation or grantor) must make a minimum level of qualifying distributions (as defined in section 4942) each year and must avoid making taxable expenditures (as defined in section 4945). Failure to comply with both of these requirements could subject the foundation to punitive excise taxes.
The regulations under section 4942 refer to distributing foundations making distributions to donee organizations, whereas the regulations under section 4945 refer to grantor foundations making or paying grants to grantee organizations. To provide clarity in the following explanations, our analysis refers to grantors making grants or distributions to grantee organizations, in reference to both of these very important Code sections.

Prior to final regulations, a foundation generally could treat grants made for charitable purposes to certain foreign organizations as qualifying distributions under section 4942 if the foundation made a good faith determination that the foreign organization was an organization described in:

- Sections 501(c)(3) and 509(a)(1), (a)(2) or (a)(3) (a public charity) that was not a disqualified supporting organization described in section 4942(g)(4)(A)(i) or (ii), or
- Sections 501(c)(3) and 4942(j)(3) (an operating foundation, also known as a private operating foundation).

Similarly, foundations could treat grants for charitable purposes to certain foreign organizations as other than taxable expenditures under section 4945 without having to exercise expenditure responsibility if the foundation made a good faith determination that the foreign organization was a public charity (other than a disqualified supporting organization) or was an operating foundation described in section 4940(d)(2) (an exempt operating foundation).

This good faith determination was commonly known as an equivalency determination.

In this white paper, a foreign grantee that is a public charity or operating foundation that may receive a qualifying distribution (or a grant for which expenditure responsibility is not required) is referred to as a qualifying public charity. The class of qualifying public charities for purposes of section 4945 is a slightly smaller subset of those for purposes of section 4942 (i.e., non-exempt operating foundations and certain disqualified supporting organizations may cause the foreign foundation grantor to still be required to exercise expenditure responsibility under section 4945 to avoid taxable expenditure treatments, even though such distributions may be treated as qualifying distributions for the purposes of a private foundation’s annual distribution requirement under section 4942).

For many years, regulations under sections 4942 and 4945 provided that a foundation would ordinarily be considered to have made a good faith determination if the determination was based on an affidavit of the grantee or on an opinion of legal counsel of either the grantor or the grantee. The affidavit or opinion was required to set forth sufficient facts concerning the operations and support of the grantee for the IRS to determine if the grantee would likely qualify as a public charity or an operating foundation under U.S. tax law governing charities. See Reg. sections 53.4942(a)–3(a)(6) and 53.4945–5(a)(5). This white paper refers to this rule, which gives assurance to foundations meeting the rule that their grants to foreign organizations will ordinarily be considered to be qualifying distributions and not taxable expenditures, as the special rule.

To provide foundations and their managers with additional guidance. Rev. Proc. 92–94, 1992–2 CB 507, provided a simplified procedure that foundations could follow for making good faith determinations under Reg. sections 53.4942(a)–3(a) (6) and 53.4945–5(a)(5), and similar reasonable judgments under Reg. section 53.4945–6(c)(2)(ii), that a foreign organization grantee was described in section 501(c)(3) (or in section 4947(a)(1), and thus could be treated under section 4947(a)(1) as described in section 501(c)(3) for purposes of chapter 42 of the Code).

Under the revenue procedure, if the grantor’s determination that a foreign organization was (1) described in section 501(c)(3) or section 4947(a)(1) of the Code, and (2) either a public charity or an operating foundation was based on a currently qualified affidavit prepared by the grantee containing the information specified in the revenue procedure, then the foundation was deemed to have made a good faith determination (for purposes of Reg. sections 53.4942(a)–3(a) (6) and 53.4945–5(a)(5)) and a reasonable judgment (for purposes of regulation section 53.4945–6(c)(2)(ii)). However, if the foundation had reason to believe the affidavit may not be reliable, the foundation and its management team were required to consider information in determining whether the affidavit it received was currently qualified. Said in another way, if the foundation knew or had reason to know that the statements made by the foreign grantee on its affidavit to the grantor foundation were false, neither the foundation nor its management could rely on such affidavit.

Rev. Proc. 92–94 provided that an affidavit would be considered valid and currently qualified if:

- The facts it contained reflected the grantee organization’s latest complete accounting year (or the affidavit was updated to reflect the grantee organization’s current data), and
- The relevant substantive requirements of sections 501(c)(3) and 4947(a)(1) and section 509(a)(1), (2) or (3) or section 4942(j)(3) remain unchanged.

If a foreign grantee’s status under the relevant Code sections was not dependent on financial support, which could change from year to year, an affidavit needed updating by the foreign grantee only with respect to the description of any facts in its original affidavit that may have changed. Therefore, if the facts were unchanged, an attested statement by the foreign grantee to that effect was enough to update an affidavit. However, if a foreign grantee’s status as a public charity or operating foundation depended on financial support, the affidavit required updating at least every other year, and the foreign grantee needed to provide an attested statement containing enough financial data to establish that it continued to meet the requirements of the applicable Code section under U.S. tax law governing charities.
The final equivalency and good faith determination regulations were in part based on proposed regulations that were issued on Sept. 24, 2012.

**Explanation of the final regulation provisions**

The final regulations balance two important considerations:

1. Removing barriers to international grant-making by foundations (as well as by entities treated like foundations for these purposes)
2. Ensuring that foundations' good faith determinations are informed by a sufficient understanding of the applicable law, are based on all relevant factual information and are likely to be correct

**Expanded class of advisors**

The final regulations modify the special rule to expand the class of advisors providing written advice on which foundations may ordinarily rely to qualified tax practitioners, including CPAs and enrolled agents (as well as attorneys) who are subject to the standards of practice before the IRS set out in Circular 230.

A qualified tax practitioner may include an attorney serving as a foundation’s in-house counsel, as well as a foundation’s outside counsel.

Because Circular 230 requires that, to practice before the IRS, an attorney or CPA must be licensed in a state, territory or possession of the United States, and an enrolled agent must be enrolled by the IRS, the final regulations effectively require that the qualified tax practitioner/advisor be authorized to practice in a state, territory or possession of the United States or as an enrolled agent.

In addition, the final regulations provide that a determination based on the written advice of a qualified tax practitioner ordinarily will be considered as made in good faith if the foundation’s reliance meets the requirements of Reg. section 1.6664-4(c)(1). Reg. section 1.6664-4(c)(1) provides that all pertinent facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on written advice, but a foundation’s reliance on written advice is not reasonable and in good faith if the foundation knows, or reasonably should have known, that a qualified tax practitioner lacks knowledge of the relevant aspects of U.S. tax law (which, in this context, would include the U.S. tax law governing charities).

Also, under this standard, a foundation (and its managers) may not rely on written advice if it knows, or has reason to know, that relevant facts were not disclosed to the qualified tax practitioner or that the written advice is based on a representation or assumption that the foundation or its management personnel have knowledge, or have reason to have the knowledge, that conclusions set forth in the written advice are unlikely to be true.

**Reliance on opinion of foreign counsel**

The final regulations provide that, for purposes of the special rule, if a foundation’s determination is based on the written advice of a qualified tax practitioner, the foundation will ordinarily be considered to have made a good faith determination. In developing these final regulations, one issue focused on by the IRS and the Treasury Department related to a foundation’s reliance on foreign counsel’s opinion regarding the U.S. tax-exempt status of the foreign organization that they represented. It was the government’s concern that these foreign practitioners may or may not have expertise in U.S. tax law governing charities.

Thus, under the final regulations, foundations basing their equivalency determination on an opinion of counsel of the grantor or foreign grantee will no longer come within the special rule unless the counsel is a qualified tax practitioner.

The standards of practice before the IRS and requirements for written advice address reliance by qualified tax practitioners on foreign counsel for questions of foreign law. In particular, sections 10.22(b), 10.35(a), and 10.37(b) of Circular 230 generally permit a practitioner to consult with and rely on other experts in appropriate circumstances. It follows, therefore, that a foundation and its managers may reasonably rely on written advice received from a qualified tax practitioner in accordance with Reg. section 1.6664-4(c)(1) that in turn reasonably relies on advice or assistance from foreign counsel as to questions of foreign law or other matters within such foreign counsel’s expertise.

**Reliance on foreign grantee affidavits**

Another problematic area addressed by the IRS and the Treasury Department in the final regulations relates to foreign grantee affidavits, which, standing alone, may not always provide as reliable a basis for making good faith determinations as written advice from qualified tax practitioners. The issue was that many foreign organizations may lack knowledge of the U.S. tax law governing charities. In addition, a foundation and/or its managers may also not possess the requisite knowledge to adequately apply U.S. tax law to foreign grantee affidavits in order to ensure that such affidavit was adequate in its stated facts in order for the foreign grantee to meet the U.S. standards for public charity status.

Therefore, under the final regulations, a foreign grantee affidavit is not included in the special rule as a basis upon which a determination ordinarily will be considered a good faith determination. The final regulations do not, however, foreclose the use of foreign grantee affidavits as a source of information in otherwise making a good faith determination. Nor does elimination of the affidavit for purposes of the special rule mean that the foundation must obtain written advice from a qualified tax practitioner in order to make a good faith determination. For example, a foundation manager with understanding of U.S. tax law governing charities may under the general rule make a
good faith determination that a foreign grantee is a qualifying public charity based on the information in an affidavit supplied by the foreign grantee. Furthermore, foundation managers or their in-house counsel may themselves be qualified tax practitioners, whose written advice may be reasonably relied upon for determinations under the special rule.

The fact of the matter is that under these final regulations, foreign grantee affidavits remain a cost-effective way of obtaining information relevant to making good faith determinations, and foundations and their managers may continue to rely on this information when making determinations to the extent reliance is reasonable and appropriate under the facts and circumstances.

To mitigate the effects of elimination of absolute reliance on grantee affidavits for purposes of the special rule, the final regulations provide a 90-day transition period similar to that set forth in Reg. section 53.4945–5(f)(2) (dealing with the implementation of the expenditure responsibility rules). During this 90-day period, foundations may distribute grants in accordance with the former regulations regarding the use of grantee affidavits and opinions of counsel of the grantor or grantee. In addition, under the final regulations, if a grant is distributed pursuant to a written commitment made prior to the applicability date of the final regulations and the grantor made a determination in good faith based on the prior regulations, the distribution is treated as compliant as long as the grant is paid out to the grantee within five years.

**Period for reliance on written advice**

For purposes of the special rule, written advice of a qualified tax practitioner serving as the basis for a good faith determination must be current. Written advice will be considered current if, as of the date of the distribution, the relevant law on which the advice was based has not changed since the date of the written advice and the factual information on which the advice was based is from the organization’s current or prior year. However, consistent with rules for determinations of public support over a five-year test period for U.S. public charities, written advice that an organization satisfied the public support requirements under section 170(b)(1)(A)(vi) or section 509(a)(2) based on support over a test period of five years will be treated as current for the two years of the grantee immediately following the end of the five-year test period. For purposes of these rules, an organization’s year refers to its taxable year for U.S. tax purposes, or its annual accounting period if it does not have a U.S. taxable year. The IRS has publicly stated it will provide additional guidance and examples illustrating the application of these rules in an update to Rev. Proc. 92–94.

It should be noted that the rules regarding when written advice will be considered current apply only for purposes of the special rule. Although this standard reflects a belief that it will usually be reasonable to rely on written advice of a qualified tax practitioner if the advice and underlying facts are no more than two years old (provided the foundation does not know or have reason to know that such information is no longer accurate), it is possible that written advice that is not current for purposes of the special rule may, under some facts and circumstances, reasonably serve as the basis for a good faith determination under the general rule. The age of the facts underlying the written advice would be a consideration in assessing whether a good faith determination has been made.

Qualified tax practitioners must, of course, satisfy all requirements for written advice under Circular 230 as of the date of issuance of the written advice (including requirements regarding the factual basis for the advice). The rules regarding when written advice will be considered current for purposes of making distributions to grantees do not alter the Circular 230 standards applicable to qualified tax practitioners, which provide that the practitioner must base the written advice on reasonable factual assumptions and reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know. To avoid any implication that the reliance period under the special rule would permit written advice to be based on outdated factual information, the final regulations clarify that the written advice must contain sufficient facts to permit the IRS to determine that the grantee would be likely to qualify as a public charity at the time the advice is written.

**Reliance on written advice shared by another foundation**

The final regulations do not prohibit a foundation from using written advice shared with it by another foundation in making a good faith determination if it is reasonable to do so under all the facts and circumstances (including the age of the facts supporting the written advice). However, the final regulations clarify that for a foundation seeking the benefit of the special rule, the written advice a foundation relies on in making its determination must be received from the qualified tax practitioner (rather than from another foundation).

**Equivalency determinations by sponsoring organizations of donor-advised funds**

Until further guidance is issued, sponsoring organizations of donor-advised funds may use these final regulations as they apply to private foundations as guidance in making equivalency determinations (applying the definition of disqualified supporting organization under section 4966(d) (4) in lieu of section 4942(g)(4)(A)(i) or (ii)). This is consistent with the Joint Committee on Taxation Technical Explanation of H.R. 4, the Pension Protection Act of 2006 (JCX–38–06, Aug. 3, 2006), at Page 349, which provides:

‘For purposes of the requirement that a distribution be ‘to’ an organization described in section 170(b)(1)(A), in general, it is intended that rules similar to the rules of Treasury regulation § 53.4945–5(a)(5) apply. Under such regulations, for purposes of determining whether a grant by a private foundation is ‘to’ an organization described in section 509(a)(1), (2), or (3) and so not a taxable expenditure under section 4945, a foreign organization that otherwise is not a section 509(a) (1), (2), or (3) organization is considered as such if the private foundation makes a good faith determination that the grantee...
is such an organization. Similarly, under the provision, if a sponsoring organization makes a good faith determination (under standards similar to those currently applicable for private foundations) that a distributee organization is an organization described in section 170(b)(1)(A) (other than a disqualified supporting organization), then a distribution to such organization is not considered a taxable distribution.

**Conclusion**

As a highly active grant-making private foundation, or a private foundation that infrequently provides foreign grantees with funding opportunities, these final regulations provide clarity in an area that at one time seemed easy enough, but potentially expensive to comply with. These final regulations provide clarity on a private foundation’s documentation requirements and allow for more cost-effective compliance due to the expansion of the definition of a qualified tax practitioner. The Treasury Department and the IRS believe that the final regulations will result in higher levels of compliance while allowing private foundations to avoid costly expenditure responsibility efforts. One conclusion you may arrive at after reading this white paper is that an investment in an equivalency opinion can and will save valuable management personnel hours and remove exposure to punitive excise taxes for failure to meet qualifying distribution requirements or being considered to have partaken into a grant arrangement considered a taxable expenditure. For more information related to equivalency opinions, please contact your tax professional.