Taxation of November/December 2007

Cross-Border Philanthropy

FIN 48

Form 990 Draft

A COMPLIANCE GUIDE TO CROSS-BORDER

Complex rules and unclear guidelines may serve to deter U.S. public charities from cross-border grantmaking.

PHILANTHROPY

TARA OWENS ANTONIPILLAI

ncreased scrutiny of funds flowing to foreign charitable causes, complex tax rules, and new laws aimed at cutting off funds to terrorist organizations have all conspired to make international charitable giving a challenge for U.S. public charities. While the variety of regulatory paradigms may seem to be a cumbersome obstacle to pursuing international grantmaking, an approved legal framework for effectuating international charitable giving does exist. A U.S. charity interested in making grants to foreign organizations must establish a comprehensive compliance program in order to (1) ensure the deductibility of contributions for its individual donors, (2) maintain tax-exempt status, and (3) comply with all legal requirements designed to prohibit the financing of terrorist activities.

Ensuring tax deductibility of contributions

An individual's contribution to a charitable organization is only deductible if the contribution is made "to or for the use of ... [a] corporation, trust, or community chest, fund or foundation ... created or organized in the United States, or in any possession thereof, or under the law of the United States, any State or Territory, the District of Columbia, or any possession of the United States" or to a U.S. federal or state government or governmental entity. Therefore, even if a foreign organization has qualified for tax-exempt status in the U.S., a donation directly to the foreign organization is not deductible

as a charitable contribution by an individual U.S. taxpayer.

If a U.S. charity receives a grant or contribution from a U.S. taxpayer "earmarked" for a foreign-organized charity or charitable program, the U.S. charity must exercise sufficient discretion and control over the contribution so as to be considered the "owner" of such contribution, thereby making the contribution deductible to the donor. If the U.S. charity fails to exercise this discretion and control, it will be treated as a conduit or pass-through for purposes of such funds, and the contribution will not be deductible to the donor.

Where there is no exercise of discretion and control over donated funds by the U.S. charity, the contribution is not deductible because the donor is treated as having made a nondeductible contribution directly to the foreign organization.³ The IRS, in a series of public and private rulings, has set forth a well-defined set of rules to determine if a U.S. charity is a mere conduit. By contrast, a donation to or for the use of a U.S. charity is deductible, even though the donation is regranted to a foreign organization, if the U.S. charity is not a mere conduit to a foreign organization.⁴

In Rev. Rul. 63-252, 1963-2 CB 101, the IRS concluded as follows:

[I]t seems clear that the requirements ... [for deductibility of contributions] would be nullified if contributions inevitably committed to go to a foreign organization were held to be deductible solely because, in the course of transmittal to a foreign organization.

TARA OWENS ANTONIPILLAI is an associate in the Washington, DC office of Arnold & Porter LLP

nization, they came to rest momentarily in a qualifying domestic organization. In such cases, the domestic organization is only nominally the donee; the real donee is the ultimate foreign recipient.

Rev. Rul. 63-252 set out five examples of this general principle, each expressing a variation on the conduit theme:

- 1. A mere conduit entity formed by the beneficiary foreign organization in order to tap into U.S. resources.
- An organization with a similar origin and function to that above, the only difference being that it was formed by persons in the U.S. interested in helping the designated foreign entity.
- An exempt domestic charity that is prevailed upon by a specific foreign organization to canvass for donations in the U.S. and to direct contributions to that foreign organization.
- 4. An exempt domestic charity that makes grants to foreign charities after reviewing the grant applications to ensure that the foreign activities will further its own charitable purposes.
- 5. An exempt domestic charity that forms, and closely manages, a subsidiary organization in a foreign country for administrative efficiency in conducting the domestic charity's foreign charitable programs.

The IRS explained that the organizations described in examples 1, 2, and 3 were mere conduits, but that the organizations described in examples 4 and 5 had "discretion and control" over contributed funds. As these examples illustrate, an organization is a conduit if it is operated solely to solicit and distribute earmarked funds for use by third-party organizations. To avoid conduit status, the U.S. charity must have full discretion and control over how to use funds received from donors.

Similar, but more specific, rules apply to U.S. charities that solicit money with the specific intent of transferring the funds to a single foreign charity. Such organizations are commonly called "friends of" organizations because they often, although not always, include the words "friends of" in the organization's name. The IRS has ruled that a U.S. "friends of" organization may solicit deductible contributions so long as the U.S. charity (1) is not required to turn over the funds to the foreign organization, (2) retains sufficient discretion and control over the use of the contributions, and (3) follows approved

procedures in exercising such discretion and control.

In Rev. Rul. 66-79, 1966-1 CB 48, the IRS considered a "friends of" organization and donations solicited for a project that was pre-approved by the board of the U.S. charity. The IRS found that the U.S. organization's board demonstrated full and independent control over the donated funds as well as discretion as to their use, ensuring that the funds were used to carry out the U.S. organization's charitable purposes. In reaching this conclusion, the IRS emphasized that the U.S. charity's board of directors carefully reviewed prospective projects before making grants and required prospective grantees to specify the purposes for which the grant would be used. In determining that contributions to the U.S. charity were deductible under Section 170, the IRS also made the following findings:

- 1. The U.S. "friends of" organization wanted to support specific projects of the foreign organization in furtherance of its own charitable purpose.
- 2. The bylaws of the U.S. "friends of" organization provided, in part, that:
- "[T]he making of grants and contributions and otherwise rendering financial assistance for the purposes expressed in the charter of the organization shall be within the exclusive power of the board of directors..."
- "[I]n furtherance of the organization's purposes, the board of directors shall have power to make grants to any organization organized and operated exclusively for charitable, scientific or educational purposes within the meaning of section 501(c)(3)...."
- "[T]he board of directors shall review all requests for funds from other organizations, shall require that such requests specify the use to which the funds will be put, and if the board of directors approves the request, shall authorize payment of such funds to the approved grantee...."
- "[T]he board of directors shall require that the grantees furnish a periodic



HAS SUFFICIENT DISCRETION AND CONTROL.

SO LONG AS IT

¹ Sections 170(c)(1), 170(c)(2)(A).

This rule applies even where the foreign-organized charity is recognized as tax-exempt by the IRS.

³ E.g., Rev. Rul. 63-252, 1963-2 CB 101 (concluding that contributions to a U.S. charity acting as a conduit for a foreign organization are nondeductible).

Section 170(c)(2)(A); Rev. Rul. 63-252, supra note 3.

EXHIBIT 1. Fundamental Principles of the Treasury Guidelines Working Group.

- Consistent with the privilege inherent in their tax-exempt status, charitable organizations must exclusively pursue the charitable purposes for which they were organized and chartered.
- Charitable organizations must comply with both U.S. laws applicable to charities and the relevant laws of the foreign jurisdictions in which they engage in charitable work. Charitable organizations, however, are non-governmental entities that are not agents for enforcement of U.S. or foreign laws or the policies reflected in them.
- Charitable organizations may choose to adopt practices in addition to those required by law that, in their judgment, provide additional confidence that all assets—whether resources or services are used exclusively for charitable purposes.
- 4. The responsibility for observance of relevant laws and adoption and implementation of practices consistent with the principles contained herein ultimately lies with the governing board of each individual charitable organization. The board of directors of each charitable organization must oversee implementation of the governance practices to be followed by the organization.
- 5. Fiscal responsibility is fundamental to international charitable work. Therefore, an organization's commitment to the charitable use of its assets must be reflected at every level of the organization
- 6. When supplying charitable resources, fiscal responsibility on the part of the provider generally involves:
 - a. In advance of payment, determining that the potential recipient of monetary or in-kind contributions has the ability to both accomplish the charitable purpose of the grant and protect the resources from diversion to non-charitable purposes.
 - b. Reducing the terms of the grant to a written agreement signed by both the charitable resource provider and the recipient.
 - c. Engaging in ongoing monitoring of the recipient and of activities under the grant.
 - d. Seeking correction of any misuse of resources on the part of the recipient.
- 7. When supplying charitable services, fiscal responsibility on the part of a provider involves taking appropriate measures to reduce the risk that its assets would be used for non-charitable purposes. Given the range of services in which organizations engage, the specific measures necessarily vary depending on the type of services and the exigencies of the surrounding circumstances. The key to fiscal responsibility, however, is having sufficient financial controls in place to trace funds between receipt by the service provider and delivery of the service.
- 8. Each charitable organization must safeguard its relationship with the communities it serves in order to deliver effective programs. This relationship is founded on local understanding and acceptance of the independence of the charitable organization. If this foundation is shaken, the organization's ability to be of assistance and the safety of those delivering assistance is at serious risk.

accounting to show that the funds were expended for the purposes which were approved by the board of directors..."

- "[T]he board of directors may, in its absolute discretion, refuse to make any grants or contributions or otherwise render financial assistance to or for any or all the purposes for which funds are requested."
- 3. The bylaws also provided that, after the board of directors of the U.S. "friends of" organization "has approved a grant to another organization for a specific pro-

ject or purpose, the U.S. organization may solicit funds for the grant to the specifically approved project or purpose of the other organization. However, the board of directors shall at all times have the right to withdraw approval of the grant and use the funds for other charitable, scientific or educational purposes."

4. "In accordance with the provisions of its charter and bylaws," the U.S. "friends of" organization "at times solicits contributions that are to be used to provide grants to the foreign organization mentioned



THE RULINGS
DO NOT
EXPLICITLY
STATE THAT
ACTING AS A
CONDUIT
WOULD PUT
THE
EXEMPTION OF
THE 'FRIENDS
OF'
ORGANIZATION
IN JEOPARDY.

above, or to individuals connected with such foreign organization, for specific purposes approved by [the organization's] board of directors in accordance with its bylaws. At all times, all of the pertinent facts, including the fact that the board of directors may withdraw its approval of a particular grant even after it has been made, are available to any contributor not previously informed of such facts should the contributor so request either before or after a contribution has been made. The corporation refuses to accept contributions so earmarked ...[for] the foreign organization."

The principles of Rev. Rul. 63-252 and Rev. Rul. 66-79 have been cited frequently in published and private IRS rulings concerning the deductibility of donations to U.S. charities that then grant some or all of the funds to foreign charities. For example, Rev. Rul. 75-65, 1975-1 CB 79, involved a U.S. charity that was formed to deal with ecological problems in a foreign country through programs that included grants to foreign private organizations. The IRS held that the U.S. charity maintained discretion and control over funds granted to the foreign organization by, prior to approving the grant, investigating "the purpose to which the funds [would] be put, by ... entering into a written agreement with the recipient organization, and lastly by performing field investigations to confirm that the grant was being spent in accordance with the agreement."

Similarly, in Ltr. Rul. 9651031,5 a U.S. charity formed to "establish, foster and maintain cultural relationships" between the U.S. and a foreign country provided in its bylaws that its board would review all requests for grants and require that all such requests specify the use of the funds. In addition, the bylaws gave the board of the U.S. charity the absolute discretion to determine which projects to fund and not fund. The U.S. board was permitted to solicit funds for any pre-approved grant, provided that the U.S. charity had full discretion and control at all times as to the use of the contributions. Moreover, the board retained the absolute power to withdraw support of any grant, for any reason, at any time. The board was not permitted to accept any contributions that required the U.S. charity to grant the contribution solely to a specific named organization. The IRS concluded that the U.S. charity was not acting as a mere

conduit, but exercised discretion and control over the use of contributions.

A contrary example is found in GCM 35319, 4/27/73, where a U.S. charity transmitted funds to a foreign organization without knowing how the money would be spent. Even though the foreign organization promised to use the funds for "humanitarian purposes," and both the foreign organization and its distributes were required to account for the use of the funds, the IRS concluded that the U.S. charity had too little discretion and control over the grant funds to meet the standards set out in Rev. Rul. 63-252 and Rev. Rul. 66-79

Based on the above IRS guidance, a Section 501(c)(3) public charity will not be a mere conduit, even if it accepts funds designated for use by a specified foreign charitable program or charity, so long as the U.S. charity has sufficient discretion and control to ensure that all funds are being used for the intended charitable purposes and to redirect grants if they are not being used properly.

The bulk of the IRS guidance discussed above was issued more than 30 years ago and, predictably, fails to contemplate some of the issues that public charities face today with respect to international philanthropy, such as the need and ability to provide immediate humanitarian relief in a crisis and the sheer volume of U.S. charities now engaged in international grantmaking. That said, the IRS has continued to rely on this guidance over the years, and public charities can comfortably depend on it as well.

Safeguarding the public charity's taxexempt status

The most recent comprehensive IRS rulings regarding "friends of" organizations are Rev. Rul. 63-252 and Rev. Rul. 66-79. They deal with the deductibility of contributions to "friends of" organizations, not the continued viability of the organizations' tax-exempt status. While these rulings do not explicitly state that acting as a conduit is not an exempt purpose, or that such activity would put the "friends of" organization's tax-exempt status in jeopardy, they do indicate that the IRS looks with disfavor on such a practice. In addition, the issue of an organization's exempt activities or exempt purposes would more typically arise

While private letter rulings are not precedent, they provide insight into the Service's interpretation of Code sections

EXHIBIT 2. Risk Factors for Charities Disbursing Funds or Resources to Grantees.

Low Risk

The grantee has explicit charitable purposes and discloses how funds are used with specificity.

The charity and the grantee have a written grant agreement that contains effective safeguards. For example, provisions addressing proper use of funds by the grantee, delineation of appropriate oversight, and programmatic verification.

The grantee has an existing relationship with the charity.

The grantee can provide references from trusted sources.

The grantee has a history of legitimate charitable activi-

Charity performs on-site regular audits and reporting.

form of video, receipts, photographs, testimonies, and written records.

The charity disburses funds in The charity authorizes grantee small increments as needed for specific projects or expenditures.

Reliable banking systems or other regulated financial channels for transferring funds are available and used by the grantee, subjecting such transfers to the safeguards of regulated financial systems consistent with international standards.

Detailed procedures and processes for the suspension of grantee funds are included within the written agreement and enforceable both in the United States and at the grantee's locale.

The charity engages exclusively in charitable work in the work in foreign U.S. or in foreign countries/regions where terrorists organizations are not known to be active.

Medium Risk

The grantee has general charitable purposes and discloses how funds are used with speci-

The charity and the grantee have a written grant agreement with limited safeguards.

The grantee has existing relationships with other known chartory with any charities. ities but not with this charity.

The grantee's references are from sources with which the chairty is unfamiliar.

formed, but its leadership has a history of legitimate charitable activities.

Charity performs remote grantee Charity performs no grantee grantee due diligence through due diligence through regular audits and reporting.

tion of the use of funds in the of the use of funds. Documenta- tation of use of funds. tion may only include receipts and written records.

discretion withim specific limits.

Reliable banking systems or other regulated financial channels for transferring funds are not reasonably available for the grantee's relevant activity, but the charity and the grantee agree on alternative methods that they resasonabley believe to be reliable, trustworthy, and protected against diversion.

Detailed procedures and processes for the suspension of grantee funds are included within the written agreement but may not be enforceable at the grantee's locale due to instability or other issues.

The charity engages in some countries/regions where terrorist countries/regions known to organizations may be active.

High Risk

The grantee has general charitable purposes and does not disclose how funds are used.

The charity and the grantee do not have a written grant agree-

The grantee has no prior his-

The grantee can provide no references or sources to corroborate references provided.

The grantee is newly or recently The grantee has little or n history of legitimate charitable activities.

> due diligence, or due diligence is random and inconsistent.

Grantee provides documenta- Grantee provides documentation Grantee provides no documen-

The charity disburses funds in one large payment to be invested and spent over time or for unspecified projects selected by the grantee.

The grantee does not use regulated financial channels or take steps to develop alternative methods that the charity and grantee reasonably believe to be reliable, trustworthy, and protected against diversion.

There exist no procedures or processes for suspension of grantee funds in the event there is a breach of the written agreement.

The charity primarily engages in work in conflict zones or in have a concentration of terrorist activity.



THERE HAS
BEEN
CONSIDERABLE
DEBATE ABOUT
THE NECESSITY
AND
EFFICIENCY OF
MANY
MEASURES
TAKEN AFTER
9/11.

during the Service's initial review of an organization's application for tax-exempt status. In this regard, the IRS has given clear indications that this type of conduit activity by a "friends of" organization would put the organization's tax-exempt status at risk.

For example, in seeking tax-exempt status for a charitable organization, the newly revised IRS exemption application (Form 1023) asks the following questions specifically designed to determine whether the organization will comply with the requirements of Rev. Rul. 66-79 or whether the applicant organization is merely acting as a conduit.

- "Provide the name of each foreign organization, the country and regions within a country in which each foreign organization operates, and describe any relationship you have with each foreign organization."
- "Does any foreign organization listed [above] accept contributions earmarked for a specific country or specific organization? If 'Yes,' list all earmarked organizations or countries."
- "Do your contributors know that you have ultimate authority to use contributions made to you at your discretion for purposes consistent with your exempt purposes? If 'Yes,' describe how you relay this information to contributors."
- "Do you or will you make pre-grant inquiries about the recipient organization? If 'Yes,' describe these inquiries, including whether you inquire about the recipient's financial status, its tax-exempt status under the Internal Revenue Code, its ability to accomplish the purpose for which the resources are provided, and other relevant information."
- "Do you or will you use any additional procedures to ensure that your distributions to foreign organizations are used in furtherance of your exempt purposes? If 'Yes,' describe these procedures, including site visits by your employees or compliance checks by impartial experts, to verify that grant funds are being used appropriately."6

As illustrated above, the requirements of Rev. Rul. 66-79 are used as a prospective test for obtaining tax-exempt status in the IRS application for recognition of exemption. U.S. charities therefore can use the exemption application questions relating to international grantmaking as a sim-

ple compliance checklist for ensuring that the U.S. charity's exempt status remains intact going forward as well.

Anti-terrorism laws and guidelines

In response to the 9/11 attacks, various U.S. government entities have attempted to prevent U.S. charitable resources from being diverted to terrorist organizations. There has been considerable debate about both the necessity and efficiency of many of these measures, due to a lack of available data on the extent to which charitable resources have actually been transferred to terrorist causes in the past as well as the burden of compliance on charitable organizations already making difficult choices about how to distribute scarce resources. In addition, because compliance with some of the anti-terrorism guidance to U.S. charitable organizations is voluntary, charitable organizations face a difficult task in developing a compliance protocol for the antiterrorism measures.

Executive Order 13224, 66 Fed. Reg. 49079 (9/23/01), aims to restrict financing of terrorist organizations by cutting off access to bank accounts and other sources of funds. The Executive Order prohibits transactions with organizations identified as terrorist organizations listed in its Annex or identified by the Department of State or the Treasury. The Order specifically prohibits the provision of financial or material support to the listed organizations or any entities associated with them. It also freezes all assets controlled by or in the possession of the listed entities and those entities that support them. Generally, the definitive list of terrorist entities is thought to be the U.S. Treasury Department's list of Specially Designated Nationals (SDN), which also includes various types of international criminals and criminal organizations. The United Nations also has a comprehensive

In October 2001, on the heels of 9/11 and Executive Order 13224, the U.S.A. Patriot Act was signed into law. It was reauthorized in 2005. Relevant provisions of the Act for U.S. charities making international grants include increased criminal penalties for knowing or intentional provision of material support or resources for terrorism.

⁶ IRS Form 1023, Part VIII, Question 14a-f.

⁷ www.cof.org/files/Documents/International_Programs/Principles_Final.pdf.

In November 2002, Treasury released the Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities ("Guidelines") to combat terrorist abuse of charitable organizations "to move funds, provide logistical support, and encourage recruitment." The Guidelines were originally issued to assist charitable organizations in complying with Executive Order 13224 and the U.S.A. Patriot Act, although the degree to which the Guidelines provide clarity has been questioned by commentators and representatives of the charitable community, who commonly complain that they are complex and overly burdensome. Following a December 2005 revision to the Guidelines and a public comment period, Treasury issued a further revised version of the Guidelines in September 2006.8

Topics covered in the Guidelines include provisions regarding direct disbursement of currency, collection of grantee information, such as "postal, email and URL addresses," and researching grantee background information, including public information. The Guidelines also incorporate an explanation by the Treasury's Office of Assets Control (OFAC) of its SDN list and how charitable organizations are prohibited from dealing with any party on the list. Finally, the Guidelines contain an Annex that describes and refers to various indicators of terrorist financing in the charitable sector.

In the most recent revision, Treasury stressed the *voluntary* and *best-practices* nature of the Guidelines. In fact, a footnote stresses that "[n]on-adherence to the Guidelines does not, in and of itself, constitute a violation of existing U.S. law." The Guidelines also make clear that where an organization has "proven internal controls and practices," the Guidelines do not promote altering or abandoning existing procedures.

In response to the original Guidelines, the Treasury Guidelines Working Group submitted its Principles of International Charity to the Treasury as an alternative to the Guidelines. The Principles offer considerably more general guidance than the Guidelines. The list of

"Fundamental Principles" they set out is shown in Exhibit 1 on page 5.

Amidst much confusion about compliance obligations, and in an effort to assist charitable organizations in evaluating risks in international giving, the OFAC released a matrix of common risk factors associated with international grantmaking in March 2007. The OFAC designed the risk matrix to assist charitable organizations in conducting due diligence on potential as well as existing grantees. Upon releasing the risk matrix, OFAC emphasized that it is not meant to be a comprehensive list of risk factors for identifying terrorist or other abusive or illicit activities. The matrix itself is shown in Exhibit 2 on page 7.

The above combination of anti-terrorist funding measures does not provide any clear answer as to what U.S. charities should undertake in the way of compliance programs. Executive Order 13224 clearly requires screening prospective grant recipients based on the SDN list. Beyond that, U.S. charities are left to determine for themselves how to comply.

Compliance

Developing a comprehensive international grantmaking compliance program is no easy task. The body of laws and voluntary guidance created over the last several years designed to prohibit terrorist financing creates an additional level of complexity and uncertainty for the U.S. public charity. Each U.S. public charity must tailor its own compliance program to fit the specific type of programs and international grant locations that it pursues. Nevertheless, the following list highlights compliance policies and practices for U.S. public charities wanting to maintain "discretion and control" over the funds they receive, safeguard their tax-exempt status, and comply with anti-terrorist financing laws and guidelines.

- Bylaws. Review bylaws to verify that they
 include all of the provisions required by
 Rev. Rul. 66-79. Conduct an annual review
 to ensure that these, and all provisions of
 the bylaws, are being followed.
- Independent board control. Exercise ultimate control over all assets.
- Grant applications and agreements.
 Review grant application forms and procedures to ensure that the language in the grant applications and forms are in com-



IN THE MOST RECENT REVISION, TREASURY STRESSED THE VOLUNTARY AND BEST-PRACTICES NATURE OF THE GUIDELINES.

⁸ See www.treas.gov/offices/enforcement/key-issues/protecting/index.shtml (updated 3/9/07).

See Guidelines, supra note 8 at fn 13.

¹⁰ See Guidelines, supra note 8 at fn 1.

¹¹ See www.cof.org/files/Documents/International_Programs/Principles_Final.pdf.

¹² See http://www.ustreas.gov/offices/enforcement/ofac/policy/charity_risk_matrix.pdf.

pliance with Rev. Rul. 66-79. The grant application should also gather basic information on the grantee, its officers, directors, and "key employees," enough so that basic due diligence can be conducted on the relevant organization and individuals, including checking the appropriate lists for potential terrorist financing connections. The grant agreement should spell out the specific projects the grant may be used for, periodic financial and program reporting the grantor expects to receive, and any other restrictions on the use of the funds. The grant agreement should also include specific language prohibiting use of funds by terrorists or terrorist organizations.

Ongoing reporting obligations. Ensure that
foreign grantees comply with all ongoing
reporting obligations. This allows the
U.S. charity to verify that its grants continue to be used for the charitable purposes originally specified in the grant
agreement.

 Solicitation materials. All solicitations should make clear that donations are being made to the U.S. public charity and that the U.S. public charity has discretion and control over the donated funds. Basic due diligence. Conduct basic due diligence on foreign grantees, such as reviewing a grantee's Web site and organizational documents, confirming contact information, and gathering basic information on officers, directors, grant reporting, and charitable programs of the grantees. Depending on the circumstances, the U.S. charity or a designated representative may make a site visit to the grantee.

 SDN list. Check the grantee, as well as its officers, directors, and managers against the SDN List.

OFAC Risk Matrix. The U.S. public charity should review the OFAC Risk Matrix to determine if any grantees or grant applicants raise red flags identified by OFAC.

Conclusion

Complex rules and unclear guidelines may serve to deter some U.S. public charities from cross-border grantmaking. While some understanding of the legal landscape and a plan of action are necessary, it is possible for U.S. public charities to take on international philanthropy. Just develop a compliance plan first.