

Cross-Border Grant Making by Private Foundations

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Charitable gifts by Americans to fund projects abroad have dramatically increased in the past decade, yet many U.S. donors and their advisors are unaware of the complex tax rules that govern such gifts.

■ THE BASIC RULES

A U.S. citizen or resident who makes a direct donation to a foreign charity is not entitled to an income tax deduction for that gift. However, if the funds are donated to a charity that was created or organized in the U.S. and which then uses the donation to fund a charitable project abroad, the donation is deductible. The U.S. charity must retain discretion and control over the use of the funds, and the funds must be put to uses recognized as charitable under U.S. tax laws. A gift to a U.S. charity for use abroad may be made through a “friends of” organization, community foundation, other U.S. public charity, or through a U.S. private foundation.

1. Donations to U.S. Charities Operating Abroad. The easiest way to get an income tax deduction for a donation to be used abroad is to make it to a U.S. public charity that operates abroad. The use of the funds is under the complete control of the U.S. charity, and the U.S. charity is treated as the true beneficiary. A number of U.S. charities, such as the Red Cross, CARE, and Oxfam America, have broad-based direct programs abroad. The U.S. donor may earmark contributions to such charities for a particular foreign *program* of the U.S. charity, but gifts may not be earmarked for re-granting to a particular foreign charity.

2. Donations via “Friends of” Organizations. Contributions may also be made to a U.S. public charity formed to support a foreign charity or charities. A U.S. donor who wishes to benefit Oxford University in England, for example, can make a donation to the “American Friends of Oxford University,” a U.S. charity formed for this purpose. The “friends of” organization monitors the use of the funds, so the gift is deductible.

3. Donations via Community Foundations. A U.S. donor can also claim a deduction for a gift to a community foundation, which, in turn, re-grants the funds to a foreign charity. The community foundation’s governing documents and internal policies must allow it to make grants abroad and it must not act as a mere conduit for the gift.

4. Donations via Private Foundations. The donor’s own private foundation can also make grants to foreign charities. The private foundation must retain discretion over the use of the funds and follow procedures to ensure the funds are used only to further its own charitable purposes.

■ RULES APPLICABLE TO U.S. PRIVATE FOUNDATIONS MAKING GRANTS ABROAD

U.S. private nonoperating foundations making grants abroad will want to determine whether the grants count as “qualifying distributions” which satisfy their required 5% annual payout. A foundation grant to a foreign charity is a qualifying distribution if it is made for charitable purposes recognized by the IRS and (i) the grant is to a foreign charity that would qualify as a public charity if it had been established here or (ii) the foundation exercises “expenditure responsibility” with respect to the grant.

1. Foreign Charities with U.S. Tax-Exempt Status. A foreign charity that is the equivalent of a U.S. public charity can apply for and obtain U.S. tax-exempt status. Few foreign charities bother to do this since U.S. donors are still not entitled to deduct direct contributions to them. If a foreign charity is granted U.S. tax-exempt status, a grant to it by a U.S. private foundation always counts toward the foundation's 5% annual payout.

2. "Good Faith Determination." If the foreign charity does not have U.S. tax-exempt status, the foundation can collect data to determine whether it is the equivalent of a U.S. public charity. If the foundation can make a "good faith determination" that the foreign charity meets the requirements for U.S. public charity status, the grant to it will be a qualifying distribution. In attempting to make an equivalency determination, the private foundation may rely on information provided in an opinion from its counsel, the foreign charity's counsel, or an affidavit of the grantee. Each U.S. private foundation generally obtains its own lawyer equivalency letter or grantee affidavit, and the cost may be prohibitive for smaller foundations. In Revenue Procedure 92-94, the IRS approved a form of affidavit of the foreign grantee that can be relied upon by multiple U.S. foundations. This helps small foundations make their equivalency determinations at a reasonable cost.

3. Expenditure Responsibility. It is often impossible to determine whether the foreign charity is equivalent to a U.S. public charity. Particularly with smaller charities in developing or underdeveloped nations, the proposed grantee may not keep adequate financial records. In such cases, the grant can still be made, but the U.S. foundation must exercise expenditure responsibility over the grant funds. Exercising expenditure responsibility maximizes the odds that the funds will be used for U.S. charitable purposes since the U.S. foundation closely monitors the use of the funds.

The U.S. foundation must make all reasonable efforts to see that the grant is spent solely for the purposes for which it was made. Exercising expenditure responsibility entails making a pre-grant inquiry to allow the grantor to determine whether the proposed foreign grantee can fulfill the charitable purpose of the grant. An officer or director of the foreign grantee must also sign a written grant agreement specifying the charitable purpose of the grant and committing the grantee to: (i) repay any funds not used for the grant's purpose; (ii) submit annual reports detailing how the funds have been used, compliance with the grant agreement, and the grantee's progress in achieving the purpose for which the grant was made; (iii) maintain books and records which are available to the grantor; and (iv) maintain the grant funds in a separate account dedicated to one or more charitable purposes. The agreement will typically also prohibit the grantee from re-granting the funds to other foreign organizations or individuals since that triggers additional complicated rules to minimize the likelihood that the funds will be diverted from charitable purposes. Expenditure responsibility grants are reported to the IRS on the U.S. foundation's Form 990-PF.

4. Grants to Governmental Units. Grants to foreign governmental units do not require either an equivalency determination or expenditure responsibility. A foreign government, or any agency or instrumentality thereof, is treated like a U.S. public charity. A grant to it counts toward the foundation's 5% payout requirement, as long as the gift must be used for charitable purposes. The U.S. foundation's file should contain documentation establishing that the grantee is a foreign government or governmental unit and a copy of its grant letter specifying the charitable purpose of the grant.

5. The "Out of Corpus" Requirement. If the foreign charity grantee is the equivalent of a U.S. private foundation, the U.S. foundation's expenditure responsibility grant to it must also meet the "out of corpus" requirement. A grant

from one private foundation to another will not count toward the U.S. foundation's 5% annual payout unless the grantee satisfies the "out of corpus" rule. The "out of corpus" rule generally requires that any grant from one private foundation to another must be spent by the grantee within 12 months after the close of the taxable year in which it received the funds. This policy is designed to ensure that such grants will be used to benefit the public and not to build the grantee's investment portfolio. Additional complex restrictions govern the "out of corpus" rule.

■ ANTI-TERRORISM FINANCING GUIDELINES

U.S. private foundations should also be aware of the potential for criminal prosecution, civil penalties, and the freezing of their assets if they are found to have made contributions to foreign or domestic charities that engage in or support terrorism.

- **Executive Order 13224 and the Patriot Act.** Very soon after the terrorist attacks of 9/11/01, President Bush issued Executive Order 13224, "Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit, or Support Terrorism" (the "Executive Order"). One month later, the USA Patriot Act was signed into law.

The Executive Order provides a means to disrupt the financial support network for terrorists and terrorist organizations by authorizing the U.S. government to block the assets of foreign individuals and entities that commit, or pose a significant risk of committing, acts of terrorism. It also authorizes our government to block the assets of individuals and entities that provide support, services, or assistance to, or otherwise associate with, terrorists and terrorist organizations. Any transaction involving persons or entities designated under the Order, "including but not limited to the making or receiving of contributions of funds, goods, or services," is prohibited.

Once an entity or individual is designated under the Executive Order, the Office of Foreign Assets Control (OFAC) of the Treasury Department blocks the assets of the individual or entity in the U.S. and adds the individual or entity to its list of "Specially Designated Nationals and Blocked Persons." Executive Order 13224 does not require knowledge or intent; making a contribution to a designated entity may subject the U.S. private foundation to sanctions even though it did not intend to support terrorism and did not know that the grant would be used for such purposes.

The "financing of terrorism" can result in substantial civil penalties or prison terms of up to 20 years, or both, if a person willfully provides or collects funds with the intention that such funds be used to carry out acts of terrorism or to support a foreign terrorist organization. OFAC's list of "Specially Designated Nationals and Blocked Persons" includes organizations that have been designated as foreign terrorist organizations. The list is available on line at <http://www.treas.gov/offices/enforcement/ofac/sdn/>, and every potential grantee, as well as its individual directors, should be checked against the list before a U.S. foundation makes a grant to it.

- **Treasury Department's Anti-Terrorism Best Practices.** In November 2002, the Treasury Department issued "Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities." According to the press release announcing the issuance of the guidelines, if a U.S.-based charity follows the voluntary guidelines, "there will be a corresponding reduction in the likelihood of a blocking order against any such charity or donors who contribute to such charity in good faith, absent knowledge, or intent to provide financing or support to terrorist organizations." In addition to containing certain standard suggestions for organizational transparency, the

guidelines provide for U.S. organizations to perform significant due diligence prior to distributing funds to foreign organizations.

Charitable organizations have expressed dissatisfaction with the guidelines for failing to take into account existing laws requiring oversight of foreign grants and the experience of U.S. grantmakers in making such grants, adopting a one-size-fits-all approach, and being so broadly and vaguely worded that compliance would be costly and difficult—if not impossible—to achieve. In response, representatives of more than 25 U.S. charities, in cooperation with the Treasury Department, worked to develop a more usable alternative to the guidelines. The new alternatives were released in March 2005 in a document entitled “Principles of International Charity,” with the hope that they will replace the Treasury Department’s voluntary guidelines.

■ BEST PRACTICES UNDER THE ANTI-TERRORIST FINANCING GUIDELINES

Most contributions to foreign charitable organizations have little risk of being diverted to support terrorism since they are made to well-known and reputable foreign charities. Nevertheless, foundations engaged in international philanthropy should routinely assess the risk of such a diversion and adopt and follow policies and procedures so as not to inadvertently run afoul of the anti-terrorist financing rules. The policies and procedures will vary depending on the nature of the particular grant and donee organization. When making grants to foreign charities, particularly if the proposed foreign donee is not a well-established charity, the U.S. private foundation should:

- Check the OFAC list of “Specially Designated Nationals and Blocked Persons.”
- Conduct due diligence to ensure that the proposed foreign donee is a bona fide charitable organization.
- Assess the likelihood of diversion based on the grantee and the circumstances.
- Manage the risk by taking steps most likely to prevent diversion, such as by disbursing funds in installments on receipt of the grantee’s financial and progress reports and/or its track-record using previously granted funds, and/or using a reliable individual in the foreign jurisdiction to help administer and monitor the grant.
- Keep good records of the foundation’s due diligence, grant procedures, and risk assessments.

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