U.S. Taxation and Regulation
of Foreign Charities

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U.S. Taxation and Regulation of Foreign Charities

I. INTRODUCTION AND SCOPE

This paper is devoted primarily to a description of the U.S. federal and state tax rules, and the state oversight rules, that may affect foreign charitable institutions operating in the United States or receiving income from U.S. sources. This paper addresses only the U.S. tax treatment of foreign organizations described in section 501(c)(3) of the Code, referred to herein as foreign charities.¹ The U.S. tax rules applicable to other kinds of foreign exempt organizations, such as qualified employee benefit plans, are not addressed herein.

II. FEDERAL INCOME TAX RULES AFFECTING FOREIGN CHARITIES

A. Introduction

The federal government of the United States imposes only a few types of taxes. The principal federal taxes are the income tax, the "unified" estate and gift (and generation-skipping) tax and a collection of (somewhat ad hoc) excise taxes. Foreign charities are not subject to the estate and gift tax rules, although those rules can affect the manner in which an individual, estate or trust may make donations to a foreign organization. The discussion in this Part II is limited to the federal income tax; Part III is devoted to the federal excise taxes on charities classified as "private foundations."

B. Federal Income Taxation of Foreign Persons Generally

Foreign persons are generally subject to federal income tax on U.S. source income, such as dividends paid by U.S. corporations and interest paid by U.S. borrowers. The tax on U.S. source income is enforced by withholding, generally at a rate of 30 percent.

Foreign persons are also subject to U.S. tax on net income that is "effectively connected with" the conduct of a trade or business in the United States, including gains from the disposition of U.S. real property interests and income allocated to a foreign partner of a partnership doing business here.

Absent an effective exemption from federal income tax, a foreign charity is subject to these rules in the same way as any other foreign person. Thus, for example, the foreign charity would be subject to the 30% U.S. withholding tax on U.S. source dividends it receives. Like any other foreign payee, the foreign charity may generally claim the benefit of an applicable tax treaty, most of which reduce the rate of U.S. withholding tax on U.S. source dividends from the standard 30% rate to 15%

¹ i.e., organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, educational and certain other limited purposes. All references to the Code or sections of the Code herein are to the Internal Revenue Code of 1986, as amended.
or even 5 percent. Similarly, the nonexempt foreign charity would be subject to the 30% U.S. withholding tax on interest received from U.S. borrowers, unless an applicable treaty reduced the rate of such tax or unless the interest qualified as exempt "portfolio interest" or bank account interest. In addition, some treaties extend a general exemption from U.S. tax on nonbusiness income to charities resident in the treaty country.²

Absent an effective exemption, the foreign charity would also be subject to federal income tax on its effectively-connected income (or, where a treaty applies, on its income attributable to a U.S. "permanent establishment"). It should be noted, however, that even an exempt foreign charity, like an exempt domestic charity, will be subject to tax on income that constitutes "unrelated business taxable income" ("UBTI") within the meaning of section 511 of the Code. The foreign charity will be taxable only on its UBTI attributable to U.S. activities.

In evaluating the need to obtain a U.S. tax exemption, the foreign charity should not overestimate the admittedly long reach of the U.S. tax regime. In particular, gifts and grants made by U.S. persons to foreign donees are neither U.S. source fixed and determinable income nor effectively-connected income, and therefore are not subject to U.S. income tax. Portfolio interest and bank interest are exempt from U.S. tax, and the foreign charity may be entitled to claim the benefit of a treaty reducing or eliminating U.S. tax on other types (or even all types) of U.S. source passive investment income. Thus, if the only contact the foreign charity has with the United States is the receipt of U.S. contributions and/or exempt items of U.S. source income, there may be no need for it to secure exempt status here. (But see the discussion at Part D below concerning grants from U.S. private foundations to foreign charities.)

C. Basic Federal Income Tax Rules Applicable to All Charities

There is an important, if theoretical, distinction between an organization "described in" section 501(c)(3) of the Code and an organization that has applied for and received a determination letter listing it as tax exempt under section 501(a). The Internal Revenue Service (the "IRS") does not, in fact, "grant" tax-exempt status to charities, but rather "recognizes" that status upon application.

Section 508(a) of the Code provides, with certain exceptions, that an organization will not be "described in" section 501(c)(3) unless it notifies the IRS of its status. This notice rule, which applies to most charities having at least $5,000 of annual gross receipts, is satisfied by filing an application for "recognition" of the organization's exempt status, on Form 1023, with the IRS.

² See, e.g., Canada Treaty, Art. XXI(1); Mexico Treaty, Art. 22(1) (religious, scientific, literary, educational or charitable organizations); Germany Treaty, Art. 27(1); Netherlands Treaty, Art. 36(1) (religious, charitable, scientific, educational or public purposes).
Section 501(c)(3) organizations come in two basic flavors: private foundations or publicly-supported organizations (nonprivate foundations are usually referred to, for the sake of brevity, as "public charities"). Private foundations are typically endowed with funds from one or a small group of families or corporate founders, and usually conduct no activities apart from making grants to public charities. (A hybrid type of private foundation, known as a "private operating foundation," consists of a nonpublicly-supported charity that directly carries on charitable activities, rather than acting merely as a passive grantmaker.) Public charities are usually active organizations that receive funds from a broad cross-section of the public and/or from governmental sources.

The notice rules of section 508 incorporate a rebuttable presumption that every section 501(c)(3) organization is a "private foundation" unless otherwise shown. To demonstrate that it will qualify as a public charity, the applicant organization ordinarily will provide the IRS with detailed financial projections showing how it plans to meet the public support tests for nonprivate foundation status.

One of the principal benefits of securing an IRS determination letter for a domestic charity is that contributions to it by individuals and corporations\(^3\) will generally be deductible under section 170 of the Code. Contributions by individual and corporate taxpayers to foreign charities, however, are not deductible.\(^4\) Estates and trusts may generally deduct contributions to all section 501(c)(3) organizations, including foreign charities "otherwise described in section 170(c)(2)."\(^5\)

There are various limitations on the amount of contributions to a domestic charity that may be deducted in any taxable year. In general, the deduction limitations are more generous for gifts to public charities than they are for gifts to private foundations. Private foundations, unlike public charities, are subject to a number of excise taxes, most of which operate as penalties on activities that Congress has deemed inappropriate. The excise tax rules applicable to foreign private foundations are discussed at Part III below.

**D. Should a Foreign Charity Secure IRS Recognition of its Exempt Status?**

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\(^3\) Corporate contributions to unincorporated domestic charities are subject to the further restriction that the contribution be used in the United States.

\(^4\) The U.S. treaties with Canada, Mexico and Israel permit residents of each treaty country to deduct contributions to charities formed under the other country's laws, but only to a limited extent. See Canada Treaty, Art. XXI (5), (6); Mexico Treaty, Art. 22(2); Israel Treaty, Art. 15A (1980 Protocol).

\(^5\) Code section 642(c) and Treas. Reg. § 1.642(c)-1(a)(2). This rule raises an issue repeatedly addressed in this paper: How does the estate or trust determine that the foreign charity is, in fact, "described in" section 170(c) or section 501(c)(3)?
Even though it cannot qualify to receive tax-deductible contributions from U.S. individual or corporate taxpayers, there are several advantages in a foreign charity’s obtaining an IRS determination letter recognizing its status as an organization described in section 501(c)(3) and as a nonprivate foundation. A foreign charity that fails to obtain such a letter may as a practical matter find it difficult to secure grants from U.S. private foundations. Section 4945 of the Code imposes punitive excise taxes on U.S. private foundations that make "taxable expenditures." Among other things, a taxable expenditure includes any grant to an organization other than a public charity, unless the donor exercises "expenditure responsibility" over the use to which the grant is put. Most U.S. foundations have concluded that the exercise of expenditure responsibility with respect to nonqualifying grants is too burdensome, and have therefore decided as a matter of general policy to avoid the issue altogether by refusing to make grants to organizations other than public charities.

A foreign charity that does not have an IRS determination letter is not precluded from obtaining U.S. private foundation grants; the exercise is only more difficult. Such a foreign charity, in seeking a grant from the typical U.S. private foundation, will be asked to establish that it is an organization "described in" section 501(c)(3) and that it is not a private foundation.

The IRS in regulations under Section 4945 has provided a special, two-part "equivalency doctrine" for grants to foreign organizations. The first part of the equivalency doctrine relates to the grantee's status as an organization described in section 501(c)(3), and is set forth in Treas. Reg. §53.4945-6(c)(2)(ii) (the "reasonable judgment" test):

... a foreign organization which does not have a ruling or determination letter that it is an organization described in section 501(c)(3) ... will be treated as an organization described in section 501(c)(3) ... if in the reasonable judgment of a foundation manager of the transferor private foundation, the grantee organization is an organization described in section 501(c)(3). ... (emphasis added).

The second part of the equivalency doctrine relates to the grantee's status as a public charity rather than a private foundation. Treas. Reg. §53.4945-5(a)(5) (the "good faith" test) provides as follows:

If a private foundation makes a grant to a foreign organization which does not have a ruling or determination letter that it is an organization described in section 509(a)(1), (2), or (3) [i.e., not a private foundation], such grant will not be treated as a grant made to an organization other than an organization described in section 509(a)(1), (2), or (3) if the grantor private foundation has made a good faith determination that the grantee organization is an organization described in section 509(a)(1), (2)
or (3). Such a "good faith determination" ordinarily will be considered as made where the determination is based on an affidavit of the grantee organization or an opinion of counsel (of the grantor or the grantee) that the grantee is an organization described in section 509(a)(1), (2), or (3). Such an affidavit or opinion must set forth sufficient facts concerning the operations and support of the grantee for the Internal Revenue Service to determine that the grantee would be likely to qualify as an organization described in section 509(a)(1), (2), or (3) (emphasis added).

The import of these provisions is that a foreign grantee that would be recognized as a public charity here if it had applied for recognition of such status need not go through the lengthy application process solely to qualify for a grant from a domestic private foundation falling outside the expenditure responsibility rules. Instead, under the equivalency doctrine the parties can use a "self-certification" procedure, based on the grantor's exercise of reasonable judgment and good faith.6

Until recently, there was little guidance, apart from the regulations cited above, as to how to apply the equivalency doctrine. A threshold issue is whether the affidavit or opinion referred to in the "good faith" regulation is a safe harbor only, permitting good faith to be otherwise shown, or is a requisite.7

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6 A similar good faith test is provided for grants to foreign charities coming within the "qualifying distribution" rules of section 4942. Treas. Reg. § 53.4942(a)-3(a)(6). Among the miscellaneous tax legislative proposals currently under consideration in Congress is a proposal that would extend the expenditure responsibility rule of section 4945 to section 4942. See the JCT Pamphlet at p. 125, reprinted in the Daily Tax Report, Special Supplement (July 11, 1995). See also section 1492, which imposes an excise tax on outbound property transfers from U.S. persons to foreign entities. Although that section only excepts transfers to certain organizations that are "exempt from income tax under" section 501(a), the regulations under that part extend the exception to certain foreign organizations that are "described in" section 501(c)(3), but have not applied for recognition of their "exempt" status under section 501(a). Treas. Reg. § 1.1494-1(b)(1).

7 In PLR 8030104 (April 30, 1980) and PLR 8515070 (January 15, 1985), the IRS ruled that domestic private foundations had satisfied the requirements of the good faith test and, implicitly, of the reasonable judgment test. The rulings were nearly superfluous, however, since they were based on an affidavit (8030104) or on a written opinion of the foundation's counsel (8515070) that satisfied the good faith standard of the regulations. The 1985 ruling appears to have viewed such an opinion (or an affidavit) necessary, referring to the opinion of counsel as "requisite."
The IRS has published Rev. Proc. 92-94,8 which provides a more detailed road map for parties who wish to rely on the equivalency doctrine. The Rev. Proc. covers both the reasonable judgment and the good faith test, and is intended to provide U.S. grantors with a "simplified procedure" or safe harbor. Under the Rev. Proc., the U.S. grantor may generally rely on a "currently qualified" affidavit prepared by the grantee to meet both the reasonable judgment and the good faith tests. The affidavit is "currently qualified" if it contains up-to-date information: if the grantee would qualify as publicly supported based on its financial statements, the affidavit must reflect financial information for its latest complete fiscal year. In other cases, only relevant facts need be updated, if warranted.

A second advantage of securing an IRS determination letter for a foreign charity is that the foreign charity may claim exemption from U.S. withholding taxes on dividends, interest and other U.S. source income that is not UBTI. Although it is possible, as discussed in Part E below, that a foreign charity with de minimis U.S. support may claim the benefit of such exemption even without an IRS determination letter, the scope of the de minimis rule is unclear. Accordingly, the foreign charity may deem it advisable to secure an IRS determination letter, which can then be given to the putative U.S. withholding agent.9

E. Establishing the Exemption

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9 Even with an IRS determination letter, it is unclear how, if at all, a foreign charity can establish its exemption from the FIRPTA withholding tax imposed by section 1445 of the Code. Although gains realized by a foreign person upon the disposition of a U.S. real property interest are treated as "effectively connected" under section 897, in most cases (e.g., unless the property were debt-financed) such gains would not be treated as UBTI subject to tax in a foreign charity's hands and should therefore be exempt from U.S. tax. Although no specific exemption for foreign charities is set out in FIRPTA, it appears that Congress intended that section 1443(a) -- imposing U.S. withholding taxes only on a foreign charity's UBTI -- should preempt the field insofar as U.S. income taxes are applicable to exempt foreign charities. See, e.g., Treas. Reg. § 1.1441-3(i) (cross-reference to § 1443); I.R.C. § 878 (cross-reference to taxes on UBTI); GCM 34769 (Feb. 8, 1972) (background document to Rev. Rul. 72-244).

A similar overlap issue is presented by section 1446, requiring withholding on a foreign partner's distributive share of effectively-connected partnership income. In this case, however, it is likely that the section 1446 withholding requirement will mesh well with the section.1443(a) withholding requirement, since the partnership's effectively-connected income would usually constitute UBTI in the foreign charitable partner's hands.
1. The "de minimis" rule

With very limited exceptions provided under some U.S. tax treaties, the U.S. tax authorities cannot and will not recognize or accord comity to a foreign organization's exempt status in its home country. The nondiscrimination language contained in U.S. treaties of friendship is not sufficient to entitle a foreign charity to exempt status here.\(^1\) Accordingly, to be treated as exempt in the United States, a foreign charity must generally secure recognition of its status from the IRS.

However, section 4948(b) of the Code sets forth a "de minimis" rule that excuses some foreign charities from having to comply with the notice rule (which would otherwise require such charities to apply to the IRS for recognition of their exempt status).\(^1\) The de minimis rule applies to any foreign organization that, since the date of its creation, has received 85% or more of its "support" from sources outside the United States.\(^2\) For this purpose, the term "support" includes gifts, grants, contributions and membership fees, but specifically excludes the foreign charity's gross investment income and gains from sales of capital assets.

The language of section 4948(b) suggests, and most commentators assume,\(^3\) that a foreign charity that is not substantially U.S. supported is automatically classified as an exempt charity and not as an ordinary, taxable foreign person. To understand why this is so, it is necessary to recall the purpose of the notice rule. As

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\(^2\) Code section 4948(b). The de minimis rule is not available if the foreign charity, otherwise qualified to rely on it, is a private foundation that has engaged in any one of certain proscribed "prohibited transactions" since 1970 and has been notified of that fact by the IRS. Code § 4948(c).

already mentioned, the IRS does not "grant" exemption from tax to organizations described in section 501(c)(3) of the Code, but merely "recognizes" their status as such. The Code generally conditions the benefits of tax-exempt status upon the charity's compliance with the notice rule, so that, as a practical matter, a charity cannot be treated as exempt without the blessing of the IRS. However, because the de minimis rule contained in section 4948(b) expressly waives compliance with the notice rule by foreign-supported foreign organizations, such organizations should be treated as exempt if they are otherwise "described in" section 501(c)(3) of the Code.

The logic of this proposition has from time to time been lost on the IRS itself. For example, the EO Technical Division of the IRS has stated that the de minimis rule applies only to foreign organizations that would otherwise be classified as private foundations.14 Presumably, this interpretation was based on the fact that the de minimis rule is contained in section 4948 of the Code, which section is, in turn, contained within Chapter 42 of the Code relating to excise taxes on private foundations.15 However, by their terms both section 4948(b) and the title of section 4948 clearly extend to all foreign organizations. The term "foreign organization," as distinct from the term "foreign private foundation," is defined in the regulations under section 4948 as any organization not described in section 170(c)(2)(A) (describing only organizations created under U.S. law). While section 4948(a), which imposes an excise tax on certain organizations, refers explicitly to a "foreign organization which is a private foundation," section 4948(b), containing the de minimis rule, refers only to "any foreign organization."

The conclusion that the EO Technical Division's reading of section 4948(b) is incorrect is not based solely on a parsing of the statutory language. As a policy matter, it makes no sense to subject a foreign charity to the notice rule if its only U.S. support is de minimis, particularly since contributions to the foreign charity are not deductible for U.S. tax purposes, and particularly since a foreign charity that obtains an IRS determination letter cannot have its status rescinded even if it never again sets foot in the United States or receives a U.S. grant.16 It also makes no sense


15 Interestingly, section 508 of the Code, which contains the notice rules generally applicable to all charities, is itself contained in Part II of Subchapter F, entitled "Private Foundations!"

16 See LTR 9141050 (July 16, 1991). This ruling is also interesting in that it may contradict the EO Technical CPE. The foreign charity was apparently publicly-supported, yet the ruling stated that it was a foreign organization described in section 4948 and exempt from the notice rule.
to except foreign private foundations, but not foreign public charities, from the notice rule.

Moreover, if the EO Technical Division were correct, then arguably no foreign charity could ever satisfy the equivalency doctrine described in Part D above. In a paradigm of circularity and "Catch-22" logic, a foreign charity could not represent to a U.S. private foundation that the foreign charity is "described in" section 501(c)(3) if it is subject to the notice rule, because the notice rule provides that an organization shall not be treated as an organization "described in" that section unless it gives notice!

More fundamentally, the _de minimis_ rule can and should be thought of as a natural extension of the equivalency doctrine. Foreign charities that do not receive substantial U.S. support, and that by definition receive no tax-deductible (or subsidized) support, should not be required to go through the expensive, irrevocable and time-consuming exercise of applying to the IRS for recognition of their exempt status. The purpose of the notice rule, first enacted in 1969, was to give the IRS the ability to monitor the activities and support of charities being at least indirectly subsidized by the U.S. fisc. The _de minimis_ U.S. tax benefits potentially realizable by non-U.S. supported foreign corporations do not justify extension of the notice rule to these organizations.

Assuming, as it appears, that a foreign charity meeting the _de minimis_ test is generally exempt from federal income tax, there remains the problem of proving that fact to a U.S. withholding agent. There is no statutory or regulatory rule that explains how such an exempt foreign charity informs the potential U.S. withholding agent of its exempt status. _Rev. Rul. 72-244_ instructs foreign charities who have been "held exempt" to add specific language to that effect on a Form 1001 (ownership certificate) provided to the withholding agent. Presumably, a foreign charity qualifying under the _de minimis_ rule could supply the withholding agent with a Form 1001 claiming its entitlement to exemption.

2. Application procedures

If, in any year, a foreign charity receives more than 15% of its support from U.S. sources, and does not wish to be taxed as a nonexempt foreign person, the foreign charity _must_ apply to the IRS for recognition of its exempt status. The application for section 501(c)(3) recognition is made on Form 1023; the preparation of this form itself is normally a time-consuming process and a user fee (currently $465) is required to be paid with the filing. Once filed, the foreign charity can expect that if everything proceeds smoothly, the exemption letter will be issued in two to six months. It is not uncommon for the process to take longer, however, especially where the IRS raises additional questions concerning the foreign charity's activities.

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17 1972-1 C.B. 282.
In the domestic context, if a charity files its Form 1023 within fifteen months of the date of its organization, the exemption letter ultimately received from the IRS will apply retroactively to the date of the charity's organization. If the domestic charity files after the 15-month period, the exemption will be recognized only as of the date of filing. In such a case, the IRS will normally treat the domestic charity as section 501(c)(4) organization, exempt from income tax but not entitled to receive tax-deductible contributions, for the earlier "stub" period.

These rules generally apply to foreign charities as well. While the 15-month rule may create some difficulties for long-established foreign charities first applying to the IRS for a determination letter, most foreign charities will be unconcerned about being ruled exempt only under section 501(c)(4) during any stub period, since contributions to them are not deductible in any event.

The Form 1023 is filed with the district office of the IRS where the charity has its "principal place of business or principal office." In the case of a foreign charity whose principal place of business and office are not located within the United States, the instructions to Form 1023 direct the filing to be made with the Baltimore District Director's office.

Once a foreign charity has applied for and received recognition of its exempt status, it will become subject to all of the U.S. reporting rules applicable to charities and will generally not be permitted to "cancel" its exempt status at a later date. The foreign charity will generally be required to file an annual information return on Form 990 with the IRS in Philadelphia, showing in detail its worldwide revenues and expenses. However, the requirement that Form 990 be filed is waived in any year in which the foreign charity "normally" derives less than $25,000 of gross receipts from U.S. sources and has no significant U.S. activities. These annual filings,

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19 The applicable regulations could be interpreted to mean that a foreign charity will be treated as "organized" for purposes of the 15-month rule only on the date it first becomes subject to the section 508 notice requirements by virtue of receiving substantial U.S. support. Treas. Reg. § 1.508-1(a)(2)(iii), (vi). However, the ambiguity on this issue is another example of how the de minimis rule is not well-integrated with other Code provisions.

20 The IRS will be consolidating all exempt organization applications into one district over the course of the next few years.

21 See LTR 9141050 (July 16, 1991).

along with the foreign charity's original application for exemption on Form 1023, must generally be made available for public inspection.  

The foreign charity, like a domestic charity, will be subject to federal income tax on its U.S. source or effectively connected UBTI, if any. A charity that earns just $1,000 of gross income from any unrelated (U.S.) business in any year is required to file Form 990-T, reporting the net amount of its UBTI. Although charities are taxable only on the net income derived from an unrelated business, section 1443(a) of the Code imposes a withholding tax on items of gross UBTI unless the foreign charity can show that "such income is or may be expected to be" effectively connected income reportable on the foreign charity's Form 990-T.  

3. Organizational test

To qualify as an organization described in section 501(c)(3), the applicant must demonstrate that it is both organized and operated exclusively for one or more purposes described in that section -- generally religious, charitable, scientific, literary or educational. The organizational test is applied with reference to the applicant's governing instruments or organizational documents.

A foreign charity's governing instruments will rarely have been drafted with IRS requirements in mind, and thus can present special problems under the organizational test. Often the most serious obstacle to securing a section 501(c)(3) ruling for a foreign charity will be the failure of its governing documents to contain a proper "dissolution" clause to the effect that:

Upon the dissolution of [this organization], assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future Federal tax code, or shall be distributed to the Federal government, or to a state or local government, for a public purpose.

The purpose of the requirement that the charity's governing documents incorporate such a clause is to ensure that its assets cannot be diverted for the benefit of private interests.

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23 Code section 6104. However, the publication inspection requirement of section 6104(d), which requires that a private foundation make its returns available at its own office, on notice, does not apply to the Form 990-PF filed by a foreign private foundation.


25 Rev. Proc. 82-2, 1982-1 C.B. 367, 368, §3.05.
The trustees or directors of foreign charities are often perplexed at the absolute rigor with which the IRS enforces the requirement that governing documents specify the disposition of assets upon dissolution. They may point out that under the laws of the foreign jurisdiction in which the foreign charity is formed, the result sought to be obtained by such a dissolution clause will in fact be obtained.26

The regulations do generally permit an organization to omit a dissolution clause where state law imposes the equivalent restriction on dissolution payments.27 However, the regulations do not mention the law of a foreign country as providing an acceptable substitute for a proper dissolution clause.28 In practice, therefore, it is almost impossible to secure a ruling from the IRS on behalf of a foreign charity unless the charity's governing documents contain a proper dissolution clause.

If the governing instruments of the foreign charity do contain a proper dissolution clause, it should be sufficient that its assets will be distributed to a foreign (rather than U.S.) charity or governmental instrumentality. Although the language of the regulations refers to distributions to federal, state or local governments, that language appears to be an example of, and not a limitation on, the types of distributees comprehended by the "public purpose" test.29

A similar problem is encountered when the foreign charity is classified as a private foundation. Section 508(e) of the Code provides that a private foundation will not be exempt unless its governing instruments contain certain provisions specifically tailored to avoid the perceived abuses catalogued in the private foundation

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26 It is noteworthy that Rev. Proc. 92-94 directly addresses the problems posed by the "governing documents" requirement in the context of the equivalency doctrine. Rather than requiring the foreign grantee to incorporate specific language in its governing documents, the Rev. Proc. contemplates that the affidavit may rely on local law and custom to demonstrate that its income and assets will not be diverted for private benefit.


28 Interestingly, the EO Technical Division appears to be open to the possibility that a foreign government could enact provisions rendering the governing documents requirement of section 508(e) (discussed below) moot, but notes that no foreign government has done so. See EO Technical CPE, at 236.

29 Cf. Rev. Rul. 75-435, 1975-2 C.B. 215 (foreign government support counted toward section 509(a)(1) "public support" fraction even though not mentioned in the statute or regulations). It should be noted that Rev. Rul. 75-435 was, at least at one time, the subject of considerable controversy within the IRS, and was being considered for revocation. See G.C.M. 36115 (Dec. 30, 1974); G.C.M. 37001 (Feb. 10, 1977); G.C.M. 38327 (March 31, 1980); EO Technical CPE, at 238.
excise tax provisions of Chapter 42 of the Code. Accordingly, the precatatory language contained in section 508(e) should be included in the charter of any foreign charity that expects to be classified as a private foundation.

4. **Operational test**

A common source of misunderstanding is the foreign charity's assumption that activities considered "charitable" in its home country will be so considered here. This problem tends to crop up first under the regulations' organizational test, since the foreign charity's articles may empower it to engage in all sorts of conduct (sometimes including private inurement) that would defeat its entitlement to exemption here. At the operational level, the foreign charity may simply engage in activities, other than in insubstantial part, which U.S. tax law does not view as charitable, literary, educational, etc.

One aspect of this general problem involves the potential application of the Code's UBTI rules. Many foreign countries continue to grant exemption to income produced by virtually any activity carried on by a **bona fide** charity, as long as the net profits realized thereby are devoted to charitable use. With one very limited exception, this approach to "feeder activities" was rejected by Congress in 1950.

The advisor to a foreign charity should not assume that the client understands the workings of the UBTI (and debt-financed income) provisions of the Code. These provisions should be explained in detail, and it should be noted that section 1443(a) of the Code requires the U.S. payor of UBTI items to withhold tax on payment thereof to a foreign charity. Additionally, the client should understand that if a substantial part of its activities (in the U.S. or worldwide) consists in carrying on one or more unrelated businesses, U.S. tax exemption may be denied or revoked.

5. **Public charity or private foundation?**

Section 508(b) of the Code provides that an exempt charity will be classified as a private foundation unless it establishes to the satisfaction of the IRS that it is described in one of the paragraphs under section 509(a). To qualify as other than a private foundation, that is, as a "public charity", the foreign charity will usually be

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30 A state's law may "deem" the language required by section 508(e) to be included in the governing instruments of any charity classified as a private foundation. See, e.g., N.Y. Not-for-Profit Corporation Law §406. The governing documents of a charity incorporated or formed under the laws of such states need not contain the section 508(e) language. Rev. Rul. 75-38, 1975-1 C.B. 161.

31 As applied to foreign governments and their instrumentalities, the U.S. principle of taxing UBTI is codified in section 892 of the Code.
required to demonstrate that it has attracted, or will attract, support from a wide range of public contributors or patrons. It is not uncommon for the foreign charity, particularly one that is long-established and well-endowed, to pass muster under section 501(c)(3), only to crash on the significant shoals of the public support test.

As noted previously, the usual reason for a foreign charity’s seeking U.S. tax exemption is to qualify for direct grants from U.S. private foundation donors. If it applies for such grants, the foreign charity will quickly discover that, because of the section 4945 taxable expenditure rules discussed above, most U.S. foundations will make grants only to organizations that have obtained a section 501(c)(3) ruling and that have been classified by the IRS, at least for an advance ruling period, as public charities. Accordingly, the foreign charity that decides to secure U.S. tax exemption will achieve very little if it cannot also qualify for public charity status. These public charity tests are more fully described below.

F. Formation and Use of a Domestic "Subsidiary" by a Foreign Charity

There are several reasons why a foreign charity may find it advantageous to conduct its U.S. fundraising, investment and/or charitable activities through a separate domestic organization rather than doing so directly. Perhaps the most obvious advantage of creating a domestic charity qualified under section 501(c)(3) is to attract tax-deductible donations from U.S. individual and corporate taxpayers.

If the directors, managers or trustees of a foreign charity embark upon the process of causing a domestic charity to be formed, they will usually want the domestic charity to qualify as publicly-supported, if at all possible, rather than being classified as a private foundation. There are basically three types of charities that are treated as publicly supported under section 509 of the Code. The first type is one that "normally" receives a "substantial" part of its support from contributions from the general public (and/or U.S. governmental agencies). The second type is a charity that normally receives more than one third of its support from a combination of contributions and charitable-activity receipts (such as museum admission charges), and normally receives not more than one third of its support from gross investment income and unrelated business activities. The third type, described in section 509(a)(3), is usually referred to as a "supporting organization" and may be of special interest to foreign charities.

1. Supporting organizations

An organization may be formed for a charitable or other purpose described in section 501(c)(3) by, in effect, "piggybacking" on the status of another

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32 Section 509(a)(1) and section 170(b)(1)(A)(vi) of the Code. This category also includes churches, qualified schools, colleges or universities and certain hospitals.
charity. Such an organization may also qualify as a public charity by virtue of section 509(a)(3) of the Code, which provides:

For purposes of this title, the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) other than --

(3) an organization which --

(A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2) [i.e., public charities],

(B) is operated, supervised, or controlled by or in connection with one or more organizations described in paragraph (1) or (2), and

(C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in paragraph (1) or (2) . . . .

The section 509(a)(3) supporting organization model is often used to avoid private foundation status for a domestic charity that itself would not be publicly-supported, but which is formed to pass on funds to a publicly-supported "parent." Nothing in the Code prevents the supported organization from being a foreign charity, as long as the foreign parent has itself secured an IRS ruling that it is an exempt public charity. This conclusion was explicitly reached in Rev. Rul. 74-229, 1974-1 C.B. 142. However, the supporting organization model is not a panacea for all of the problems discussed above. As a prerequisite, the foreign parent must still go through the sometimes difficult process of obtaining its own section 501(c)(3) exemption and public charity classification.33

From the individual donor's perspective, a supporting organization for a foreign charity is a curious creature. Ever since the publication of Rev. Rul. 63-252,34 U.S. donors and organizations soliciting them have had to be concerned that the

33. Flush language in section 509(a) does permit the supported organization to secure exemption under the less stringent standards of section 501(c)(4), 501(c)(5) or 501(c)(6).

charitable contribution deduction under section 170 may be disallowed if the domestic charity acts as a "mere conduit" for passing the donor's gift on to a foreign organization. The theory underlying the various fact patterns and holdings in Rev. Rul. 63-252 is that a donor ought not to obtain a deduction, indirectly through a domestic conduit, for a contribution that would not have been deductible if made directly, i.e., to the ultimate foreign recipient.

The linchpin test of Rev. Rul. 63-252, as "amplified" by Rev. Rul. 66-79, is that, to be deductible, a gift intended for foreign application must be made to a domestic charity that has control over the funds received, and discretion as to the use to which such funds will be put. If a gift is "earmarked" in such a way as to require the domestic charity to pass it on to a foreign recipient, the deduction will be denied. If, however, the domestic charity is free to honor the donor's intention or not to, retaining ultimate control and discretion over the application of the unrestricted gift, the deduction would be allowable even in the usual case in which the domestic charity has overtly adopted a foreign charity's project and applies the gift to such foreign project in accordance with the implicit wishes of the donor.

As has been noted, Rev. Rul. 74-229 contemplates the existence and qualification of a domestic supporting organization of a foreign public charity. To qualify as a supporting organization, the domestic entity must generally be organized for the exclusive purpose of supporting (or benefitting) one or more identified supported organizations, and must be "operated, supervised, or controlled by or in connection with" the supported organization. It is surprising that almost nothing has been written or reported concerning the apparent conflict between Rev. Rul. 74-229 and Rev. Rul. 63-252. It seems usually to be assumed that a domestic

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35 The 1980 Tax Court decision in Bilingual Montessori School of Paris, Inc., 75 T.C. 480 (1980), is often cited as standing in contradiction to Rev. Rul. 63-252. That case, however, did not involve a domestic conduit for a foreign organization, but rather a domestic organization all of whose own activities were conducted abroad. Cf. Rev. Rul. 63-251, id. at 483, and in the author's view the Montessori case is extremely limited in scope.


37 The problem is discussed by Hopkins, supra, at §44.5 p. 988, who points out the difficulty in straddling the line between the conduit principles of Rev. Rul. 63-252 and the supporting organization requirements, and who is not very encouraging that the problem can be solved. It is also noted in the EO Technical CPE, at 238-39, which finds that the two rulings are at "cross purposes" and fails to suggest any means of reconciling them. Interestingly, the explanation of the U.S.-Canadá income tax treaty apparently referred expressly to this problem. See 2 (continued...)
supporting organization for a foreign supported organization may negotiate the narrow path between the conduit problem and the requirements of section 509(a)(3) by satisfying only the weakest prong of the section 509(a)(3) regulations. Under that test, the supporting organization may be only "operated in connection with," rather than "supervised by" or "controlled by or in connection with," the supported organization.

Even the "operated in connection with" prong of section 509(a)(3) requires, at a minimum, that the supporting organization remit substantially all of its income to the (foreign) supported organization, and that it respond to the parent's program needs (typically by establishing interlocking directorates). It is difficult to distinguish this type of connection to the foreign parent from the connection proscribed by the "discretion and control" standard of Rev. Rul. 63-252. The distinction becomes even more difficult if the supporting organization carries on no activities parallel to those carried on by its parent, but merely acts as a fundraising vehicle for the parent.

Given the existence of hundreds of domestic charities organized along the "American Friends" model and collecting contributions for foreign parents, it is tempting to conclude that Rev. Rul. 63-252 may, at least in this context, be a dead letter. However, recent developments indicate that the IRS has not abandoned the conduit principle in the tax-exempt setting. Accordingly, conservative tax advisors

37 (...continued)

38 Treas. Reg. § 1.509(a)-4(i). Theoretically, the supporting organization could satisfy these tests, without remitting its funds to the parent, by engaging in an activity that would otherwise be carried on by the parent. In practice, a domestic supporting organization will rarely if ever be in a position to support its foreign parent in such an interdependent operational role.

39 In GCM 39875 (June 26, 1992), the Chief Counsel's Office announced its withdrawal and reconsideration of GCM 39748 (January 27, 1988). The earlier GCM had taken a fairly liberal view of earmarking through "donor-directed" funds, holding that earmarked contributions could be included in such funds' public support fraction. In withdrawing GCM 39748, the later GCM stated only that the holding thereof had been applied more broadly than anticipated.

In PLR 9118013 (January 31, 1991), the IRS Income Tax & Accounting branch ruled that contributions made by alumni of a fraternity to an exempt historical society for use in connection with the renovation of a historically significant fraternity house were nondeductible. Surprisingly (and in my view inappropriately), the ruling did not base its holding on the (continued...
should make their foreign charitable clients aware that the 1963 ruling has not been revoked or made obsolete. If the political or enforcement climate prevailing within the IRS changes, there is little to prevent the IRS from challenging the right to deduct contributions to these types of "conduit" charities. Even an isolated case involving a challenge of a single donor's contribution could have a chilling effect on the fundraising activities of other groups similarly organized, if donors' tax advisors become concerned that the 1963 ruling might be enforced.

2. Publicly-supported organizations

If qualification under section 509(a)(3) is not desirable or feasible, the domestic charity may qualify as publicly-supported under the general public support tests of sections 509(a)(1) or (2). It is, unfortunately, not uncommon to find that, at least in the early years, a domestic charity created by a foreign parent is less likely to attract contributions from the public at large, and much more likely to enjoy the favor of a few major contributors interested in the foreign connection.

If the domestic charity is engaged in U.S. charitable activities in its own right, it is far less likely to be classified as a private foundation. Even here, however, if the domestic charity is the recipient of a substantial "start-up" grant from its foreign "sister," the private foundation problem must be addressed. Normally, gifts or grants from substantial contributors (those whose aggregate gifts exceed 2% of the donee's overall support) are not counted toward a charity's public support fraction, except to the extent of 2% of total support. An exception is made for any substantial contributor that is itself a public charity, but this exception does not appear to be available for a grant from a foreign public charity.

39 (...continued) conduit principles of Rev. Rul. 63-252, which principles clearly apply in the domestic context. Instead, the letter ruling found that the donors expected a "quid pro quo" in the form of a private benefit to them. IRS personnel have informally confirmed that, because they viewed the conduit principle as having been limited or undercut by the Montessori case (see EO Technical CPE, at 227), they felt compelled to extend the quid pro quo analysis to a set of facts that could otherwise be addressed by the conduit principle.

40 If the domestic charity is not publicly supported and cannot qualify as other than a private foundation under section 509(a)(1), (2) or (3), the fact that it carries on active operations would at least allow it to seek intermediate status as a "private operating foundation" and/or an "exempt operating foundation." Such entities qualify for broader individual contributions, relief from Chapter 42 excise taxes and grants from other private foundations not subject to expenditure responsibility. See Code sections 170(b)(1)(A)(vii), 170(b)(1)(E)(i), 4942(j)(3), §4945(d)(4)(A) and 4940(d)(2).

41 Treas. Reg. §1.170A-9(e)(6)(i); (v). The exception from (continued...
This seed money problem is usually addressed by the recipient classifying any initial grant as an "unusual grant," excludible from its public support fraction.\(^\text{42}\) To qualify as an unusual grant, the grant must be (1) attracted by reason of the publicly-supported nature of the domestic charity and (2) "unusual or unexpected" in amount. Among other factors taken into account in determining whether a grant is unusual is whether the grant is made by the creator of the organization. The inference is that large, start-up grants from foundation backers are not "unusual." The "unusual" standard may be difficult to satisfy where the foreign parent has, from the outset, intended to provide start-up funds to its domestic offshoot. It can be argued that this much of the definition ought not be applied too literally to the expansion of a foreign charity's activities into the United States.

III. FEDERAL EXCISE TAX RULES AFFECTING FOREIGN CHARITIES

The Code contains a battery of excise taxes potentially applicable to private foundations.\(^\text{43}\) The principal excise tax applicable to foreign private foundations is the 4% tax on U.S. source gross investment income imposed by section 4948(a). This tax applies to foreign private foundations in lieu of the "regular" 2% (or 1%) tax on net investment income imposed on domestic private foundations under section 4940.

A. Amount of the § 4948(a) Tax

Calculating the amount of the section 4948(a) excise tax is usually a straightforward exercise. The tax applies to the gross amount of U.S. source interest,

\(^{41}\) (...continued)

the 2% rule that applies to gifts from publicly-supported charities is, at least, difficult to apply where the donor is a foreign charity. Such a donor cannot qualify as a section 170(b)(1)(A)(vi) organization, because the regulations restrict the definition thereof to domestic organizations. Treas. Reg. §1.170A-9(e)(1)(i). Whether a foreign donor can otherwise qualify as an organization that "normally receives a substantial part of its support from direct contributions from the general public," for purposes of this exception, is unclear. The difficulty of applying the public support regulations to foreign charities was pointedly addressed in the three G.C.M.'s discussing Rev. Rul. 75-435, note 5 supra. Over the objections of counsel's office, the IRS staff "solved" this difficulty by reading out the requirement of section 170(b)(1)(A)(vi) that the organization be domestic. In doing so, the staff stated its belief that Congress had simply overlooked the problem.

\(^{42}\) Treas. Reg. §1.170A-9(e)(6)(ii); §1.509(a)-3(c)(3). In cases of doubt, the domestic organization may consider applying for an advance ruling on whether a proposed grant will be "unusual." The advance ruling guidelines are set forth in Rev. Proc. 80-24, 1980-1 C.B. 658.

\(^{43}\) See generally Code sections 4940 through 4948.
dividends, rents, royalties and payments with respect to securities loans.\textsuperscript{44} The tax is collected by means of withholding pursuant to section 1443(b) and reported on the foreign private foundation’s annual Form 990-PF.\textsuperscript{45}

It is unclear whether the section 4948(a) excise tax applies to "portfolio interest" described in sections 871(h) and 881(c) of the Code. Portfolio interest is, by definition, interest from U.S. sources, but has been generally exempt from U.S. income tax since 1984. The regulations under sections 4948(a) and 1443(b) predate the 1984 repeal of U.S. income tax on portfolio interest. Although the exemption from tax for portfolio interest relates to the income tax, the fact that income tax treaty relief is extended to the section 4948(a) excise tax suggests that a similar extension of the exemption should apply in the case of portfolio interest. Moreover, the regulations state that "the withholding tax provisions of Chapter 3 of the Code [§§ 1441-1464] and the regulations thereunder shall apply with respect to the gross investment income...of such foundation from sources within the United States...as if the excise tax imposed by section 4948(a) were a tax imposed by Chapter 3 of the Code."\textsuperscript{46} Given this directive, albeit one predating the repeal of the withholding tax on portfolio interest, it appears that portfolio interest paid to a foreign private foundation should be exempt from the section 4948(a) tax.

A similar issue, although one with a more convoluted history, is currently presented by the taxability of interest on U.S. bank accounts. When section 4948 was first enacted, the Code treated bank account interest as "foreign source." Accordingly, it seemed clear that such interest was not subject to the section 4948(a) excise tax.

However, in 1986 the Code provisions governing bank account interest were amended (for reasons having nothing to do with foreign charities) to reclassify such interest as "U.S. source" but generally exempt from income tax and withholding. As a result, a bank could be concerned that interest it pays to a foreign private foundation may now be subject to excise tax withholding under section 1443(b). Presumably, most U.S. banks are ignoring this statutory glitch.

\textsuperscript{44} The tax does not apply to the extent that any of these types of income is exempt from U.S. income tax under an applicable tax treaty, whether the exemption is generally available to all treaty-country residents or only to specified exempt organizations. Treas. Reg. §§ 53.4948-1(a)(3); 1.1443-1(b)(ii); see also Rev. Rul. 74-183, 1974-1 C.B. 328. (The U.S.-Canada treaty specifically exempts Canadian private foundations from this excise tax.) However, it does not appear that the mere reduction of the rate of U.S. withholding tax on a particular type of income by treaty, e.g., from 30% to 15%, will proportionately reduce the section 4948(a) excise tax.

\textsuperscript{45} A foreign private foundation is required to file this return. Treas. Reg. § 53.6017A-1(a).

\textsuperscript{46} Treas Reg. § 1.1443-1(b)(1)(i) (emphasis added).
B. Foreign Charities Subject to the § 4948(a) Tax

Determining whether a given foreign charity is subject to the section 4948(a) tax can be surprisingly difficult. The tax clearly applies to any foreign charity that has applied for and received a ruling from the IRS classifying it as a private foundation. Conversely, the tax clearly does not apply to a foreign charity that has received a letter classifying it as a public charity. The difficulties arise under the section 4948(b) *de minimis* rule, a troublemaker already discussed in Part II, E, 1 of this paper.

The IRS takes the view that a U.S.-supported foreign charity (i.e., one that receives over 15% of its support from U.S. sources) that fails to obtain the required recognition U.S. exempt status is not subject to the section 4948(a) tax, even if such charity would have been classified as a private foundation. While section 4948(a) by its terms imposes the tax on "every" foreign foundation, both the regulations\(^\text{47}\) and G.C.M. 38840 (April 22, 1982), have long limited the section 4948(a) tax to exempt foreign foundations, i.e., foreign charities that have obtained an exemption ruling under section 501(c)(3) and have been classified by the IRS as private foundations.

The IRS position as stated in GCM 38840 seems correct. If a foreign charity is subject to the notice rule by virtue of receiving substantial U.S. support, and does not comply with the notice rule, it cannot be "described in" section 501(c)(3) and should be treated like a domestic charity that fails to secure IRS recognition of its exempt status.

What is unclear is whether a foreign charity that has no IRS determination letter, because it is foreign-supported and meets the *de minimis* test, is or is not subject to the section 4948(a) tax. Absent an IRS determination, how can the IRS or a withholding agent determine whether or not such a foreign charity is a "private foundation"?\(^\text{48}\) The usual presumption, contained in section 508(b), that all section 501(c)(3) organizations are private foundations unless otherwise established has no application in this case, since such a foreign charity is specifically excused from the notice rules of section 508.

The regulations promulgated under section 1443(b) attempt to address this problem of classification. The regulations acknowledge the difficulty of determining whether the foreign payee is, or is not, a private foundation by permitting

\(^{47}\) Treas. Reg. § 53.4948-1(a).

\(^{48}\) Note that it does no good here to read section 4948(b) as limited to foreign private foundations, as the EO Technical Division did in the EO Technical CPE; such a reading merely begs the question.
the U.S. payor to rely on a "good faith" standard similar to that applied under the second prong of the equivalency doctrine in the section 4945 regulations.49

This would seem to be the end of the matter. However, in Rev. Rul. 76-330,50 the IRS ruled that a foreign-supported Belgian charity was subject to the section 4948(a) tax. The Rev. Rul. is remarkable for the absence of any indication as to who, if anyone, determined (in good faith?) the Belgian charity to be a "private foundation," and on what basis. The ruling makes no mention of the de minimis rule or the section 1443(b) regulations' equivalency doctrine.

Foreign-supported foreign charities, at least those who might qualify as publicly-supported if given the chance, should be subject to no worse treatment under section 4948(a) than the taxable foreign charities described in GCM 38840. However, given the uncertainty surrounding the application of the section 4948(a) tax and the equivalency doctrine in the section 1443(b) regulations to a foreign-supported foreign charity, if such a charity believes it would be treated as other than a private foundation, it may be well advised to apply for exempt status even though not required to do so. This rather unfortunate conclusion requires rethinking by the IRS.

C. Other Excise Taxes

A foreign charity that receives substantial U.S. support and that is classified as a private foundation by the IRS is subject to all of the other excise taxes imposed on domestic private foundations (except the section 4940 tax, for which the section 4948 tax is a proxy). Unlike the section 4948 and 4940 taxes on investment income, the other excise taxes are essentially prohibitions on certain activities, and can equal 100% of the amount involved in a given transaction. Most of these prohibitions and taxes also apply to foundation managers. Although a complete discussion of the private foundation excise taxes is beyond the scope of this article, a listing of these taxes follows: (1) the section 4941 taxes on self-dealing; (2) the section 4942 tax on failure to distribute income; (3) the section 4943 tax on excess business holdings; (4) the section 4944 tax on investments that jeopardize the private foundation's charitable purposes; and (5) the section 4945 tax on taxable expenditures (described in detail elsewhere herein).

IV. STATE TAX RULES AFFECTING FOREIGN CHARITIES

The governments of the fifty states and the District of Columbia, as well as many local governments, impose and collect their own taxes. Most states levy income taxes, corporate franchise taxes and sales taxes, while most municipalities impose property (ad valorem) taxes. A few large municipalities, such as Los Angeles and New York City, also impose income taxes that are in addition to the federal and state income taxes on taxpayers resident therein.

Many states that impose some type of income or franchise tax on corporate or other entities have explicitly adopted the federal tax rules contained in the Code for purposes of determining their tax base. Many of these states also recognize as exempt from most of these taxes charities that are recognized as exempt by the IRS.

In many cases, no special state application or filing is required for the exemption to be effective. Some states will honor the federal exemption only upon the charity’s compliance with independent state application procedures. These procedures range from the mailing of a simple letter to the state tax authority (enclosing a copy of the IRS determination) to the completion of a separate tax exemption application similar to the federal Form 1023.

For purposes of obtaining an exemption from state sales taxes, the states' approaches to charitable organizations vary widely. In Virginia, for example, the sales tax exemption is not general but is limited to governmental entities, certain educational organizations and hospitals, and a list of specially-targeted sales and purchases.\(^{51}\) In Nevada, a public referendum recently repealed the sales tax exemption for charities.\(^{52}\) Fortunately, the majority of states do grant exemption from sales tax to charitable organizations, and the exemption usually covers both purchases and sales.

Because state sales tax laws contain specific provisions for registration and exemption, the sales tax exemption for charities is never self-executing. A charity that would otherwise be liable to pay sales tax on retail purchases made within a state, or to collect sales tax on sales made, will need to complete and file an exemption application. It will then be issued an exemption certificate that can be provided to vendors in lieu of paying sales tax on purchases.

Many municipalities have adopted rules that reduce or even eliminate local property taxes (usually imposed on real property and, less frequently, on personality) with respect to property owned by charities and used in furtherance of the charity's charitable or other exempt purposes.

V. STATE REGULATION OF CHARITIES

From a state's point of view, a charity based in a foreign country is no different from a domestic charity organized under the laws of a sister state: in both cases, the charity is classified as a "foreign" organization.

All states impose some type of registration requirement upon foreign organizations doing business, owning property or conducting certain specified activities within their borders. Just as a New York charitable corporation must register

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\(^{51}\) Va. Code § 58.1-609.1 et seq.

\(^{52}\) See State Tax Notes, Feb. 20, 1995, at 735.
to "do business" in New Jersey, a non-United States charity must register to "do business" in any and all states where it has sufficient contacts (or "nexus") to trigger the registration requirement. The registration filed by a foreign organization is usually filed with the Secretary of State's office.

In addition to registering with the Secretary of State, the foreign charity will often be required to register with the office of the state attorney general or other agency charged with the oversight of charitable activities and solicitations in the state. Under the U.S. federal system, states retain and exercise independent powers to regulate the activities of organizations -- including charities -- operating within their borders. Moreover, there exists no unified procedure pursuant to which a single registration in one state will suffice to cover activities or solicitations in any other state. Thus, a charity soliciting contributions in all 50 states may, assuming it has "nexus" in all 50 states, be required to qualify to do so under 50 distinct systems.

Most states enforce their registration rules only in those cases where the foreign charity has an active, continuing, physical presence within their borders. Leasing an office within the state is certainly sufficient to trigger the registration requirements; conducting a high-profile benefit or other fundraising event may also subject the foreign charity to the supervisory role of the state in which the event is held.

The penalties for failure to comply with state rules governing charities registration and oversight may consist of monetary penalties, a court order to desist from soliciting contributions or carrying on activities within the state, and the loss of any available state tax exemptions. Accordingly, a foreign charity should exercise care in determining whether its proposed interstate activities or solicitations may subject it to local registration procedures.

Once a charity has properly registered to conduct its activities in a given state, it may often be required to file annual reports similar to those filed on its federal Form 990. It may also be necessary to file separate reports with the state attorney general's office. Typically, these reports, like Form 990, are required to be made available to the general public. Many states require that all fundraising and promotional materials distributed by a registered charity incorporate language directing the solicitee to the public documents on file for that particular charity.

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