

THE GLOBALIZATION OF PHILANTHROPY: INTERNATIONAL CHARITABLE GIVING IN THE TWENTY-FIRST CENTURY

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Editors' Synopsis: U.S. citizens are becoming more involved in international charitable activities, and consequently, the role of these activities in tax planning is becoming increasingly important. International charitable giving can involve giving directly to foreign governments, charitable entities in foreign nations, and domestic entities involved in international charitable activities. Individuals and entities who choose to make these gifts must consider a range of issues. This Article addresses the tax implications of international gifts including the exceptions created by international tax treaties. The authors also discuss several alternatives for structuring international charitable activities.

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** Parts III and IV of this Article were previously included in the article written by Milton Cerny, *Taxation and Transition: Nonprofit Organizations in a Market Economy*, published in the Sept. 27, 1999 issue of TAX NOTES INTERNATIONAL. Part II was included in ALI-ABA Course No. SF23, *International Charitable Planning*, written by Julie W. Davis and Milton Cerny, presented in August, 2000. Both publishers have granted permission to reproduce these materials in this Article.

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I. INTRODUCTION

Today, families are in the midst of one of the largest wealth transfers in history. In the next five to seven years, estimates are that we will see over “\$13 trillion of assets moving from one generation to another.”¹ Global wealth increased in 2009 not only in the United States but also in the emerging market countries and Europe.

The U.S. Congress’s failure in 2009 to preserve the federal estate and generation-skipping transfer (GST) tax for 2010 created uncertainty for estate planning purposes.² However, unless Congress acts in 2010 the estate and gift taxes will automatically return in 2011 to the 2001 rates: “55% rate (with a 5% surcharge on estates or cumulative gifts between \$10 million and \$17.18 million), a \$1 million exemption for lifetime and testamentary transfers, and a \$1 million exemption from GST tax indexed for inflation.”³

With the globalization of the world market place, the redefinition of historical geopolitical borders, the increasing mobility of U.S. and foreign managers of multinational companies, and the emergence of substantial new venture capital fortunes, international charitable giving is evolving as a tax planning area of significant importance.⁴ The return of the estate tax in a currently unknown form will require that individuals review their foreign giving plans in 2011.

Many U.S. citizens and U.S. residents are acquiring assets physically located in foreign jurisdictions. Those assets may be subject to taxation in the country where located if the assets are gratuitously transferred within the family. Such a gratuitous transfer of assets held by a U.S. citizen or a

¹ Annie Gasparo, *The Next Generation*, WALL ST. J., (June 14, 2010), <http://online.wsj.com/article/SB10001424052748704717004575268340749255712.html>.

² See PRIVATE WEALTH SERVS. GRP. OF MCGUIRE WOODS LLP, ESTATE PLANNING IN UNCERTAIN TIMES: THE IMPACT OF THE REPEAL OF THE ESTATE TAX AND WHAT YOU NEED TO CONSIDER, 1 (2010), available at <http://www.mcguirewoods.com/news-resources/publications/taxation/The%20Possible%20Impacts%20of%20Estate%20Tax%Repeal.pdf> (discussing the impact of the repeal of the federal estate and GST tax).

³ *Id.* The GST exemption after indexing will be \$1,340,000 in 2011.

⁴ See THE CTR. ON PHILANTHROPY AT IND. UNIV., GIVING USA 2010: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2009, at 2 (2010) (reporting that 2009 giving for international affairs was up 6.6%, which was the largest percentage increase of any of the major giving categories).

U.S. resident is also subject to U.S. transfer taxes.⁵ Accordingly, the applicability of U.S. estate tax to non-U.S. assets of U.S. citizens or residents may be one of the most important considerations of U.S. estate planning for domestic citizens holding foreign-based assets.

This article summarizes some of the major issues that U.S. and foreign individuals and entities must address in considering whether and when to make lifetime and testamentary gifts to U.S. and foreign entities engaged in charitable activities.

II. U.S. TAX LAW: LIFETIME AND TESTAMENTARY INTERNATIONAL GIVING

A. Federal Income Tax Rules

Section 170(a) of the Internal Revenue Code (Code) allows an income tax deduction for any charitable contribution to a corporation, trust, community chest fund, or foundation that meets four requirements set forth in section 170(c)(2):

1. The donee must be “organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.”⁶

2. The donee must be “created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States.”⁷

3. The donee must avoid the prohibition against political campaign activity and substantial lobbying activity.⁸

4. The donee must not allow private inurement or private benefits to individual entities.⁹

For purposes of international philanthropy, the most significant requirement is the second, which limits the charitable deduction to gifts made to entities organized under U.S. law. “Prior to passage of the Revenue Act of 1938, U.S. individual taxpayers were allowed to make deductible contri-

⁵ See I.R.C. § 2501(a)(1).

⁶ I.R.C. § 170(c)(2)(B).

⁷ I.R.C. § 170(c)(2)(A). The Tax Court held that contributions made to a foreign church are not tax deductible because the contributions do not go to a qualified U.S. charity. *See Anonymous v. Comm’r*, T.C. Memo. 2010-87, at 8 (filed Apr. 22, 2010), available at <http://www.ustaxcourt.gov/InOpHistoric/anonymous.TCM.WPD.pdf>.

⁸ See I.R.C. § 170(c)(2)(D).

⁹ See I.R.C. § 170(c)(2)(C).

butions to charitable organizations regardless of where the organization” was organized.¹⁰ After enactment of that legislation, the charitable deduction was available to U.S. individual taxpayers only if the contribution was to a U.S. charitable organization.¹¹ For corporations, the deduction had been limited “to contributions to organizations established in the United States that used the contribution within the United States.”¹²

The rationale for allowing a charitable deduction only for contributions by corporations and individuals to U.S. charities is this: the savings realized from private gifts to organizations whose charitable activities relieve the U.S. government of obligations and programs requiring the use of public funds offsets the loss of the tax revenue resulting from the deduction.¹³ Gifts to foreign organizations obviously would not produce the desired result in the United States.

The section 170(c)(2) requirements thus prevent an organization created under foreign law, as well as foreign governments and international organizations, from receiving direct contributions that are deductible for U.S. income tax purposes.¹⁴ As discussed below, however, the deduction for gifts to U.S. charities and U.S. governmental units generally is available to non-U.S. individuals as well as to U.S. citizens and residents, subject to various limitations.¹⁵

1. *Income Tax Charitable Deduction for Individuals*

a. *General Deduction Rules*

A donor who itemizes deductions generally may take an income tax charitable deduction for contributions to qualified charitable organizations, subject to any general limitations on itemized deductions under the Code.¹⁶

For a gift of cash or unappreciated property to a “50%-type” organization—generally organizations described in section 509(a)(1), (2), or (3); private operating foundations; and conduit private foundations, but not private foundations—the donor generally may deduct the full amount of the

¹⁰ BRUCE R. HOPKINS, *THE TAX LAW OF CHARITABLE GIVING* 548 (3rd ed. 2005).

¹¹ See Revenue Act of 1938, Pub. L. No. 554, § 23, 52 Stat. 447, 463 (1938).

¹² HOPKINS, *supra* note 10, at 548.

¹³ See *id.*

¹⁴ See I.R.C. § 170(c)(2)(A).

¹⁵ See I.R.C. § 170(a).

¹⁶ See I.R.C. § 170(a). *But see* I.R.C. § 68(a) (limiting the allowable deductions where an individual’s adjusted gross income exceeds the applicable amount).

contribution up to 50% of the donor's adjusted gross income (the "50% ceiling").¹⁷

For a gift of cash or unappreciated property to a "30%-type" organization—a private foundation, other than a private operating foundation or a conduit private foundation—and gifts for the use of a 50%-type organization, the donor generally may deduct the full amount of the contribution up to 30% of the donor's adjusted gross income.¹⁸

For gifts to a 50%-type organization of appreciated long-term capital gain property, the donor may deduct the full fair market value of the gift only up to 30% of the donor's adjusted gross income.¹⁹ For gifts of such property to a private foundation, the Code limits the deduction to 20% of the donor's contribution base.²⁰

The amount of the charitable deduction for gifts of ordinary income or short-term capital gain property is reduced by the amount of the ordinary income that a donor would have recognized had the donor sold the property on the date of the gift.²¹ This category includes inventory, crops, dealer property, and works that the donor created.²² If the artist donates a painting, for example, the deduction is limited to the artist's cost of materials. Normally, this rule limits the deduction for these types of assets to the property's basis.

A donor may take a charitable deduction equal to the greater of fair market value or basis for a contribution of tangible personal property if the use of such property is related to the donee's exempt purpose.²³ If the use of the property is not related to the donee's exempt purpose, the donor's deduction is limited to the property's basis or fair market value if less.²⁴ Tangible personal property that "is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the contribution was made and with respect to which" the donee's officer has not signed a written statement under the penalties of perjury either (1) certifying that the use of the property was related to the donee's exempt purpose or function and "describ[ing] how the property was used and how such use furthered such purpose or function" of the donee or (2) "stat[ing] the intended

¹⁷ See I.R.C. § 170(b)(1)(A).

¹⁸ See I.R.C. § 170(b)(1)(B).

¹⁹ See I.R.C. § 170(b)(1)(C).

²⁰ See I.R.C. § 170(b)(1)(D).

²¹ See I.R.C. § 170(e).

²² See Treas. Reg. § 1.170A-4(b)(1).

²³ See I.R.C. § 170(e).

²⁴ See I.R.C. § 170(e)(1)(B).

use of the property by the donee at the time of contribution and certif[ying] that such intended use has become impossible or infeasible to implement” is deemed to be “unrelated use” property.²⁵ If the donee disposes of the property after the close of the taxable year of the contribution and within three years of the date of the contribution (unless the donee makes the certification described above), the donor must recapture the charitable deduction in an amount equal to the difference between the amount claimed as a deduction and the property’s basis.²⁶ The donor must include this recapture amount in ordinary income in the year the disposition occurs.²⁷

In addition to the deduction limitations discussed above, the deduction for gifts of appreciated property to private foundations has further limitations.²⁸ If an individual contributes long-term capital gain property, such as real estate held for more than one year, the Code limits the amount of the deduction to the lesser of the property’s basis and the property’s fair market value.²⁹ However, an exception allows a deduction at fair market value for a contribution of “qualified appreciated stock,” which is generally stock for which market quotations are readily available on an established securities market.³⁰

b. Carryovers of Excess Contributions

If a donor’s U.S. income tax charitable contribution limitation cannot be used in full because of the percentage limitation, the unused amount may be carried over for up to five years until fully used.³¹ A donor may want to make a charitable gift even if the donor will not be able to use the deduction in full when the value of the property to be donated is high but that value is expected to decline in the future. An example is where the value of the donation of foreign real estate is determinable under a foreign currency. The value of the property may continue to rise but currency declines may offset or eliminate the property’s appreciation. Immediately after receipt of the property, the charity could sell the property and realize the fair market value before the anticipated declines occur. Generally that property disposition would be without federal income tax consequences to the charity. However, if the property is located in a foreign jurisdiction, the U.S. charity would

²⁵ I.R.C. § 170(e)(1)(B)(II), (7)(D).

²⁶ See I.R.C. § 170(e)(7).

²⁷ See *id.*

²⁸ See generally I.R.C. § 170(e).

²⁹ See I.R.C. § 170(e)(1)(B).

³⁰ See I.R.C. § 170(e)(5).

³¹ See I.R.C. § 170(d).

need to determine whether the charity is recognized as having tax-exempt status for foreign income tax purposes so that the gain is exempt from tax in the foreign jurisdiction. If the donated property is capital gain property, that gain may not be subject to tax in the foreign jurisdiction as many jurisdictions do not impose income tax on property dispositions.³²

2. *Special Rules for Contributions by Nonresident Aliens*

A nonresident alien's U.S. gross income is limited to certain specified amounts not connected with a U.S. trade or business and income that is connected with a U.S. business.³³ Generally, a nonresident alien is only allowed deductions connected with the conduct of a trade or business within the United States in computing U.S. taxable income subject to the prescribed apportionment rules.³⁴ However, the Code allows a deduction for charitable contributions and gifts, regardless of whether the income is related to or effectively connected with the conduct of a U.S. trade or business.³⁵

A nonresident alien may only obtain the benefits of the income tax charitable deduction (and other deductions) by filing an accurate U.S. income tax return.³⁶ A nonresident alien will likely file a U.S. income tax return when the nonresident alien has U.S. trade or business income but not when the only U.S. income is income not connected with a U.S. trade or business that is subject to the 30% withholding at source (or other lower rate under an applicable tax treaty). In this situation, the nonresident will have to file a U.S. income tax return to claim the charitable deduction, which the nonresident alien may not be willing to do.³⁷

³² For a general discussion of the tax affect on the disposition of foreign property see WILLIAM P. STRENG, U.S. INTERNATIONAL ESTATE PLANNING § 20.04[3][c], 20.04[4] (1996) (citing I.R.C. § 170(b)(1)(C)(ii), (b)(1)(C)(ii), (d)(1) (discussing the deductions for the 20%, 30%, and 50% categories)).

³³ See I.R.C. §§ 871(b), 872(a)(2).

³⁴ I.R.C. § 873(a).

³⁵ For a general discussion on the special rules for nonresident alien contributions see STRENG, *supra*, note 32.

³⁶ See I.R.C. § 874(a).

³⁷ See STRENG *supra* note 32, ¶ 20.04[4] (citing I.R.C. §§ 871-74; Treas. Reg. § 1.873-1(c)(2)(iii)) ("Reminds taxpayers that the deduction for charitable contributions is available only for contributions or gifts made to domestic corporations, community chests, funds, or foundations created in the United States.").

B. Estate and Gift Tax Rules

The rules for U.S. estate and gift tax deductions are different, and in some respects more complicated, than the limitations that restrict the section 170(a) income tax deduction for contributions to U.S. charities. First, the rules for estate and gift tax deductibility are different from the rules for income tax deductibility. Second, the rules for U.S. citizens and residents are different from those for nonresident aliens.

As a threshold matter, U.S. citizens or residents may deduct contributions to any foreign organization that is not a foreign governmental unit for estate and gift tax purposes so long as the organization uses the funds exclusively for charitable purposes and the foreign organization satisfies the prohibitions against private inurement and political campaign activities.³⁸ The lobbying limitations applicable to domestic, tax-exempt charitable organizations extend to foreign associations as well.³⁹

In the case of nonresident aliens, however, the U.S. estate and gift tax rules allow the deduction for charitable gifts and bequests only if the contribution is to a U.S. charitable corporation or a U.S. governmental entity, or is for use exclusively in the United States by a U.S. or foreign charitable trust, community chest, fund, or foundation.⁴⁰ If the contribution is a testamentary bequest, the decedent must include the contributed assets in the U.S. gross estate.⁴¹ Thus, no estate tax charitable deduction exists for testamentary bequests of non-U.S. assets by nonresident aliens.

III. TAX PLANNING OPPORTUNITIES FOR U.S. CHARITIES, FOUNDATIONS, AND INDIVIDUALS

Private individuals, public charities, and private foundations can use a number of methods to engage in international philanthropy while preserving the deductibility of donations by U.S. citizens and residents. These methods will become increasingly important as U.S. charities and foundations move away from direct development in foreign countries and move toward supporting local groups engaged in charitable activities.⁴² A U.S. income tax treaty may expand the scope of eligible charitable donees to include recipients in the tax treaty partner country on a reciprocal basis.

³⁸ See I.R.C. §§ 2055(a)(2), 2106(a)(2)(A)(ii), 2522(a)(2).

³⁹ See I.R.C. §§ 2055(a)(2), 2522(b).

⁴⁰ See Treas. Reg. § 20.2106-1(a)(2).

⁴¹ See I.R.C. § 2106(a).

⁴² See Stephen G. Greene, *Rethinking International Assistance*, THE CHRON. OF PHILANTHROPY, Apr. 3, 1997, at 1.

Discussed below are the major planning opportunities that address the statutory prohibitions against income, gift, and estate tax deductibility described thus far: (1) gifts that take advantage of favorable tax treaty provisions; (2) gifts to U.S. charities with overseas operations; (3) gifts to U.S. "friends of" organizations that support foreign charitable activities; (4) gifts to U.S. private foundations that make grants to support foreign charitable activities; and (5) gifts to charitable entities or units organized by foreign governments and international organizations that are generally exempt from U.S. income tax under section 892.⁴³

A. U.S. Tax Treaty Provisions

1. *Income Tax Treaties*

The United States has created some exceptions to these general rules pursuant to treaties with Mexico, Israel, and Canada that provide for reciprocal deductibility of contributions to charitable organizations.⁴⁴ The United States also has provided for reciprocal exemption of charitable organizations in treaties with Canada, Germany, and the Netherlands.⁴⁵ To date, the United States has established no other such protocols.

a. *United States-Mexico Tax Treaty*

The United States-Mexico Tax Treaty provides that a U.S. individual or corporation can deduct contributions to Mexican public charities, but not Mexican private foundations, against the individual's or corporation's Mexican source income only.⁴⁶ The treaty further provides for mutual recognition of the income tax exemptions of qualifying charities, for grantmaking by U.S. foundations to Mexican charities without a need for exercising expenditure responsibility, and for chapter 42 excise tax exemption for Mexican private foundations if the foundations receive substantially all of their support from non-U.S. sources.⁴⁷

The Mexican government is still resolving various regulatory and interpretative matters that affect the implementation of the treaty, although the procedures for formally registering as a Mexican charity are apparently in

⁴³ See Treas. Reg. § 1.509(a)(2); Rev. Rul. 66-177, 1966-1 C.B. 132.

⁴⁴ See *infra* Parts III.A.1.a-c.

⁴⁵ See *infra* Parts III.A.1.c-e.

⁴⁶ See Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Mex., art. 22, Sept. 18, 1992, KAV No. 6264 [hereinafter United States-Mexico Tax Treaty].

⁴⁷ See *id.*

place. To implement the treaty, a simultaneously executed protocol provides that, except for churches or conventions of churches, the Mexican and United States tax laws provide essentially equivalent standards for public charities.⁴⁸

The normal percentage limitations on charitable deductions limit the deductions under U.S. law for contributions to Mexican charities, with the limitations being applied to Mexico source income.⁴⁹ The deductions under Mexican law for contributions to U.S. charities are also subject to the normal Mexican limitations applied to U.S. source income.⁵⁰

To take advantage of the treaty's provisions, more than 50% of an exempt organization's beneficiaries, members, or participants must be eligible to receive benefits under the treaty in their own capacity—for example, by being an individual resident of the United States or Mexico.⁵¹ This limitation on benefits applies to both the reciprocal exemption provision and the deductibility of contribution provision.⁵²

b. United States-Israel Tax Treaty

The United States-Israel Tax Treaty provides that contributions by a U.S. citizen or resident to an Israeli public charity or private foundation are deductible under U.S. law if the Israeli charity would qualify as a public charity under U.S. law and if the contributions otherwise would be deductible under U.S. law.⁵³ The treaty limits the deductions to 25% of an individ-

⁴⁸ See United States-Mexico Tax Treaty, *supra* note 46, Protocol, para. 17. The United States-Mexico Tax Treaty recognized that Mexican charities could choose to be governed by Article 70-B of Mexico's tax laws, which was identical to the rules established by the Internal Revenue Service (Service) for U.S. public charities and thus made the Mexican charity the equivalent of a U.S. public charity. *See id.* In 2001, Article 70-B, with some minor modification, became Article 97. The Service has not determined whether the same treaty rights will apply under the new Article 97.

⁴⁹ *See id.*, art. 22.

⁵⁰ *See id.*

⁵¹ *See id.*, art. 17, para. 1(e).

⁵² See TREASURY DEPARTMENT, TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED MEXICAN STATES FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON ON SEPTEMBER 18, 1992, art. 22 (n.d.), available at <http://www.irs.gov/pub/irs-utl/mexicotrweb.pdf>.

⁵³ See Convention Between the Government of the United States of America and the Government of the State of Israel with Respect to Taxes on Income, U.S.-Isr., Protocol 1, art.

ual U.S. donor's Israeli source gross income and to 25% of a corporate U.S. donor's Israeli source taxable income.⁵⁴ A reciprocal rule applies to Israeli donors who contribute to U.S. public charities or private foundations.⁵⁵ The treaty does not provide, however, that a charitable organization that is tax-exempt in one country is tax-exempt in the other country.⁵⁶

Similar to the United States-Mexico Tax Treaty, the United States-Israel Tax Treaty provides that an exempt organization can take advantage of the deductibility of contribution provision only if more than 50% of an exempt organization's beneficiaries, members, or participants are themselves eligible to receive benefits under the treaty—for example, by being an individual resident of the United States or Israel.⁵⁷

c. United States-Canada Tax Treaty

The United States-Canada Tax Treaty provides that a charitable organization that is tax-exempt in one country will be tax-exempt in the other country as long as the organization meets the tax-exemption requirements of the other country.⁵⁸ Further, contributions by a U.S. citizen or resident to a Canadian public charity or private foundation are deductible under U.S. law if the Canadian charity would qualify as a public charity under U.S. law and if the contributions otherwise would be deductible under U.S. law.⁵⁹

X, November 20, 1975, KAV No. 3554 (adding article 15-A (Charitable Contributions) to the Convention in 1980).

⁵⁴ *See id.*

⁵⁵ *See id.*

⁵⁶ *See id.*

⁵⁷ *See* United States-Israel Tax Treaty, *supra* note 53, Protocol 2, art. XII (adding article 25 (Limitations on Benefits) to the Convention in 1993).

⁵⁸ *See* Convention Between the United States of America and Canada with Respect to Taxes on Income and Capital, U.S.-Can., art. XXI, Sept. 26, 1980, T.I.A.S. No. 11087 [hereinafter United States-Canada Tax Treaty] (amended by art. X of the 1983 protocol); *see also* Priv. Ltr. Rul. 9120026 (Feb. 21, 1991) (holding that for a Canadian nonprofit organization to be tax-exempt in the United States, it must meet the criteria under U.S. law for tax exemption as well as the criteria under Canadian law). Article XXI of the United States-Canada Tax Treaty, however, denies the exemption for income derived from related persons or from the conduct of a trade or business.

⁵⁹ In Notice 99-47, dated Sept. 7, 1999, [the Service] indicates that the Competent Authorities have entered into a mutual agreement (the Agreement) under which Canadian and U.S. charities receive reciprocal exemption. . . . [U]nder the Agreement, every Canadian registered charity, as determined by Revenue Canada, is now automatically treated as a section 501(c)(3) organization, regardless of whether the Canadian charity has filed a Form 1023 Application for Recognition of Exemption

The normal percentage limitations on charitable deductions limit the deductions under U.S. law for contributions to Canadian charities with the limitations being applied to Canadian source income.⁶⁰ The deductions under Canadian law for contributions to U.S. charities are also subject to the normal Canadian limitations, with the limitations being applied to U.S. source income.⁶¹ A reciprocal rule applies to Canadian donors who contribute to U.S. public charities or private foundations. The United States-Canada Tax Treaty also provides that Canadian private foundations are exempt from chapter 42 excise taxes if they receive substantially all of their support from non-U.S. sources.⁶²

Under a 1994 protocol, the law of a decedent's country of residence governs the taxation of property that passes on death to a charity, with the charity treated as if it is also a resident of that country.⁶³ For a U.S. resident who dies and leaves property to a Canadian charity, no tax will be owed on that property because U.S. law has an unlimited charitable deduction for bequests to charity.⁶⁴ For a Canadian resident who dies and leaves property to a U.S. charity, three-quarters of the gain, if any, on that property is taxed. However, a charitable contribution tax credit, calculated by multiplying the amount of the contribution (up to a limit of 50% of the year's U.S. source income) by the highest marginal tax rate, offsets this tax.⁶⁵

The 1994 protocol also added a limitation on benefits provision that is essentially the same as the provision included in the treaties with Mexico and Israel.⁶⁶

with the IRS. The Notice states . . . a presumption that all such organizations are private foundations, unless they demonstrate otherwise. . . . Accordingly, if a Canadian registered charity does not provide the U.S. with the financial information needed to . . . [establish public charity status], the organization will be presumed to be a private foundation under U.S. law.

LaVerne Woods, IRS Notice 99-47: A Help or Hindrance for Foundation Grants to Canadian Charities?, 28 THE EXEMPT ORG. TAX REV. 203, 206 (2000) (footnote omitted). As discussed below, some commentators have questioned whether this Notice helps or hinders grants by U.S. private foundations to Canadian charities.

⁶⁰ See United States-Canada Tax Treaty, *supra* note 58, art. XXI.

⁶¹ See *id.*

⁶² See *id.*

⁶³ See United States-Canada Tax Treaty, *supra* note 58, Protocol 3, art. 19 (adding art. XXIX B (Taxes Imposed by Reason of Death) to the Convention).

⁶⁴ See I.R.C. § 2055(a)(2).

⁶⁵ See Income Tax Act, R.S.C. 1985, c.1 §§ 38, 118(1) (Can. 5th Supp.).

⁶⁶ See United States-Canada Tax Treaty, *supra* note 58, Protocol 13, art. 20.

d. United States-Germany Tax Treaty

The United States-Germany Tax Treaty provides that a tax-exempt charitable organization in one country will be tax-exempt in the other country as long as the organization meets the tax-exempt requirements of the other country. None of the provisions in the convention allow a resident or citizen of one country to deduct from income a contribution made to a tax-exempt organization of the other country.⁶⁷ Also, no applicable limitations on benefits provision exists, such as those contained in the treaties with Mexico, Israel, and Canada, regarding either the income tax exemption or the estate and gift tax exclusion provisions.⁶⁸

e. United States-Netherlands Tax Treaty

The United States-Netherlands Tax Treaty provides similar exempt organization provisions as the United States-Germany Tax Treaty, although the United States-Netherlands Tax Treaty does not have a comparable estate tax treaty provision.⁶⁹ Unlike the United States-Germany Tax Treaty, however, the United States-Netherlands Tax Treaty does contain a limitation on benefits provision similar to the provisions contained in the treaties with Mexico, Israel, and Canada.⁷⁰

2. Estate and Gift Tax Treaties

With the repeal of the federal estate tax in 2010, and without Congressional action to reintroduce the tax for 2010, a question exists regarding whether the estate and gift tax treaties remain valid for 2010. Furthermore, people are uncertain if the tax treaties will be valid in 2011 and beyond when the estate tax is scheduled to return in some form. However, we will assume for purposes of this discussion that Congress will pass compromise

⁶⁷ See Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, U.S.-Ger., art. 27, Aug. 29, 1989, 1708 U.N.T.S. 3 [hereinafter United States-Germany Tax Treaty].

⁶⁸ Article 28 section (1)(f) of the United States-Germany Tax Treaty does contain a limitations on benefits provision applicable to exempt organizations, but Article 27 of the same treaty makes that provision inapplicable to the treaty's reciprocal exemption provision.

⁶⁹ See Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Neth., art. 36, Dec. 18, 1992, KAV No. 6475 [hereinafter United States-Netherlands Tax Treaty]. Article 36, however, denies the exemption to income derived from the conduct of a trade or business.

⁷⁰ See *id.* art. 26, para. (1)(e).

legislation or that the 2001 estate and gift tax exemption of \$1 million and the 55% tax rate will return, with the following treaties remaining in effect in either case. Currently, only five U.S. bilateral tax treaties in force reference the deductibility of charitable gifts and bequests. The United States' agreement with Canada regarding charitable transfers is part of the United States-Canada Income Tax Treaty, while the United States has separate estate and gift tax treaties with Denmark, France, Germany, and Sweden. The treaty with Sweden closely follows the recommendations in the U.S. Treasury Department's 1980 model treaty.

a. United States-Canada Tax Treaty

Contributions to qualifying tax-exempt organizations in either the United States or Canada receive treatment as though made to tax-exempt organizations of the taxing country.⁷¹ The treaty defines an "exempt organization" as a "religious, scientific, literary, educational or charitable organization."⁷² With respect to the United States, this treaty means that the Convention permits a Canadian resident who is not a citizen or domiciliary of the United States to claim a charitable contribution deduction for testamentary transfers of property to a Canadian charitable organization if the property is included in the U.S. gross estate.

b. United States-Denmark Tax Treaty

This treaty provides for an exemption or deduction when a taxpayer makes a transfer to a qualifying tax-exempt institution in the other treaty country.⁷³ To qualify for the exemption, the transfer must be exempt from tax or taxed at a reduced rate in the other country and the entity must be "operated exclusively for religious, charitable, scientific, literary, or educational purposes."⁷⁴ If this test is met, the taxpayer can apply the exemption or deduction as if the transfer were to a domestic entity.⁷⁵ This provision applies to transfers to political subdivisions of a country and transfers to a corporation or organization "operated exclusively for religious, charitable, scientific, literary, or educational purposes."⁷⁶

⁷¹ See United States-Canada Tax Treaty, *supra* note 58, art. XXIX, para. (B)1.

⁷² *Id.* art. XXI, para. (1).

⁷³ See Convention Between the Government of the United States of America and the Government of the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritances, Gifts and Certain Other Transfers, U.S.-Den., art. 9, para. 1, Apr. 27, 1983, T.I.A.S. No. 11089.

⁷⁴ *Id.*

⁷⁵ See *id.*

⁷⁶ *Id.*

c. United States-France Tax Treaty

Under this treaty, a transfer to a qualifying tax-exempt institution in the other treaty country is exempt or fully deductible.⁷⁷ “Essentially, it must be shown that a transfer to the same entity in the taxing country would have also qualified for the exemption or deduction.”⁷⁸ To qualify, the entity must “(1) be tax-exempt in its home country; (2) be organized and operated solely for religious, charitable, scientific, literary, or educational purposes; and (3) receive a substantial part of its support from public or government funds.”⁷⁹ Accordingly, as the Senate Foreign Relations Committee Report points out, “a contribution to a private foundation, which is deductible in the United States, might not be deductible in France.”⁸⁰

d. United States-Germany Tax Treaty

Transfers are exempt if made to a corporation or organization organized and operated exclusively for religious, charitable, scientific, educational, or public purposes or to a public body when property is to be used for such purposes.⁸¹ The exemption is available even though the charitable entity is in the other treaty country. While the competent authorities are to work out the application of this provision, the exemption is limited to the amount allowed by the country in which the charitable entity is organized and operated as well as the amount that the country imposing the tax would have allowed if the entity were organized and operating in that country.⁸²

B. Gifts to Public Charities with Overseas Operations

Domestic organizations, such as the American Red Cross and various religious relief societies, coordinate their relief efforts with similar organizations around the world. Even though donors are well aware that these domestic organizations will often, or—in the case of specific fundraising

⁷⁷ See Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritances, and Gifts, U.S.-Fr., art. 10, para. 1, Nov. 24, 1978, 32 U.S.T. 1935.

⁷⁸ JEFFREY A. SCHOENBAUM, *MULTISTATE AND MULTINATIONAL ESTATE PLANNING* 21-60 (2009 ed.) (citing United States - France Tax Treaty, *supra* note 77, art. 24).

⁷⁹ *Id.* at 21-60 n. 461.

⁸⁰ *Id.* (citing S. Ex. Rep. No. 96-3, 2 Tax Treaties (CCH) ¶3095, at 27,279 (Dec. 1998)).

⁸¹ See United States-Germany Tax Treaty, *supra* note 67, at art. 27, para. 1.

⁸² See Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts, U.S.-F.R.G., art. 10, para. 2, Dec. 3, 1980, T.I.A.S. No. 11082.

drives—almost certainly, use donor contributions outside the United States, the contributions remain deductible. An activity that is charitable if carried out in the United States is also a charitable activity if carried out in a foreign country.⁸³

However, if a contribution to a U.S. public charity is earmarked for a foreign donee rather than for a U.S. charitable use, the taxpayer cannot deduct the contribution because the taxpayer will have made the contribution directly to the foreign donee and not to the U.S. charity.⁸⁴ Thus, a U.S. public charity cannot serve as a conduit for foreign philanthropic activities.

But if a domestic charity exercises sufficient discretion and control over the funds, the contribution will be deductible even if the domestic charity ultimately transfers the contribution to a foreign donee.⁸⁵ For these purposes, an activity that is charitable if carried out in the United States is also charitable if carried out in a foreign country.⁸⁶

C. Gifts to U.S. “Friends of” Organizations

“Friends of” organizations are U.S. organizations formed to aid programs operated by one or more non-U.S. charities while meeting the legal requirements for contributions to be deductible for U.S. income tax purposes.⁸⁷

⁸³ See Milton Cerny & Adam M. Damerow, *Charitable Giving and Disaster Relief Efforts in Response to the Haitian and Chilean Earthquakes*, 65 THE EXEMPT ORG. TAX REV. 483 (2010).

⁸⁴ Cf. *Thomason v. Comm’r*, 2 T.C. 441 (1943) (denying a charitable contribution deduction for payments made for the benefit of a particular individual who was in the care of a public charity); Rev. Rul. 54-580, 1954-2 C.B. 97 (denying a charitable contribution deduction for tuition payments to church-sponsored schools).

⁸⁵ See Rev. Rul. 75-65, 1975-1 C.B. 79; Rev. Rul. 66-79, 1966-1 C.B. 48; Rev. Rul. 63-252, 1963-2 C.B. 101.

⁸⁶ See *Bilingual Montessori School of Paris, Inc.*, 75 T.C. 480 (1980) (holding that a U.S. nonprofit organization that conducts all or part of its activities outside the United States is still exempt from tax under section 501(c)(3), assuming that it meets the other requirements of that section); Treas. Reg. § 1.170A-8(a) (“A charitable contribution by an individual to or for the use of an organization described in section 170(c) may be deductible even though all, or some portion, of the funds of the organization may be used in foreign countries for charitable or educational purposes.”); Rev. Rul. 71-460, 1971-1 C.B. 231 (holding the same as *Bilingual Montessori*).

⁸⁷ See Victoria B. Bjorklund & Jennifer I. Reynoso, *How a Private Foundation Can Use “Friends of” Organizations*, UNITED STATES INTERNATIONAL GRANTMAKING (2005), http://www.usig.org/legal/friends_of_organizations.asp.

1. *General Rules*

Friends of organizations are usually nonprofit corporations with several board members associated with the supported organization. A majority of the board, however, should be independent of the supported organization.⁸⁸ Friends of organizations generally qualify as section 509(a)(1) publicly supported charities, but they can also qualify as section 509(a)(2) public charities (public fee-for-service supported) if the sale of goods or services funds them.⁸⁹ Support from foreign governments receives the same treatment as support from a domestic government entity and therefore is not subject to the 2% limit on certain support under sections 509(a)(1) and 170(b)(A)(vi).⁹⁰

Qualification as a supporting organization under section 509(a)(3) is problematic because, for the contributions to be deductible, the supported foreign charity cannot control or supervise the friends of organization. Moreover, a section 509(a)(3) organization cannot operate in connection with an organization organized under foreign law.⁹¹

An organization can show responsiveness by having a single director, officer, or trustee overlap⁹² and can show significant involvement by having the friends of organization paying substantially all (85%) of its income to the foreign entity.⁹³ But, under changes made by the Pension Protection Act of 2006, this type of supporting organization—referred to as a Type III supporting organization—may not support a foreign organization.⁹⁴ Thus, friends of organizations likely will need to be public charities under section 509(a)(1) or (a)(2).

2. *Example of a “Friends of” Organization*

A good example of a friends of organization was the Coalition for International Justice (Coalition),⁹⁵ a U.S. public charity established to support

⁸⁸ *See id.*

⁸⁹ *See id.*

⁹⁰ *See* Rev. Rul. 75-435, 1975-2 C.B. 215.

⁹¹ *See* I.R.C. § 509(f).

⁹² *See* Treas. Reg. § 1.509(a)-4(i)(2).

⁹³ *See* Treas. Reg. § 1.509(a)-4(i)(3); Rev. Rul. 76-208, 1976-1 C.B. 161 (holding that “substantially all” means 85%). Proposed regulations issued following the enactment of the Pension Protection Act of 2006 would require certain Type III organizations to distribute assets to their supported organizations. *See* Prop. Treas. Reg. § 1.509(a)-4 (i)(5)(ii).

⁹⁴ *See* I.R.C. § 509(f).

⁹⁵ Coalition closed its operations on March 31, 2006. *See* Farewell Letter from the board of the Coalition for International Justice (Feb. 28, 2006), *available at* <http://web>.

the International War Crimes Tribunal (Tribunal) that the United Nations created to prosecute persons responsible for violating international human rights laws in the former Yugoslavia and Rwanda.⁹⁶ The Coalition supported the Tribunal in four significant ways:

1. Securing and coordinating financial and in-kind support for the Tribunal;
2. Coordinating activities of nongovernmental organizations that support the Tribunal's mission;
3. Providing technical and legal assistance as requested by the Tribunal; and
4. Providing grants to organizations and individuals to carry on its charitable and educational programs.

The Coalition received tax-exempt status as a section 501(c)(3) organization because it lessened the burdens of the U.S. government, a major supporter of the Tribunal,⁹⁷ and defended human and civil rights secured by law.⁹⁸ The organization was a publicly supported organization under sections 509(a)(1) and 170(b)(1)(A)(vi).

The Coalition's board of directors decided which projects to fund and support. These decisions were based in large part on the recommendations made by a twelve-member advisory council composed of prominent U.S. and foreign legal scholars, human rights advocates, and other nongovernmental leaders. The Coalition received regular reports from the Tribunal to ensure that funds allocated to Tribunal projects were expended for the purposes of the grant.

[archive.org/web/20060527091153/http://www.cij.org/CIJ_Farewell_Letter.pdf](http://www.cij.org/CIJ_Farewell_Letter.pdf) (accessed by searching for www.cij.org/CIJ_Farewell_Letter.pdf in the Internet Archive index).

⁹⁶ ENCYCLOPEDIA OF ASSOCIATIONS, INTERNATIONAL ORGANIZATIONS: AN ASSOCIATIONS UNLIMITED REFERENCE, at 716 (Alan Hedblad ed., 40th ed. 2004).

⁹⁷ See Treas. Reg. § 1.501(c)(3)-1(d)(2) (defining "charitable" to include lessening the burdens of government); Rev. Rul. 85-2, 1985-1 C.B. 178 (holding that an organization lessens the burdens of government if the organization's activities are activities that a government unit considered to be its burdens, and if such activities actually lessen such government burdens); Rev. Rul. 85-1, 1985-1 C.B. 177.

⁹⁸ See Treas. Reg. § 1.501(c)(3)-1(d)(2) (defining charitable to include "defend[ing] human and civil rights secured by law"); Priv. Ltr. Rul. 9223054 (Mar. 12, 1992) (holding that fostering freedom of speech and freedom of the press through grants in Eastern European countries is a charitable activity); Gen. Couns. Mem. 30,945 (July 26, 1997) (assuming that "human and civil rights secured by law" include rights secured by international law); Gen. Couns. Mem. 38,468 (Aug. 12, 1980) (holding that "human and civil rights secured by law" includes rights other than those guaranteed by the U.S. Constitution).

D. Gifts to U.S. Private Foundations

Another technique for making tax deductible gifts that will support overseas charitable activities is establishing a U.S. private foundation that will engage in foreign grantmaking. However, care is necessary to ensure that the U.S. foundation's grantmaking program satisfies the technical rules applicable to such grants set forth in chapter 42 of the Code.

1. *Expenditure Responsibility for Grants to Foreign Charities*

Perhaps the most significant of these rules, at least with respect to the operations of the private foundation, is the requirement that the private foundation exercise expenditure responsibility over grants to foreign charities that the Internal Revenue Service (Service) has not recognized as such.⁹⁹ Under applicable regulations, a private foundation must exercise expenditure responsibility with respect to all grants to foreign organizations that the Service does not recognize as charitable.¹⁰⁰ If the private foundation does not exercise such responsibility, the grant will be a taxable expenditure.¹⁰¹ A taxable expenditure not only is subject to a series of tiered excise taxes but also requires correcting.¹⁰²

Exercising expenditure responsibility requires (1) a pregrant inquiry, (2) a written grant agreement binding the grantee to repayment of funds not used for the purposes of the grant, (3) submission of annual reports by the grantee to the donor, (4) maintenance of books and records by the grantee that are available to the donor, (5) a commitment by the grantee not to use the funds for political, legislative, or nonexempt activity, (6) provision by the grantee of periodic reports to the grantor on the use of funds, and (7) provision by the donor foundation of information about the expenditure responsibility grant to the Service as part of the donor foundation's annual information return.¹⁰³ For grants made to a nonpublic charity or private foundation, including a foreign charity that has not filed for U.S. recognition of its public charity status, the grantee must also agree to keep the provided funds in a separate fund dedicated to charitable purposes.¹⁰⁴

⁹⁹ See I.R.C. § 4945(d)(4).

¹⁰⁰ See I.R.C. § 4945(h); Treas. Reg. § 53.4945-5.

¹⁰¹ See I.R.C. § 4945(h).

¹⁰² See I.R.C. § 4945.

¹⁰³ See I.R.C. § 4945(h); Treas. Reg. § 53.4945-5(b), (c)(1), (d); *see also* TREASURY GUIDELINES WORKING GRP. OF CHARITABLE SECTOR ORGS. AND ADVISORS, PRINCIPLES OF INTERNATIONAL CHARITY (2005), available at http://usig.org/PDFS/Principles_final.pdf.

¹⁰⁴ See Treas. Reg. § 53.4945-6(c)(2)(i).

A foundation can avoid the need to exercise expenditure responsibility if the foundation determines after a good faith effort that the foreign organization would qualify under sections 501(c)(3) and 509(a)(1), (2), or (3) if the organization had applied for U.S. recognition as a public charity.¹⁰⁵ Either an equivalency determination or an affidavit demonstrates a good faith effort.¹⁰⁶ Expenditure responsibility can also be avoided if the grantee is a foreign government, including any agency or instrumentality thereof, or an international organization recognized under 22 U.S.C. section 288.¹⁰⁷

a. Equivalency Determination – Opinion of Counsel

An equivalency determination is an opinion of counsel—retained by either the grantor or the grantee—that the foreign grantee organization, except for its place of organization, is equivalent to a U.S. public charity.¹⁰⁸ While the Service has not provided explicit guidelines regarding the information on which such an opinion should be based, the requirements for affidavits described in Part III.D.1.b indicate that the opinion should be based on at least the following information and documents:

1. Organizational documents of the foreign grantee, including bylaws, articles, governing rules, etc.;
2. A detailed description of the grantee's purposes;
3. A copy of the relevant statutory law—dissolution, powers, etc.;
4. A demonstration that the grantee does not grant any individual private benefits and does not engage in noncharitable activity;
5. A demonstration that the grantee does not engage in legislative or political activity; and
6. Financial support data.¹⁰⁹

b. Grantee Affidavit: Underused but Vital Vehicle

Another option for establishing a good faith effort concerning the status of the foreign organization is to obtain an affidavit from the grantee. The affidavit must be in English, be attested to by a principal officer of the grantee, and contain the following:

1. A statement that the grantee is operating exclusively for charitable purposes;
2. A description of the grantee's past and present activities;

¹⁰⁵ See Treas. Reg. § 53.4945-5(a)(5).

¹⁰⁶ See *id.*

¹⁰⁷ See Treas. Reg. § 53.4945-5(a)(4).

¹⁰⁸ See Treas. Reg. § 53.4945-5(a)(5).

¹⁰⁹ See Rev. Proc. 92-94, 1992-2 C.B. 507.

3. Copies of the grantee's charter, bylaws, and other governing instruments;
4. A statement that the country's laws and customs do not allow the grantee's assets to benefit private parties;
5. Dissolution provisions guaranteeing that the grantee will distribute the remaining assets for charitable and public purposes;
6. A statement that the country's laws or customs do not allow the grantee to engage in substantial lobbying or any political activity;
7. For a grantee other than a church, hospital, or educational institution, a showing that the grantee meets the public support test under section 170(b)(1)(A)(vi) or section 509(a)(2) by furnishing current financial information; and
8. A statement identifying what other organizations, if any, control or operate with the grantee.¹¹⁰

2. *Capital Equipment and Endowment Grants to Foreign Charities*

Making capital equipment and endowment grants to foreign grantees is possible, but the Service will closely monitor these transactions. Accordingly, foundations should observe the following cautions:

1. The grantor foundation should obtain an equivalency determination if the donee is a public charity.
2. For noncharity grantees, the grantor foundation should exercise expenditure responsibility with the grantee agreeing to keep the funds in a separate fund dedicated to charitable purposes.
3. Endowments established from grant funds will require written reports from the grantee to the grantor at the end of each accounting period until the funds are spent.
4. Grants to private foreign foundations will require reporting from the grantee foundations on how the foreign foundations spent the principal for the taxable year and the succeeding years.¹¹¹

3. *Special Rules for Nonoperating Private Foundations Making Grants to Foreign Charities*

Nonoperating private foundation grant programs have special concerns because of the minimum distribution and other requirements that such foundations face.

¹¹⁰ See *id.*

¹¹¹ See Treas. Reg. § 53.4945-5(c).

a. Out of Corpus Grants

Nonoperating private foundations with little international experience may be tempted to make grants to other nonoperating private foundations, either domestic or foreign, with the required expertise. Or the nonoperating private foundation may be concerned about the fate of funds sent overseas and therefore make the grant to an organization, perhaps even a public charity, controlled by the private foundation. In either case, the grant will be considered as being made out of corpus. As a result, the grant will be ineligible to count toward the minimum distribution requirements imposed on the foundation, unless certain conditions are met:

1. The grantee must pay out the grant in full by the end of the first taxable year after the year in which the grantee receives the grant;
2. The grant must be paid out either to a public charity or for a charitable purpose; in the latter instance, the previously described expenditure responsibility requirements apply;
3. The grant must be paid out of the corpus of the grantee—the grantee must have made qualifying distributions sufficient to exhaust its minimum distribution requirements for the current and preceding tax year; and
4. An adequate record must be kept that these requirements have been satisfied.¹¹²

b. Regranting of Funds

Expenditure responsibility concerns also arise if a grant is from one nonoperating private foundation to another. Such grants are subject to the previously described expenditure responsibility requirements.¹¹³ In addition, if the second foundation regrants the funds and the first foundation has some control over selecting the recipient for the regrant, the first foundation has a responsibility to obtain the required periodic reports from the secondary grantee.¹¹⁴

¹¹² See Treas. Reg. § 53.4942(a)-3(c)(1). If the grantee is not a private foundation, the grant must still be made out of corpus and the grantee is treated as a private foundation. See also Milton Cerny & Doug Varley, *Legal Dimensions of International Grantmaking: Spring 1999: The Out of Corpus Rule Reviewed*, COUNCIL ON FOUND., <http://classic.cof.org/action/content.cfm?ItemNumber=1073>.

¹¹³ See I.R.C. § 4945(d)(4).

¹¹⁴ See Treas. Reg. § 53.4945-5(b)(1); see also Priv. Ltr. Rul. 9717024 (Apr. 25, 1997); Milton Cerny & Beth Sellers, *Legal Dimensions of International Grantmaking: Fall 1997: Private Ruling Takes Pragmatic Approach to International Regranting*, COUNCIL ON FOUND., <http://classic.cof.org/action/content.cfm?ItemNumber=1079>.

E. Grants to International Organizations and Foreign Governments

A grant to a non-U.S. organization will receive the same treatment as a grant to a public charity if the non-U.S. organization “is a foreign government, or any agency or instrumentality thereof, or an international organization designated as such by Executive order under 22 U.S.C. section 288, even though not described in section 501(c)(3).”¹¹⁵ But, such a grant must be made exclusively for section 170(c)(2)(B) purposes.¹¹⁶ Grants to support the general purposes of the government are not allowed.

For such grants, no equivalency determination, grantee affidavit, or expenditure responsibility is necessary. Nonetheless, the grant file should, include (1) documentation that the grantee is a unit of a foreign government or specially designated international organization and (2) a copy of the grant letter clearly specifying the charitable purpose of the grant.

F. Additional Underused But Effective Planning Tools

Although often overlooked, other tools exist for engaging in international philanthropy.

1. Program-Related Investments

A program-related investment (PRI) is a special type of social investment that, unlike many other investments, meets the criteria for qualifying distributions for private foundations, is not subject to the excise tax on excess business holdings by private foundations, and is not subject to the excise tax on jeopardizing investments by private foundations.¹¹⁷ An investment satisfies the statutory requirements for a PRI as long as the following are true: (1) the primary purpose in making the investment is charitable, (2) a charitable effect would not have occurred without the investment, and (3) such charitable effect is commensurate with the investment.¹¹⁸ Examples of PRIs include investment in minority-owned businesses in deteriorated

¹¹⁵ Treas. Reg. § 53.4945-5(a)(4)(iii).

¹¹⁶ *See id.*

¹¹⁷ *See* I.R.C. § 4944(c) (defining a PRI and excluding it from consideration as a jeopardizing investment); Treas. Reg. § 53.4942(a)-3(a)(2)(i) (including a PRI within the definition of a “qualifying distribution”); Treas. Reg. § 53.4943-10(b) (excluding PRIs from the definition of “business holdings” for purposes of the excess business holdings excise tax); Rev. Rul. 78-90, 1978-1 C.B. 380 (holding that loans to blind persons who were otherwise unable to obtain the necessary funds to go into business for themselves were PRIs).

¹¹⁸ *See* Treas. Reg. § 53.4944-3(a). A PRI also cannot have a purpose of furthering political or substantial legislative activities. *See* Treas. Reg. § 53.4944-3(a)(iii).

neighborhoods, investment in businesses that employ low-income persons from such neighborhoods, and low-interest loans to media organizations in former Communist countries.¹¹⁹ A PRI should not exhibit a significant purpose of producing income or holding appreciating property. In such cases, the Service generally will look at two factors to determine if a significant noncharitable purpose is present: (1) if the interest rate is substantially below market; and (2) if the interest is at market, whether the risk would be higher than the risk a conventional lender would take on.¹²⁰

PRIs may be made to foreign charities. If a private foundation makes a PRI that, if it were a grant, would be subject to the expenditure responsibility requirements, the PRI is also subject to the expenditure responsibility requirements. The required written agreement must also include several additional terms: (1) an agreement only to use the provided funds for the agreed upon investment, (2) an agreement to repay any funds not so used, and (3) a specification that the annual report and records maintained by the recipient must be equivalent to those that commercial investors under similar circumstances would ordinarily require.¹²¹

2. *Microcredits and Venture Capital Funds*

One popular form of international philanthropy is microcredits, which are small loans to budding entrepreneurs in impoverished areas.¹²² “The first microcredit [apparently] originated in Bangladesh, where in the 1970’s a banker named Muhammad Yunus pioneered the practice of giving poor people—mostly women—small loans to help them start businesses.”¹²³

¹¹⁹ See Treas. Reg. § 53.4944-3 (giving examples of PRIs); Rev. Rul. 74-587, 1974-2 C.B. 162 (holding that an organization that provided loans to and purchased equity interests in various business enterprises in economically depressed areas was charitable); Priv. Ltr. Rul. 9551005 (Sept. 15, 1995) (discussing loans to media outlets); Gen. Couns. Mem. 39,883 (Oct. 16, 1992) (discussing charitable community development organizations).

¹²⁰ See, e.g., Priv. Ltr. Rul. 8710076 (Dec. 10, 1986); Priv. Ltr. Rul. 8637120 (June 19, 1986); Priv. Ltr. Rul. 8141025 (July 20, 1981); see also Treas. Reg. § 53.4944-3(a)(2)(ii) (making the existence of profit not determinative); Gen. Couns. Mem. 33,906 (Aug. 7, 1968) (concluding that the making of loans to for-profit entities or individuals may serve a charitable purpose under certain circumstances). Similar factors are examined for equity investments. See, e.g., Priv. Ltr. Rul. 8807048 (Nov. 23, 1987); Gen. Couns. Mem. 39,720 (Mar. 30, 1988).

¹²¹ See Treas. Reg. § 53.4945-5(b)(4).

¹²² See Byron York, *The Clintons’ Brewing Micro-Scandal*, THE AM. SPECTATOR, Sept. 1997, at 31.

¹²³ *Id.* at 32; see Milton Cerny, *Microcredit Lending In South Africa*, 20 THE EXEMPT ORG. TAX REV. 291 (1998).

Microcredits have since seen an incredible boom. For example, Accion International of Somerville, Massachusetts, has seen the loans made by it and its affiliates in Latin America and the United States grow to \$331 million as of 1995.¹²⁴ Microcredits are often also linked with the concept of community banks, such as the South Shore Bank in Chicago (also known as Shorebank), which concentrate their lending in poor, run-down neighborhoods.

Microcredit programs tend to rely “heavily on foundation grants, government contracts, and private donations for their capital.”¹²⁵ To avoid this reliance, some U.S. charities are now seeking to develop venture capital funds to invest “in projects that are too costly for microcredit programs to handle—a food-processing plant that can serve scores of small farmers, for example”—but which also serve poor communities.¹²⁶ The capital for these funds would come primarily from private investors.¹²⁷

3. *Debts for Development*

Domestic charities can purchase debt of foreign countries in which they operate so that payments from that country’s government will remain in the foreign country to be reinvested in social, humanitarian, educational, or ecological needs. Recent examples of such purchases include the purchase of debt instruments in exchange for rain forest preservation in Panama and the purchase of debt instruments in exchange for low-cost housing in the Czech Republic. To many countries, such arrangements can be more attractive than direct subsidies because retirement of debt improves the international financial standing of the country and the government retains complete control over the resulting charitable programs.

4. *Establishing a Foreign Foundation*

According to published reports, hundreds of private foundations have formed in recent years in such out-of-the-way places as Bermuda, Barbados, Malta, Gibraltar, and the Channel Islands.¹²⁸ Establishing charities or foundations in countries other than the United States and major Western European countries, where extensive regulations govern such entities, can have a number of advantages for an individual. Organizations that would not quali-

¹²⁴ See Stephen G. Greene, *Tiny Loans Power a Global Campaign to Aid the World’s Poorest People*, THE CHRON. OF PHILANTHROPY, Apr. 3, 1997, at 9.

¹²⁵ *Id.*

¹²⁶ *Id.* at 10.

¹²⁷ *See id.*

¹²⁸ See Stephen G. Greene, et al., *For Anonymous Donors, Offshore Philanthropy Can be Appealing*, THE CHRON. OF PHILANTHROPY, Feb. 6, 1997, at 13.

fy as exempt from tax in the United States might qualify as such elsewhere in the world. Restrictions that apply to U.S. private foundations, such as limits on business holdings and the tax on investment income, do not exist in many other countries.

Privacy can also be a significant concern. In the United States and many European countries, financial, director, and compensation information must be reported to the government and is often available to the public. In contrast, these disclosures do not exist in many other countries. The tradeoff is that contributions to such foreign charities and foundations are not tax deductible unless a reciprocal agreement or treaty of some type exists. An individual may consider, however, the lack of a deduction to be a fair cost for the ability to pursue his or her charitable goals anonymously with little or no government oversight or interference.

IV. WITHHOLDING AND REPORTING ISSUES

A. Withholding on Grants to Nonresident Aliens

If a private foundation or a public charity makes payments to a nonresident alien to conduct research or engage in other activities, those payments may be subject to withholding. Generally, anyone who makes a fixed or determinable annual or periodic payment, which includes grants, to a nonresident alien must withhold a percentage of that payment if that income comes from a U.S. source.¹²⁹ Scholarships, fellowship grants, and other types of grants paid by U.S. private foundations or public charities generally qualify as U.S. source income and are subject to withholding if paid to nonresident aliens.¹³⁰ If all of the grant-related activities occur outside of the United States, however, the payments are foreign source income not subject to withholding.¹³¹

B. Withholding and Reporting for Foreign Private Foundations

Foreign private foundations are subject to a 4% withholding rate on their gross investment income derived from sources within the United States.¹³² The 4% rate is available to the foreign private foundation, without

¹²⁹ See I.R.C. § 1441.

¹³⁰ See Treas. Reg. § 1.863-1(d)(2)(i).

¹³¹ See Treas. Reg. § 1.863-1(d)(2)(iii).

¹³² See I.R.C. §§ 4948(a), 1443(b). “Gross investment income” is defined in section 4940(c)(2) as “the amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties, but not including any such income to the extent included in computing the tax imposed by section 511.” I.R.C.

having to file a Form 1023 seeking a Service determination letter, with an opinion of counsel or qualifying affidavit confirming the foundation's charitable status.¹³³ However, the foreign organization is subject to the same annual reporting requirements as a U.S. private foundation because the organization must report taxes on a Form 990-PF for the taxable year and pay at the time prescribed for filing such return (determined without regard to any extension of time for filing).¹³⁴

The major difference in treatment between the foreign and U.S. private foundation is that the foreign foundation may not have to report all of its U.S. income if an applicable treaty provides exclusions. In addition, if the foreign foundation receives substantially all its support (at least 85%), other than its support from its gross investment income, from sources outside the United States, it is exempted from the chapter 42 excise tax restrictions altogether except for the 4% tax on gross investment income.¹³⁵

V. FOREIGN INVESTMENTS AND TAXATION

A. Apportionment of Charitable Deductions Between U.S. and Foreign Source Income

Treasury Regulation section 1.861-8(e)(12), intended to encourage charitable giving, applies to both U.S. and foreign donors and addresses the apportionment of charitable deductions under sections 170, 873(b)(2), and 882(c)(1)(B).¹³⁶ The regulation creates an actual foreign tax credit benefit for charitable giving. Under the regulation, a taxpayer who makes a section 170 charitable contribution can use more foreign tax credits than an identical taxpayer who does not make a charitable contribution.¹³⁷

B. Foreign Corrupt Practices Act, Terrorism, and Embargo Issues

U.S. nonprofit organizations must be careful in granting funds to foreign charities under the rules prescribed in the Foreign Corrupt Practices Act (FCPA) regarding distributions to charities, which may have officers or directors who are government officials, in order to gain governmental

§ 4940(c)(2). The term also includes income from sources similar to those listed under an expansion to the definition made by the Pension Protection Act of 2006. *See id.*

¹³³ *See supra* Part III.D.1.

¹³⁴ *See* Treas. Reg. § 53.4948-1(a)(1).

¹³⁵ *See* Treas. Reg. § 53.4948-1(b).

¹³⁶ *See* Milton Cerny & Rebecca Rosenberg, *U.S. Issues Guidance on Apportionment of Charitable Contributions to U.S.-Source Income*, 35 TAX NOTES INT'L, 493 (2004).

¹³⁷ *See* Treas. Reg. § 1.861-8(e)(12); *see generally* Cerny & Rosenberg, *supra* note 136.

access.¹³⁸ Executive Order 13224 prohibits transactions between a domestic charity and foreign organizations the federal government deems to be a terrorist group or individuals associated with such groups.¹³⁹ The Treasury Department of Foreign Asset Control lists embargoed countries.¹⁴⁰

The Supreme Court in *Holder v. Humanitarian Law Project*¹⁴¹ upheld a ban on material support to groups designated as foreign terrorists by the Secretary of State. The Federal law banning material support for foreign terrorist organizations includes not only money or material but also training and expert advice or assistance.¹⁴² The facts in *Holder* detail an attempt to instruct the Kurdish separatist party known as the PKK to advance its goals through the peaceful use of international law.¹⁴³ The Court noted that some terrorist groups may conduct both peaceful and violent activities, but Congress found that they may be so tainted by their criminal conduct that any contribution to such an organization facilitates their conduct.¹⁴⁴ U. S. citizens remain free to advocate for the political aims of these groups under constitutional protected free speech as long as citizens do not coordinate with these groups.¹⁴⁵ Chief Justice Roberts also wrote in the Court's opinion that cases may exist in which some interaction with foreign terrorist groups could be constitutionally protected, but those difficult cases would have to be addressed in the future as they arise.¹⁴⁶ Accordingly, until the Court rules otherwise, any provision of charitable assistance to a terrorist organization, including humanitarian aid, is "material assistance" precluded by Federal law.

C. Congress and the Service Eye Foreign Investments of U.S. Charities

The Service has directed its field agents to scrutinize the use of equity swaps and other offshore investments in hedge funds and private equity funds to determine whether "dividend arbitrage" is being practiced to avoid

¹³⁸ See Mark Brzezinski, *Obama Administration Gets Tough on Business Corruption Overseas*, WASHINGTON POST, May 28, 2010.

¹³⁹ See Milton Cerny, Virginia Gift Planning Council Program on International Philanthropy (May 13, 2010). Prohibited transactions include financial support, in-kind support, and technical assistance. Humanitarian assistance to persons associated with terrorists or acts of terrorism is also covered.

¹⁴⁰ See *id.*

¹⁴¹ 78 U.S.L.W. 4569, 4627 (2010).

¹⁴² See *id.* at 4628.

¹⁴³ See *id.* at 4627.

¹⁴⁴ See *id.* at 4633–36.

¹⁴⁵ See *id.* at 4636.

¹⁴⁶ See *id.* at 4569.

tax on so-called dividend income. The Senate Finance Committee is especially attuned to nonprofit offshore investments that may serve as abusive tax shelters and tax avoidance schemes in the committee's efforts to find funding offsets for various legislative programs.¹⁴⁷

Section 4965, applicable to tax exempt entities, designates certain transactions as prohibited tax shelters and includes an entity-level excise tax on the party that engaged in the prohibited tax shelter transaction.¹⁴⁸ The Service gives the example of a tax-exempt entity that enters into a transaction with an S corporation, receives the S corporation stock, and aids the S corporation and its shareholders in avoiding taxable income because the entity facilitates the transaction by reason of its tax-exempt status.

The Service recently held that a Charitable Remainder UniTrust ("CRUT") could under certain circumstances establish a foreign corporation for investment purposes.¹⁴⁹ There the CRUT created the foreign corporation to manage alternative investments including United States and foreign hedge funds. The Service ruled that the income received by the CRUT from the foreign controlled corporation was a dividend and was not subject to unrelated business income tax.¹⁵⁰

VI. CONCLUSION

International philanthropy provides opportunities for family wealth planning, but care must be taken to understand both the domestic and foreign law. Fortunately, the Code and regulations provide helpful guidance and are not a significant barrier. While there are some pitfalls, numerous planning opportunities and tools exist that allow U.S. donors, public charities, and private foundations to engage in international philanthropy in an effective and important way.

¹⁴⁷ See Freda, Diane, *Exempt Organizations: IRS Targeting Exempt Controlled Entities, UBIT, Following College and University Study*, BNA Daily Tax Report, 101 DTR G-8, May 27, 2010.

¹⁴⁸ See I.R.C. § 4965(2)(1)(A).

¹⁴⁹ See Priv. Ltr. Rul. 2010-43-041 (October 29, 2010).

¹⁵⁰ See I.R.C. §§ 511, 512(b)(1), 512(b)(17).