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In This Section

[International Dateline](#)

[Legal Dimensions of International Grantmaking](#)

[United States International Grantmaking \(USIG\)](#)

[Electronic Discussion List](#)

[Press Kit](#)

[Calendar of Events](#)

[International Committee](#)

[Staff](#)

Home > Members > International > *Legal Dimensions of International Grantmaking*

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Legal Dimensions of International Grantmaking: International Grantmaking from Donor-Advised Funds

New Requirements and Changing Practices after the Pension Protection Act of 2006

International Grantmaking from Donor-Advised Funds: New Requirements and Changing Practices after the Pension Protection Act of 2006

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In existence since the 1930s, donor-advised funds have been one of the fastest growing charitable giving vehicles of the past decade.^[1] Capitalizing on this growth and on the increasing interest in international philanthropy among donors in the United States, a number of public charities have developed expertise in international grantmaking and have offered donor-advised funds as a giving vehicle to individual donors, companies, and foundations.

At the same time, donor-advised funds have come under increased scrutiny by regulators and legislators. The Pension Protection Act of 2006 (PPA), enacted on August 17, 2006, ushered in a new era of regulation for donor-advised funds, which had been operating without clear legal guidelines for many years. For the first time, the federal tax code defines donor-advised funds and regulates the administration and distribution of their assets. Failure to comply with the rules may subject the donor advisor, sponsoring organization, fund managers, and others to significant penalties.^[2]

For international grants, the new legislation requires donor-advised funds to comply with certain rules imposed on private foundations. Sponsoring organizations administering international grants from advised funds have adopted various practices to comply with the new requirements. These changes are discussed below, along with a brief description of the new rules.

What is a donor-advised fund?

The PPA defines a donor-advised fund in new section 4966 as a fund that meets three requirements:

1. It is separately identified by reference to the contributions of a donor or donors.
2. It is owned and controlled by a sponsoring organization (a sponsoring organization is defined as any 501(c)(3) public charity that holds one or more donor-advised funds).

3. A donor (or any person appointed or designated by the donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of the fund.

Many complexities lurk behind the definition. But, in short, any individual or organization can create a donor-advised fund with a contribution that the sponsoring organization separately tracks with reference to the donor, take an immediate tax deduction (to the extent permitted by law), and recommend grants to qualified charitable organizations. The administration and operation of the donor-advised fund will be subject to the PPA requirements and to guidelines adopted by the sponsoring organization.

Requirements for International Grants from Donor-advised Funds [3]

Pre-PPA Requirements

Prior to the PPA, a sponsoring organization approving grants from donor-advised funds to foreign charities had to comply with the basic requirements that applied to all public charities making international grants. A public charity has to “limit distributions to specific projects that are in furtherance of its own exempt purposes” and must not act as a mere conduit that re-grants earmarked funds to a foreign grantee. In other words, the charity has to “retain control and discretion as to the use of the funds and maintain records establishing that the funds were used for section 501(c)(3) purposes.” [4]

The charity also has to see that contributions made to support projects of foreign organizations are tax-deductible to donors. A donation to or for the use of a U.S. charitable organization is deductible, even if the donation is re-granted to a foreign organization, if the U.S. charity maintains control over the funds and is not a mere conduit for the contribution.[5] What constitutes sufficient discretion and control over the donated funds is determined based on all the facts and circumstances. In general, the charity should review and approve prospective projects before making grants, require grantees to specify the purposes for which the grant will be used, and require periodic reporting from grantees to show that the funds were expended for approved purposes.[6] In many cases, public charities adopt modified versions of the more detailed private foundation requirements to ensure proper oversight of international grants.

Post-PPA Requirements

In contrast to public charities, private foundations must follow specific rules when making grants to foreign charities. The PPA requires that international grants from donor-advised funds comply with section 4945(h) of the private foundation rules.

Section 4945(h) requires a private foundation to make reasonable efforts to ensure that a grant to a foreign charity is spent for its intended purposes, to obtain reporting from the grantee that shows how the funds were expended, and to provide reporting about the grant to the IRS. This process is called “expenditure responsibility.” As an alternative, a private foundation can make a good faith determination that the foreign organization is the equivalent of a U.S. public charity. This process is known as “equivalency determination.”[7] Different factors and circumstances will determine which option is most appropriate and efficient.

Expenditure responsibility provides the most flexible and widely-used due diligence option for international grantmaking. It requires a private foundation to exercise the following oversight:[8]

- Conduct a pre-grant inquiry to make a reasonable determination that the intended grantee is capable of fulfilling the charitable purposes of the grant.
- Enter into a written agreement with the grantee that specifies the charitable purpose of the activity to be funded and sets forth additional restrictions if required by law.
- Require the grantee—unless it is a private foundation—to maintain the grant in a separate account.[9]
- Require the grantee to provide regular reports on the expenditure of the funds and

the accomplishment of the charitable activities supported by the grant.

- Provide a report of the grant in its Form 990-PF that identifies the grantee and the amount of the grant and briefly describes the charitable purpose and current status of the grant.

Equivalency determination is sometimes used by grantmakers that commit substantial or long-term support to a foreign charity if it is not necessary or efficient to require a high-level of continuous oversight until all the funds are expended. The disadvantage is that the process of showing that the foreign grantee is the “equivalent” of a U.S. public charity can be administratively burdensome and costly, and in some cases not possible for lack of the required documentation. In brief, the process involves either obtaining a written legal opinion that the grantee is the equivalent of a U.S. public charity or making the determination without assistance of legal counsel based on information contained in an affidavit provided by the grantee. Under either option, substantial documentation (in English) of the grantee’s organization and operation will be required.^[10]

Unanswered Questions about the PPA

The IRS has not yet issued comprehensive regulations interpreting the PPA’s provisions and many questions remain unanswered. Some of these questions include:

To what extent do the private foundation regulations and guidance apply to donor-advised funds? A fundamental question is to what extent the regulations and other guidance issued by the IRS over the years interpreting the private foundation rules apply to donor-advised funds. The IRS’s approach to this issue is significant because most of the private foundations rules are fleshed out in the regulations and additional guidance.^[11] Furthermore, the expenditure responsibility rules have many pitfalls and unresolved issues even for private foundations. Will these also cause uncertainty for donor-advised funds? For example, donor-advised funds should be aware of the difficulties encountered with reporting for grants for capital equipment and with the oversight requirements for re-granting.

Can donor-advised funds use equivalency determination? Private foundations have the option of undertaking either expenditure responsibility or equivalency determination. The PPA’s legislative history expressly states that donor-advised funds also have the option of using equivalency determination,^[12] and it is expected that the IRS will issue regulations accordingly.

Can donor-advised funds choose between expenditure responsibility and equivalency determination? In a 2001 letter to the Council on Foundations, the IRS clarified that private foundations do not have to make an initial evaluation of whether equivalency determination can be made before undertaking expenditure responsibility.^[13] Donor-advised funds will likely have the same flexibility.

Impact of the New Rules

The philanthropic community in the United States has a long tradition of international giving and support and has built extensive knowledge and experience in cross-border philanthropy. Some of the new and expanded opportunities in international grantmaking have come from public charities that specialize in international giving from donor-advised funds. (See the [United States International Grantmaking](#) website of the Council on Foundations for a list of some of these public charities.) These organizations have assisted donors in giving responsibly, effectively, and wisely to foreign charities. Similarly, some community foundations have built extensive traditions of cross-border giving, in particular community foundations that operate along the borders with Mexico and Canada. Private foundations, corporations, and individuals are increasingly partnering with these public charities to make international grants.

The new rules have had minimal impact on public charities that have followed the expenditure responsibility or equivalency determination rules voluntarily prior to the PPA. Other organizations have welcomed the new rules for international grantmaking from

advised funds because they provide clearer guidance, and these public charities adjusted their procedures for cross-border giving to reflect the new requirements. On the other hand, at least one community foundation has decided to stop administering international giving because managers found the cost of compliance to be too high.

Strategies and Practices for Complying with the New Rules

Organizations that distribute grants to foreign charities from donor-advised funds have exercised various options for complying with the new requirements imposed by the PPA. Some examples of changing practices and potential new opportunities are described below.

Reviewing and revising practices to comply with the private foundation rules. Most organizations that specialize in international grantmaking from donor-advised funds have followed modified versions of the private foundation requirements—typically the expenditure responsibility rules—even before the PPA. As a result, these organizations have been minimally impacted by the new law. In some cases, however, the PPA necessitates a change in practice. For example, some organizations that followed expenditure responsibility sometimes allowed an exception to the requirement that the grantee maintain grant funds in a separate account. This was done if the requirement to maintain a separate account would have caused significant difficulties for the grantee and would not have provided additional safeguards under the circumstances. As a result of the new rules, exceptions are no longer granted.

Considering the equivalency determination option. Some organizations exercise expenditure responsibility as the sole option to maintain due diligence over international grants. Organizations that specialize in international grantmaking often maintain staff in countries or regions where their grants are targeted, and as a result the ongoing oversight required for expenditure responsibility does not create significant obstacles. However, the PPA allows sponsoring organizations to consider whether equivalency determination would be a more efficient and cost-effective alternative in some circumstances. For example, equivalency determination for a large, well-established foreign charity may be relatively easy and appealing if a donor would like to provide long-term support to the organization. Grantees with an equivalency determination could also be placed on a preferred list for donors to choose from. Finally, unlike grants distributed pursuant to equivalency determination, expenditure responsibility grants must be limited to specific projects or specific purposes and, in general, are not permitted for general operating support.

Using designated funds. The PPA excludes from the definition of a donor-advised fund a fund that benefits a single identified organization. Therefore, designated funds are not subject to the new requirements. Some organizations, such as community foundations, that do not specialize in international grantmaking from donor-advised funds but may have active programs supporting cross-border philanthropy, may have donors who wish to support a single foreign organization. In such cases, it may be appropriate to offer international grantmaking from a designated fund or to convert an existing donor-advised fund that has historically supported a single organization to a designated fund.^[14] The sponsoring organization will have to continue exercising the due diligence required of all public charities making grants to foreign charities, but it will not be subject to the additional private foundation rules.

Using field of interest funds. Similar to designated funds, field of interest funds also fall outside the definition of donor-advised funds.^[15] A field of interest fund has many donors and typically restricts its distributions to a particular program area, such as education, health, youth, or the environment. The sponsoring organization, sometimes with recommendations from an independent advisory committee, selects specific recipients. Advisory committees, where they exist, may include contributors to the fund. There is nothing that prohibits a field of interest fund from supporting foreign charities. Of course, the sponsoring organization will have to exercise the appropriate due diligence required of all public charities.

Making grants from donor-advised funds to support the sponsoring organization's international programs. In addition to administering donor-advised

funds, sponsoring organizations, especially community foundations, initiate philanthropic programs of their own. There are many ways to structure these activities without creating donor-advised funds. For example, the sponsoring organization can support these initiatives from its general endowment or from a field of interest fund it has created. International giving could be one of the sponsoring organization's projects, with the sponsoring organization selecting grant recipients. In this case, a donor-advised fund can make distributions directly to the sponsoring organization to support its international programs without being affected by the new restrictions.

Outsourcing international grantmaking. Because of the increased costs of complying with the new requirements for international giving from donor-advised funds, some organizations that do not have significant cross-border programs no longer allow donors to recommend grants to foreign charities from advised funds. As an alternative, these organizations could consider partnering with intermediary organizations to offer donors the option of international giving.

Special considerations for community foundations: Community foundations need to consider special restrictions that may limit their ability to undertake international grantmaking from their advised, field of interest, designated, or unrestricted funds. First, community foundations usually limit their grantmaking and charitable services to within a particular geographic area.^[16] Community foundations need to review their organizing documents (articles of incorporation, trust instruments, and bylaws) and policies to ensure that any limitations are consistent with distributing grants outside the United States. Second, when distributing grants to a foreign charity from a designated fund, community foundations must be sure that the fund is not acting as a conduit and that they have control and discretion over the assets.

Conclusion

Although the full impact of the new rules is not yet clear, the most obvious effect has been to increase the compliance costs for cross-border philanthropy. At this point, the additional costs do not seem to have slowed the growth and interest in international giving overall. In addition, once the IRS issues regulations, sponsoring organizations that administer international giving from donor-advised funds should have clearer legal requirements to guide them. In some cases, the new guidance may lead to additional opportunities in structuring due diligence for grants.

About the Author

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1. There is only limited data available, but according to one report donor-advised funds held more than \$19 billion in assets in 2006, an increase of more than 21% from \$16 billion in assets in 2005. Noelle Barton and Peter Panepento, "A Surge in Assets: Donor-Advised Funds Are Growing Exponentially," *Chronicle of Philanthropy* (May 3, 2007).

2. See the Council's [detailed analysis](#) of the new regulations.

3. Although it is not discussed in this article, grantmakers need to have procedures in place to comply with anti-terrorism laws.

4. Rev. Rul. 68-489, 1968-2 C.B. 210.

5. Treas. Reg. §1.170A-8(a)(1); Rev. Rul. 63-252, 1963-2 C.B. 101.

6. Rev. Rul. 66-79, 1966-1 C.B. 48; see also Rev. Rul. 75-65, 1975-1 C.B. 79 (holding that a charity maintain discretion and control over funds granted to a foreign organization by, prior to approving the grant, investigating the purpose to which the funds would be put, entering into a written agreement with the recipient organization, and performing field

- investigations to confirm that the grant is being spent in accordance with the agreement).
- 7.Treas. Reg. §53.4945-5(a)(5). A detailed discussion of these rules can be found in John A. Edie and Jane C. Nober, *Beyond Our Borders: A Guide to Making Grants Outside the U.S.* (Council on Foundations, 3rd ed., 2002).
- 8.Treas. Reg. §53.4945-5(b).
- 9.Most foundations interpret this requirement to be satisfied if the grantee maintains the funds either in a separate bank account or in a separate bookkeeping account.
- 10.Rev. Proc. 92-94.
- 11.The Tax Section of the American Bar Association submitted [detailed comments](#) [pdf] about which expenditure responsibility rules should and should not apply to donor-advised funds. American Bar Association, Section of Taxation, Comments in Response to IRS Notice 2006-109 on the Application of the Pension Protection Act of 2006 to Donor Advised Funds and Supporting Organizations (June 4, 2007).
- 12.Staff of the Joint Committee on Taxation, Technical Explanation of H.R.4, The “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, at 349 n.526 (“Joint Committee Report”).
- 13.See the full text of the [letter](#) [pdf].
- 14.A community foundation should use its variance power, after consulting with the donor, to convert a donor-advised fund to a designated fund.
- 15.Joint Committee Report, at 343.
- 16.The Council on Foundations’ definition of a community foundation requires a community foundation to be “organized and operated primarily as a permanent collection of endowed funds for the long-term benefit of a defined geographic area no larger than three states.” The National Standards for U.S. Community Foundations limits the geographic area to “typically no larger than a state.” The Treasury regulations do not place a specific geographic limitation on community foundations, but rather indicate that a community foundation supports charitable activities “in the community or area it serves.” Treas. Reg. §1.170A-9(e)(11)(iii).