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Introduction

There presently are few rules that pertain solely to U.S. charities (i.e., section 501(c)(3) organizations¹, also referred to herein as 'domestic charitable organizations') for engaging in international grant making and activities. Nonetheless, because of increased focus on terrorist activities after 9/11, we have been asked to study past compliance, practice, and due diligence efforts of charities making grants to international organizations and individuals. This international spotlight arises because nearly all of these terrorist activities have or have had an international component.

First, this discussion sets forth the standards governing the charitable aspects of international grant making and activities by U.S. charities. The standards are largely the same as those that apply to domestic grant making and activities. To understand the rules it is, therefore, necessary to understand when and how a charity can make a grant to an individual, another charity, and a non-exempt organization. Second, the

¹ All section references are to the Internal Revenue Code.

discussion sets forth the standards applicable to private foundations engaging in the same funding or activities.

In General

A section 501(c)(3) organization may conduct part or all of its charitable activities in a foreign country. Rev. Rul. 71-460, 1971-2 C.B. 231. See also Rev. Rul. 68-117, 1968-1 C.B. 251 (organization assists needy families in developing countries by facilitating access to markets, arranging credit, teaching modern farming methods and home economics, and furnishing other technical assistance); Rev. Rul. 68-165, 1968-1 C.B. 253 (organization promotes student and cultural exchanges and provides technical and material assistance to improve living conditions of underprivileged people in Latin America).

A section 501(c)(3) organization may make grants to another section 501(c)(3) organization. Rev. Rul. 67-149, 1967-1 C.B. 149. There is no geographic or other limitation.

A section 501(c)(3) organization will not jeopardize its exemption even though it distributes funds to organizations that are not themselves charities. The exempt organization must “ensure” use of the funds for permitted purposes by limiting distributions to specific projects that further its own purposes. The exempt organization also needs 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. Rev. Rul. 68-489, 1968-2 C.B. 210. These procedures do not make any distinction regarding the geographic location of the non-exempt organizations.

Similarly, a section 501(c)(3) organization will not jeopardize its exemption even though it distributes funds to individuals, provided the distribution is on a charitable basis in furtherance of the organization’s purpose. Again, there is no distinction regarding the geographic location of individual distributees. In order to substantiate that individual distributions are appropriate, the organization needs to maintain records and case histories showing the name and address of each recipient, the amount distributed to each, the purpose for which the aid was given, the manner in which the recipient was selected and the relationship, if any, between the recipient and members, officers, or trustees of the organization. Rev. Rul. 56-304, 1956-2 C.B. 306.

A deduction is not allowable under section 2055 (estate tax) with respect to a transfer of property to a foreign government or political subdivision thereof unless it is used for exclusively charitable purposes. Rev. Rul. 74-523 1974-2 C.B. 304. In contrast, a deduction is allowed for a transfer of property to a domestic government or political subdivision if it is to be used exclusively for public purposes. Section 2055(a)(1); see also section 170(c)(1).

In The Church in Boston v. Commissioner, 71 T.C. 102 (November 1, 1978), the Tax Court considered, for purposes of the definition of charitable under section 501(c)(3), the inadequacy of the Church's records of its grants to individuals where: "The only documentation contained in the administrative record is a list of grants made during 1975 which included the name of the recipient, the amount of the grant, and the 'reason' for the grant which was specified as either unemployment, moving expenses, school scholarship, or medical expense." Id. at 107. The Tax Court concluded that this stated documentation failed to establish whether exempt charitable purposes were served in fact, and the Court noted that failure "to keep adequate records of each recipient can result in abuse." Id. at 107.

When providing relief for disasters there is an issue regarding the determination of eligibility for charitable assistance. There is a tension between the requirements of Rev. Rul. 56-304, supra, and the practicalities of providing relief to individuals. Most recently, the IRS provided in Notice 2001-78, 2001-2 C.B. 576 a relaxed standard for charities that were making payments due to the death, injury or wounding of an individual incurred because of the September 11, 2001 terrorist attacks. The Internal Revenue Service stated that it would treat such payments made by a charity to individuals and their families as related to the charity's exempt purpose if the payments were made in good faith using objective standards. Congress subsequently enacted a special statutory rule to allow charitable organizations to disburse aid to victims of these attacks and their families without the charity making a specific assessment of need. Victims of Terrorism Relief Act of 2001, Pub. L. 107-134, § 104(a)(2), 115 Stat. 2427. The special statutory rule applies if the organization makes the payments in good faith using a reasonable and objective formula that is consistently applied.

Deductibility – Control Rules

Contributions to a section 501(c)(3) organization that transmits the funds to a foreign charitable organization are deductible only if it can be shown that the contribution is in fact to or for the use of the domestic organization, and that the domestic organization is not serving as an agent for, or conduit of, a foreign charitable organization. Rev. Rul. 63-252, 1963-2 C.B. 101.

Rev. Rul. 63-252 provides examples to illustrate what is and is not permissible. In each example, the "foreign organization" is an organization chartered in a foreign country, and is organized so that it meets all of the requirements of section 170(c)(2) except that it is not a domestic organization as required by section 170(c)(2)(A). Rev. Rul. 63-252 demonstrates that the requirements of section 170(c)(2)(A) 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, 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 foreign recipient.

Rev. Rul. 63-252 also provides an example of a domestic charitable organization that furthers its own purposes by granting funds to foreign charitable organizations and makes such grants for purposes which it (the domestic charitable organization) has reviewed and approved. The grants are paid from the domestic charitable organization's general funds and are subject to control by the domestic organization. No special funds are raised by a solicitation on behalf of the foreign organization nor are contributions earmarked in any manner. In this example, the contributions by individuals to the domestic charitable organizations are considered to be deductible.

Rev. Rul. 66-79, 1966-1 C.B. 48, amplifying Rev. Rul. 63-252, provides rules for determining whether a domestic charitable organization has and exercises sufficient control as to the use of contributions for the purposes of applying section 170(c). Contributions to a foreign charity generally are not deductible. While a domestic charity can use the contributions abroad, it cannot merely transfer them to a foreign charity. The domestic charitable organization in Rev. Rul. 66-79 is organized by individuals who have become interested in furthering the work of a foreign organization which was organized and operated exclusively for charitable, scientific, and educational purposes. The name of the domestic organization suggests a purpose to assist the named foreign organization. The domestic charitable organization is interested in raising funds for specific projects to be carried out by the foreign organization.

In determining whether a grant should be made, the bylaws of the domestic charitable organization in Rev. Rul. 66-79 provide, in part, that: (1) The making of grants and contributions and otherwise rendering financial assistance for purposes expressed in the charter of the organization shall be within the exclusive power of the board of directors; (2) in 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); (3) the 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; (4) the board of directors shall require that the grantees furnish periodic accounting to show that the funds were expended for the purposes which were approved by the board of directors; and (5) the 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 purposes for which funds are requested. The bylaws also provide that after the board of directors approves a grant to another organization for a specific project or purpose, the domestic charitable organization may solicit funds for that particular grant; however, at all times, the board has the right of withdraw approval of the grant. The domestic charitable organization also refuses to accept contributions so earmarked that they must in any event go to the foreign organization.

Rev. Rul 66-79 summarizes that the domestic charitable organization may only solicit for specific grants that are viewed and approved by it as being in furtherance of its purposes. Further, the domestic charitable organization solicits only on the condition

that it has control and discretion as to the use of contributions received by it. Therefore, contributions received by the domestic charitable organization from such solicitations are regarded as for the use of the domestic organization and not for the organization receiving the grant. Because of these controls, the contributor is permitted a deduction under section 170.

Special Rules Applicable to Private Foundations

Grants to Individuals

Section 4945 imposes a tax on the taxable expenditures of private foundations. A taxable expenditure, defined in section 4945(d), includes any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or similar purposes unless the grant satisfies the requirements of section 4945(g). Special rules applicable to satisfying the requirements for private foundations making grants to individuals are found generally in Treas. Reg. 53.4945-4.

Any grant to an individual for travel, study, or similar purposes is not a taxable expenditure if the grant was awarded on an objective and nondiscriminatory basis, and was made pursuant to a procedure approved in advance by the Internal Revenue Service. The private foundation must also demonstrate to the satisfaction of the Commissioner that (1) the grant constituted a scholarship or fellowship grant not includible as gross income pursuant to section 117(a) and was used to study at an educational organization described in section 170(B)(1)(a)(ii); (2) the grant constituted a prize or award not includible as gross income pursuant to section 74(b)(1) and (2) (but disregarding (3)) and the recipient is selected from the general public; or (3) the grant had the purpose of achieving a specific objective, producing a report or other similar product, or improving or enhancing a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee. See section 4945(g)(1), (2) and (3).

In order to secure advance approval by the Internal Revenue Service of its procedure for making grants to individuals, the private foundation must demonstrate that (1) its grant procedure includes an objective and non-discriminatory selection process; (2) its grant procedure is reasonably calculated to result in the performance by grantees of the activities intended to be financed; and, (3) the private foundation will obtain reports from the grantees to determine whether they have performed the activities that the grants are intended to finance.

No single procedure or set of procedures is required and variant factual situations will determine what precautions are appropriate in each case. Nevertheless, a procedure (or set of procedures) must include methods to supervise the use of scholarships, fellowships, and other types of grants to individuals; to investigate jeopardized or diverted grants; and, to retain records of scholarships, fellowships and grants made.

Grants to Non-exempt Organizations

Section 4945(d) states that the term taxable expenditure includes any amount that a private foundation pays or incurs as a grant to an organization *other than* a public charity described in section 509(a)(1), (2), or (3), *unless* the grantor foundation exercises 'expenditure responsibility' with respect to the grants.

Section 4945(h) states that 'expenditure responsibility' means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures to (1) see that the grant is spent solely for the purpose for which made, (2) obtain full and complete reports from the grantee on how the funds are spent, and (3) make full and detailed reports with respect to such expenditures to the Internal Revenue Service. Special rules applicable to satisfying the requirements for ensuring 'expenditure responsibility' are found generally in Treas. Reg. 53.4945-5(b), (c), (d) and (e).

Grants to Foreign Organizations

Many foreign organizations do not have rulings or determination letters to show that they are described in section 501(c)(3) or 509(a)(1), (2), or (3). Hence, grants they received from private foundations may be taxable expenditures. These grants are not taxable expenditures if a foreign organization meets two tests.

The first test, in Treas. Reg. 53.4945-6(c)(2)(ii), concerns foreign grantee organizations that do not have section 501(c)(3) rulings. Generally, a foreign organization will be treated as akin to a section 501(c)(3) organization if in the reasonable judgment of a foundation manager of the grantor private foundation, the grantee foreign organization is organized and operated as a section 501(c)(3) organization. Reasonable judgment is defined by its generally accepted legal sense within the outlines developed by judicial decisions in the law of trusts. This test does not apply to testing for public safety organizations.

The second test, in Treas. Reg. 53.4945-5(a)(5), provides that if a grantor private foundation makes a good faith determination that the foreign grantee organization is described in section 509(a)(1), (2), (3), such grants made to that foreign organization are considered to have been made to an organization described in the aforementioned Code sections. The good faith determination must be based upon an affidavit of the grantee foreign organization or an opinion of counsel (of the grantor or grantee), either of which must set forth sufficient facts concerning the operations and support of the grantee foreign organization for the Internal Revenue Service to determine that it would be likely to qualify as an organization described in section 509(a)(1), (2) or (3).

Rev. Proc. 92-94, 1992-2 C.B. 507, provides that a private foundation may base its reasonable judgment and good faith determination, as required by the tests above, upon an affidavit of the foreign grantee, which was prepared for another foundation.

Thus, under the revenue procedure, a foreign grantee does not have to prepare a new affidavit for each grant. The affidavit must be currently qualified. An affidavit is considered to be currently qualified if its facts are up to date.

Review and Supervision of Grants to Non-exempt Organizations

A private foundation must maintain expenditure responsibility over grants it makes to organizations (other than section 509(a)(1), (2) and (3)) for the grants not to be taxable expenditures. That private foundation will be considered to be exercising expenditure responsibility under if it meets three requirements. First, the private foundation must take certain precautions to ensure that the grant funds will be spent for proper purposes (in connection with this requirement the foundation must conduct a pre-grant inquiry concerning potential grantees and make all its grants subject to a certain type of written agreement with the grantee). Second, the private foundation must obtain full and complete reports from the grantee concerning the use of funds. Third, the private foundation must submit full and detail reports describing its expenditures to the Internal Revenue Service. Treas. Reg. 53.4945-5(b)(1). A private foundation must strictly comply with these requirements.

Pre-Grant Inquiry Requirement

Before a private foundation makes a grant to an organization subject to expenditure responsibility, the private foundation should conduct a limited pre-grant inquiry to ensure that the grant will be used for proper purposes. Special rules applicable to satisfying the requirements for pre-grant inquiries and examples illustrating the rules are found generally in Treas. Reg. 53.4945-5(b)(2).

The pre-grant inquiry should concern itself with matters such as (1) the identity, prior history, and experience of the grantee organization and its managers; and (2) whether the grantee has a history of compliance or noncompliance with the terms of previous grants, and any knowledge concerning the management, activities, and practices of the grantee organization.

The scope of the pre-grant inquiry will vary in each case depending on the size and purpose of the grant; the period over which it will be paid; and any prior experience the grantor has had with the grantee. Ordinarily, no further pre-grant inquiry is necessary where a grantee has properly used all prior grants and filed the required reports.

Terms of Grant Agreements

Compliance with the expenditure responsibility provisions will also require the grantor organization to make all such grants subject to a written commitment signed by an appropriate officer, director, or trustee of the grantee organization.

The commitment must include provisions that:

- a. clearly state the purposes of the grant. Such purposes may include contributing to capital endowment, purchase of capital equipment, specific program or series of programs, or general support of the grantee organization, provided that neither the grants nor the income thereof may be used for non-section 170(c)(2)(B) purposes;
- b. indicate that the grantee organization must repay any funds not used for grant purposes;
- c. indicate that the grantee organization must submit annual reports on the use of funds (unless the grant is to a private foundation for endowment or other capital purposes (see Treas. Reg. 53.4945-5(c)(2)), and in which case the reports on use of principal and income will be made the first year and the immediately succeeding two years if it is apparent that funds will be used appropriately.
- d. indicate that complete records of receipts and expenditures must be maintained, and to make such records available to the grantor. The grantee organization must also agree not to use funds in a manner inconsistent with the provisions of section 4945(d)(1) through (5). See Treas. Reg. 53.4945-5(b)(3).

Written Agreements for Grants to Foreign Organizations

If the grant is to a foreign organization, the written grant agreement must impose restrictions that are substantially equivalent to the limitations placed on domestic private foundations. Such restrictions may be phrased in appropriate terms under foreign law or custom and ordinarily will be considered sufficient if an affidavit or opinion of counsel (of the grantor or grantee) is obtained stating that, under foreign law or custom, the agreement imposes restrictions on the use of the grant substantially equivalent to the restrictions imposed on a domestic private foundation. See Treas. Reg. 53.4945-5(b)(5).

Conclusion Based on Current Published Precedents

Special international or foreign rules provide overlays only in a few areas.

It is not a charitable activity merely to support a foreign government; however, a deduction is allowable with respect to a transfer of property to a foreign government or political subdivision thereof if the transfer is used for exclusively charitable purposes.

For private foundation grants to foreign organizations, a recipient will be treated as akin to a section 501(c)(3) entity if in the reasonable belief of a foundation manager the grantee is organized and operated as a section 501(c)(3) organization and the grantor foundation makes a good faith determination that the foreign grantee is described in 509(a)(1), (2) or (3) based upon an affidavit of the grantee or an opinion of counsel. In addition, written expenditure responsibility agreements for international organizations

must impose restrictions that are substantially equivalent to those used for similar kinds of domestic grants.

As a general matter, these rules consider whether the requisite degree of control and oversight is exercised by the grant making U.S. charity. The deductibility of a charitable contribution or the determination that a grant is not a taxable expenditure depends upon the U.S. charity's ability to satisfy these requirements.