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Outcome Based Philanthropy:
Thinking About and Measuring Impact in an Increasingly Complex World and Why it Matters

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Outcome Based Philanthropy: Tax Considerations

Primary Tax Considerations Include:

I. Legal Distinction Between Grants and Payments for Services
II. Certain Tax Aspects of Prize Programs
III. Private Benefit Doctrine
IV. Expenditure Responsibility
V. Treatment of Grant as Indebtedness

I. Distinction Between Grants and Payments for Services; Public Support Test Implications

a. As discussed in more detail below, ER applies to grants made to non-exempt organizations.

b. "Grants" are defined in §53.4945-4(a)(2), which provides that: "[f]or purposes of section 4945[1], the term 'grants' shall include, but is not limited to, such expenditures as scholarships, fellowships, internships, prizes and awards. Grants shall also include loans for purposes described in section 170(c)(2)(B) and 'program related investments' (such as investments in small businesses in central cities or in businesses which assist in neighborhood renovation.) Similarly, 'grants' include such expenditures as payments to exempt organizations to be used in furtherance of such recipient organizations' exempt purposes whether or not such payments are solicited by such recipient organizations."

c. In contrast, the regulation further provides that: "'grants' do not ordinarily include payments (including salaries, consultant's fees and reimbursement for travel expenses such as transportation, board, and lodging) to persons (regardless of whether such persons are individuals) for personal services in assisting a foundation in planning, evaluating or developing projects or areas of program activity by consulting, advising, or participating in conferences organized by the foundation." Treas. Reg. §53.4945-4(a)(2).

d. Therefore, the regulations make it clear that ER applies to grants but not to consultancies and similar payments for services.

e. The distinction between grants and payments for services (or amounts received by an organization as "gross receipts") is further elaborated upon in the regulations under Section 509.

f. Section 509(a) defines private foundations by excluding, among others, organizations that normally receive more than one-third of their support in each taxable year from any combination of gifts, grants, contributions or membership fees, and gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities to the extent such receipts do not exceed $5,000 or 1 percent of the organization's support in such taxable year. Section 509(a)(2)(A).

[1] All section references contained in this outline are to the Internal Revenue Code of 1986, as amended from time to time, and all references to Treas. Reg. sections are to the regulations promulgated thereunder.

g. Treas. Reg. §1.509(a)-3(g)(1) provides that in determining whether an organization normally receives more than one-third of its support from public sources, ". . . all 'grants' (within the meaning of section 509(a)(2)(A)(i)) received from permitted sources are includible in full in the numerator of the support fraction in each taxable year. However, 'gross receipts' (within the meaning of section 509(a)(2)(A)(ii)) from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business, are includible in the numerator of the support fraction in any taxable year only to the extent that such gross receipts do not exceed the limitation with respect to the great of $5,000 or 1 percent of support which is described in paragraph (b) of this section."

h. The regulation further provides that: "[a] grant is normally made to encourage the grantee organization to carry on certain programs or activities in furtherance of its exempt purposes. It may contain certain terms and conditions imposed by the grantor to insure that the grantee's programs or activities are conducted in a manner compatible with the grantor's own programs and policies and beneficial to the public."

i. Yet the IRS recognizes that this distinction is not always clear. The regulation states that: "[t]he grantee may also perform a service or produce a work product which incidentally benefits the grantor. Because the imposition of terms and conditions, the frequent similarity of public purposes of grantor and grantee, and the possibility of benefit resulting to the grantor, amounts received as grants 'for' the carrying on of exempt activities are sometimes difficult to distinguish from amounts received as gross receipts 'from' the carrying on of exempt activities."

j. To that end, the regulation makes it very clear that labels don't matter: the fact that an agreement is designated as a "contract" or a "grant" is not controlling for purposes of classifying the payment under section 509(a)(2) (and presumably, of course, for purposes of the ER rules.)

k. The regulation does offer some helpful guidance to distinguish a contract from a grant. Treas. Reg. §1.509(a)-3(g)(2) states that "gross receipts" means "amounts received from an activity which is not an unrelated trade or business, if a specific service, facility or product is provided to serve the direct and immediate needs of the payor, rather than primarily to confer a direct benefit upon the general public."

l. The regulation also provides that "in general, payments made primarily to enable the payor to realize or receive some economic or physical benefit as a result of the service, facility or product obtained will be treated as "gross receipts" with respect to the payee. The fact that a profit-making organization would, primarily for its own economic or physical betterment, contract with a nonprofit organization for the rendition of a comparable service, facility or product from such organization constitutes evidence that any payments received by the nonprofit payee organization (whether from a government unit, a nonprofit or a profit-making organization) for such services, facilities or product are primarily for the economic or physical benefit of the payor and would therefore be considered 'gross receipts' rather than 'grants' with respect to the payee organization."

m. Thus, because of the limitation on the inclusion of gross receipts in the public support test fraction in section 509(a)(2)(A), the determination of whether payments are received as grants or gross receipts could have significant implications on the ability of an organization to meet the public support test, depending upon how its operations are structured.

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