

Grantmaking by U.S. Public & Private Charities  
Outside the U.S.<sup>1</sup>  
by  
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I. Introduction

Making grants to charitable organizations in other countries is not as simple an exercise as writing a grant check to the local symphony or museum. However, the additional rules that must be followed should not be seen as insuperable barriers. Many types of grantmaking require extra time and attention. Scholarship programs, attempts to influence public policy, program-related investments and grants to nonpublic charities all require additional care. With a little homework and some attention to detail, there is virtually no place in the world,<sup>2</sup> nor any legitimate object of philanthropic concern, that cannot legally and effectively be funded by a U.S. grantmaker willing to follow the necessary procedures.

American support of charitable activities in other countries draws on a long historical tradition and is a dynamic part of today's philanthropy. The U.S. Congress, through its lawmaking power, has made clear that there are strict limits to the charitable deduction when grants or gifts are made to non-U.S. organizations. In the same way, Congress is concerned that U.S. charities, which benefit from tax exempt status and wish to make grants overseas, not stray from their obligation to operate exclusively for charitable purposes.

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<sup>1</sup> While adapted slightly to meet the needs of this conference, the text presented here is found in its more complete form in Edie, Beyond Our Borders: A Guide to Making Grants Outside the U.S. (Council on Foundations, 1994).

<sup>2</sup> From time to time, the U.S. State Department will prohibit any kind of trade or other exchange with certain countries.

One should know at the outset that there are unavoidable start-up expenses. Virtually any grantmaker stepping into this area for the first time should recognize the need for: 1) thorough understanding by staff and board, 2) extra time and administrative expense to comply with additional procedural and recordkeeping requirements, and 3) ongoing oversight review by the grantmaker's legal counsel.

The decision to make grants outside the United States does not require a total overhaul of the funder's existing grantmaking process. Many of the normal procedures will and should stay in place. The usual process for grant application, review, approval and evaluation need not be discarded. Indeed, many of the same forms will continue to be useful. However, at various steps in the process, new elements must be added to meet additional requirements. A foundation that starts with a solid set of grantmaking procedures will find the adjustments necessary to make international grants much easier.

## II. Basic Legal Framework

Grantmaking by U.S. charities--whether domestic or international--must serve a charitable purpose. The Internal Revenue Code adopts a definition of "charitable" that is not limited to the older notion of merely caring for the poor. Rather, the interpretation of charitable purpose is broad and changing as new needs and areas of human endeavor evolve.

All public charities and private foundations must acquire a determination letter from the Internal Revenue Service verifying that they are exempt from taxation under Section 501(c)(3) of the Internal Revenue Code. Each organization qualified under this code section must be "organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, or to foster national or international sports competition or for the prevention of cruelty to children or animals."

From time to time, IRS rulings and Tax Court decisions continue to refine the definition of charitable, but the basic rule remains. Whether making grants within or outside the United States, the programs or services funded must serve a recognized charitable purpose. Charitable activity outside the United States is clearly permissible for organizations recognized under Section 501(c)(3).<sup>3</sup>

#### D. Private Foundation Versus Public Charity

The first step in understanding the rules governing grants to non-U.S. institutions is to understand the distinction, under U.S. tax law, between private foundations and public charities. Both public charities and private foundations are exempt from income tax under Section 501(c)(3) and must comply with its requirements and prohibitions. But private foundations--a subcategory of charitable organizations carved out by Congress in 1969 in response to perceived abuses--are subject to an additional (and more complex) set of rules, not applicable to public charities.<sup>4</sup>

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The remainder of this paper will summarize in brief the rules that apply to grants made to non- U.S. organizations by public charities, for-profit corporations and private foundations.

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<sup>3</sup> See Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal Year 1992 (Training 4277, TPDS 86827) pp. 222-23, hereafter referred to as EO Technical CPE (1992). This training manual is provided by IRS to field staff on an annual basis. The 1992 edition contains an essay entitled "Foreign Activities of Domestic Charities and Foreign Charities" by James F. Bloom, Edward D. Luft and John F. Reilly. This manual was designed for training purposes only and its cover states: "Under no circumstances should the contents be used or cited as authority for settling or sustaining a technical position." Later footnotes will refer to this document not as technical authority but as evidence of current analysis by the Service.

<sup>4</sup> This paper presumes that the reader understands the legal distinctions between private foundations and public charities. For more detail see Beyond Our Borders, pp.4-5 or Edie First Steps in Starting a Foundation (Council on Foundations, 1993), Third Edition, pp.3-16.

### Grants by Public Charities

For the public charity that decides to make occasional grants outside the United States, the legal requirements are significantly less onerous than those for private foundations. The IRS cannot levy a penalty tax on the public charity or its managers for failure to meet a minimum payout requirement or for making a grant to an organization that is not a public charity. Thus, the stricter requirements of equivalency determination and expenditure responsibility (as discussed later under private foundations) do not apply.

Two other related legal problems, however, must be considered. The governing board of any public charity has a fiduciary duty under its governing instruments to be certain that the funds under its control are used for charitable purposes. Failure to exercise this duty could jeopardize the organization with state enforcement authorities. Similarly, the IRS can revoke the tax-exempt status of the charity unless it can show that it operates exclusively for charitable purposes as required by Section 501(c)(3). This analysis from an IRS publication notes that:

....if a domestic organization, otherwise qualified under IRC 501(c)(3), transmits its funds to a private organization not described in IRC 501(c)(3) and fails to exercise, or has too little, discretion and control over the use of such funds to assure their use exclusively for charitable purposes, the domestic organization forfeits its qualification for exempt status because it cannot demonstrate that it is operated exclusively for charitable purposes, and contributions to it are not deductible.<sup>5</sup>

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<sup>5</sup> EO Technical CPE (1992), p. 233, as cited in footnote 3.

The key words in this analysis are "discretion and control."<sup>6</sup> If a public charity is to protect its tax-exempt status, it must be prepared to demonstrate upon audit that it has established and has maintained adequate discretion and control to assure that the grant funds were used for charitable purposes.

What constitutes sufficient discretion and control? The IRS has not provided specific guidance to public charities as to what degree of documentation and oversight will qualify as sufficient discretion and control.

Given this lack of certainty, any public charity contemplating grants outside the United States should consult with its legal counsel and outside auditors for advice in setting up forms, procedures and recordkeeping systems that will protect the organization from challenges by IRS.

Treasury regulations stipulate quite clearly what is required of private foundations in order to design and exercise the requisite discretion and control. Clearly, the closer a public charity comes to following the private foundation rules, the safer it will be. The task for a public charity is to determine just how much of the private foundation rules need be followed to provide adequate protection. There is no one answer to this question. Different charities, in consultation with their legal counsel, will choose different degrees of oversight depending on their comfort level and the types of grantees they expect to encounter.

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<sup>6</sup> For more detail on this issue, see discussion of "friends of" organizations in Beyond Our Borders, pp. 8-9. See also Rev. Rul. 63-252, 1963-2 C.B. 101.

### Grants by For-Profit Corporations

U.S. corporations organized for profit may give anything they want to anyone in any place so long as the gift is consistent with a legitimate purpose of that corporation. Corporate law for decades has prohibited actions that were *ultra vires*, or beyond legitimate corporate purposes. However, if the corporation wants to make a charitable gift and obtain a charitable tax deduction, there are significant limitations beyond the question of whether or not the gift serves a corporate purpose.

It is well settled now, under the rules of corporate law in the United States, that corporate management has the power and the discretion to authorize corporate charitable contributions for public purposes even when there is no direct financial benefit to the corporation. Corporations may deduct charitable contributions up to 10 percent of taxable income in any tax year.<sup>7</sup> Of course, the corporation may not need a charitable deduction. It may be able to qualify the gift as a business deduction, or it may find it easier to take either type of deduction through its non-U.S. subsidiary operation in accordance with foreign tax law.

#### A. Direct Gifts to Non-U.S. Charities

For purposes of the charitable deduction, the tax code defines a charitable contribution as one that is made for a charitable purpose to a governmental unit, or to a "corporation, trust, or community chest, fund, or foundation" that is created or organized in the United States.<sup>8</sup> Thus, gifts to charities formed or created outside the United States may not be claimed as a charitable deduction. This rule holds true for gifts by individual U.S. citizens as well.

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<sup>7</sup> Section 170(b)(2).

<sup>8</sup> Internal Revenue Code Section 170(c).

#### B. Gifts to U.S. Charities Which Use the Funds Outside the U.S.

If a U.S. corporation makes a grant to a charity created in the United States, the contribution is usually deductible even if the charity uses the funds outside of the United States. Many so-called "international" U.S. charities have active programs in other countries. Examples include the Red Cross, CARE, World Wildlife Fund and Africare.

Corporate givers must be certain that the U.S. charity providing services outside the United States is organized as a corporation and not as a trust or unincorporated association. This requirement is purely a technicality caused by a quirk in the law.

#### C. Gifts Made Through Non-U.S. Subsidiaries

Increasingly, U.S. corporations are becoming multinational in scope and have formed various kinds of subsidiary operations in other countries. It is perfectly possible for a multinational corporation to make grants of cash or inventory to charitable organizations created in non-U.S. countries. Under these circumstances, the non-U.S. subsidiary of the parent corporation will make the contribution and take advantage of whatever tax deduction may be available in the country where it operates. In many countries (especially in Europe), it is much easier to take a business expense deduction than it is to take a charitable deduction. The charitable or business deduction of the non-U.S. subsidiary is claimed solely when calculating the foreign income tax owed by the subsidiary to the country where it is located. U.S. tax laws do not come into play. This treatment of the gift under foreign law may be the simplest and most advantageous to the multinational corporation. But, since each country's tax laws are quite different, no effort will be made here to provide further detail.

D. Company Foundation.

A company may form its own foundation in the form of a private foundation organized in the corporate form and controlled by the company. Non-earmarked grants can be made to the company foundation which may then, at its discretion, make grants from the foundation to charitable organizations formed outside the United States. The rules for private foundation grants to non-U.S. charities are explained in the next section. On the following page is a summary of the grantmaking rules for corporations.



## International Giving by Corporations

| Grantee Organization   | Can You Fund? | Is Gift Deductible? | Limitations   |
|--|---------------|---------------------|---|
| 1. U.S. 501(c)(3) charity operating outside the U.S.                                 | Yes           | Yes                 | Same as for grants used in the U.S. The 501(c)(3) must be a corporation.  |
| 2. Corporate or other private foundation that makes grants to non-U.S. institutions. | Yes           | Yes                 | Same as for grants used in the U.S. The grantee must be a corporation. Caution: To be deductible, must not engage in "earmarking" of grant. |
| 3. "Friends of" organization   | Yes           | Yes                 | Same as for grants used in U.S. The 501(c)(3) must be a corporation.  |
| 4. Non-U.S. entity with 501(c)(3) status   | Yes           | No                  | May qualify for business expense deduction.   |
| 5. Non-U.S. 501(c)(3) equivalent   | Yes           | No                  | May qualify for business expense deduction.   |
| 6. Other non-U.S. organizations  | Yes           | No                  | May qualify for business expense deduction.   |

### Grants by Private Foundations

The rules for private foundations are more complex. These rules are also valuable to corporations and public charities. Any private foundation formed by a U.S. corporation (a company foundation) must abide by these rules for any grants to non-U.S. organizations, and while public charities are not bound to these rules, they provide useful guidance and relative safety if they are followed closely.

Any private foundation moving into this international realm must be mindful of two legal requirements: 1) Are its grants clearly for charitable purposes<sup>9</sup> and 2) Will its grants count toward meeting its five percent minimum payout requirement.<sup>10</sup>

#### A. Grants to Public Charities Recognized by the IRS

The easiest way for a private foundation to satisfy both of these needs is to choose a grantee that is a public charity; that is, governmental units and all IRS-recognized Section 501(c)(3) organizations that are not private foundations. Grants to any other type of organization are subject to an additional set of rules which require the private foundation to execute more complicated administrative procedures called "equivalency determination" or "expenditure responsibility" described below. Failure to follow these additional rules could subject the grantor foundation to a penalty tax.

Taking the easier route by making grants to an organization recognized by IRS as a public charity can be accomplished in three ways:

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<sup>9</sup> Section 4945(d)(5) defines as taxable any expenditure for any purpose that is not charitable under Section 170(c)(2)(B). The penalty tax can be applied to the foundation and to the foundation manager.

<sup>10</sup> Section 4942(a). In some cases, it will not matter whether a grant qualifies in meeting the minimum payout if the foundation has already met this requirement in other ways.

1. Making grants to a public charity organized in the United States that performs activities and services in other countries.
2. Making grants to a charity created outside the United States that has applied for and obtained public charity status from the Internal Revenue Service.
3. Making grants to a "friends of" organization.<sup>11</sup>

B. Grants to Non-U.S. Organizations Not Recognized by the IRS

While making grants to recognized public charities may be significantly easier, foundations active in the international arena will more frequently encounter potential grantees that are not U.S. public charities and that have not spent the time and considerable legal expense to become recognized by the IRS. Fortunately for private foundations, the tax law provides some extra flexibility for grants made to non-U.S. organizations that are not recognized by the IRS. There are two options to choose from: 1) determine that the non-U.S. grantee is the "equivalent" of a U.S. public charity; or, 2) exercise "expenditure responsibility."

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<sup>11</sup> For a full discussion of "friends of" organizations, see Beyond Our Borders, Appendix 4, pp. 43-44; see also Rev.Rul. 63-252, 1963-2 C.B. 101.

### 1. Option: Equivalency Determination

The law permits private foundations to make grants to a non-U.S. organization if a determination can be made that the grantee is the "equivalent" of a U.S. public charity. Moreover, this determination of equivalency will also qualify the grant to count toward the minimum payout requirement. The following citation from the regulations is instructive (the words in brackets are added):

If a private foundation makes a grant to a foreign organization which does not have a ruling or determination letter that it is [a public charity], such grant will not be treated as a grant made to an organization other than [a public charity and thus requiring expenditure responsibility] if the grantor private foundation has made a good faith determination that the grantee organization is [the equivalent of a U.S. public charity]. 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 [a public charity]. 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 [a public charity].<sup>12</sup>

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<sup>12</sup> Treas. Reg. Section 53.4945-5(a)(5).

This regulation lies at the heart of most private foundation grantmaking to non-U.S. grantees.<sup>13</sup>

The good news is that the non-U.S. charity need not go through the time-consuming and costly process of seeking an IRS determination letter. The bad news is that the charity must provide virtually all the same information and financial data to the private foundation (or to its lawyer) which must then make the determination that the IRS would have made. The administrative burden is not easy. First, both grantor and grantee must understand what is needed. Here is a brief summary:

- Copies of the organizational documents. These may be called articles of incorporation, charter, certificate of incorporation or the like. Generally, bylaws are the organizations internal governing rules, which you may wish to obtain as well.
  
- A detailed description of the purposes and all the activities of the grantee, both past and proposed.
  
- A copy of relevant statutory law, or provisions in the governing instrument, stating how the assets of the grantee will be distributed if it should cease operations.

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<sup>13</sup> A virtually identical regulation provides for public charity equivalency for purposes of meeting the minimum payout requirement. See Treas. Reg. Sec. 53.4942(a)-3(a)(6). Note also the following quote from EO Technical CPE (1992), page 244:

The concept of "good faith determination" is as critical to determining whether a distribution to a non-U.S. organization is a qualifying distribution, as it is to determining, for purposes of IRC 4945, whether expenditure responsibility need be exercised....The components of the determination are the same for IRC 4942 and IRC 4945.

- The grantee must also demonstrate that: 1) none of its assets or income will provide a private benefit to individuals; 2) any noncharitable activities or legislative lobbying are, and will be, insubstantial; and 3) it will not participate or intervene directly or indirectly in any political campaign or specific public election on behalf of, or in opposition to, any candidate for public office. Each of these requirements can be satisfied by providing copies of relevant law by which the organization is bound or by its own governing instruments.
  
- For organizations that are not religious institutions, educational organizations or medical institutions, detailed financial support data for several years will be required.

b. Lawyer Equivalency Letters

In order to accomplish this required determination of equivalency, most foundations historically have retained legal counsel to provide them with written advice on which they may rely in making grants to non-U.S. charities. Given the legal expenses involved, however, it is not surprising that larger foundations have been the most active in international grantmaking.

c. Grantee Affidavits and Revenue Procedure 92-94

As the Treasury regulation above makes clear, a private foundation may also make legitimate grants to non-U.S. charities by obtaining a written affidavit from the grantee containing enough information for a foundation manager to make a reasonable determination that the non-U.S. organization is the equivalent of a U.S. public charity. As noted above, many foundations have traditionally preferred the use of lawyer equivalency letters. A problem with this approach is that different private foundations

making grants to the same non-U.S. charity must each obtain a separate letter. A November 1992 ruling by the IRS, known as Revenue Procedure 92-94, describes how a written affidavit might be crafted. The main significance of this new revenue procedure is that more than one foundation may rely on the same affidavit. The purpose of the procedure is to simplify the process so that more small and medium size foundations will be encouraged to make grants outside the United States using this affidavit format which does not require incurring legal fees for each grantee. Foundations that decide to use the grantee affidavit format would do well, however, to consult with legal counsel for guidance in setting up appropriate forms and procedures to follow in order to ensure that the process will withstand IRS scrutiny on audit.

## 2. Option: Exercise Expenditure Responsibility

If all efforts to support a reasonable determination that the non-U.S. organization is the equivalent of a U.S. public charity fail, the grant can still be made if the private foundation exercises expenditure responsibility. Part of the stricter set of rules established by Congress in 1969 penalized private foundations for grants made to certain types of organizations. In essence, this prohibition states that the foundation and its managers may be penalized for any grant or contribution to an organization that is not a public charity. Thus, a grant to any public charity is a "safe" grant. Grants to any other type of organization will incur a penalty unless the private foundation is willing to follow precise, good grantsmanship procedures known as "expenditure responsibility."<sup>14</sup> But, there is a golden lining in this prohibition. It offers significant flexibility to a private foundation. If the foundation is willing to follow precise, good grantsmanship procedures, it may make a grant for charitable purposes to virtually any kind of organization almost anywhere in the world.

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<sup>14</sup>. Section 4945(h) and Treas. Reg. Section 53.4945-5.

Expenditure responsibility normally requires five steps (four if the grantee is the equivalent of a private foundation):

Step one: A pre-grant inquiry where the private foundation makes a reasonable determination that the intended grantee is capable of fulfilling the charitable purposes of the grant.

Step two: A written grant agreement signed by an officer or director of the grantee that specifies the charitable purposes of the grant. These written agreement commitments are required for all expenditure responsibility grants to U.S. organizations that are not public charities.

Step three: A report on the status of the grant which includes a description of how the funds have been used, compliance with the terms of the grant agreement and the grantee's progress toward achieving the purposes for which the grant was made. Grantee reports should be submitted at the end of the grantee's annual accounting period within which the grant was received and at the end of all such subsequent accounting periods until the grant funds are expended or the grant is otherwise terminated.

Step four: Notification to the IRS that an expenditure responsibility grant has been made during the tax year. Such notice is required as part of the Form 990-PF tax return which asks if an expenditure responsibility grant has been made. The grantor foundation must answer in the affirmative and provide a brief description of the status of the grant as a separate schedule to the tax return. This report to the IRS should include:

- a) name and address of the grantee; b) date, amount and purpose of the grant; c) amounts expended by the grantee based on the most recent report from the grantee; d) whether the grantee has diverted any portion of the funds from the purpose of the grant (to the



knowledge of the grantor); e) the dates of any reports received from the grantee; and f) the date and results of any verification of the grantee's reports undertaken by the grantor or by others at the direction of the grantor.

In addition to these four steps which are required in all instances of expenditure responsibility, a fifth step is necessary when the grantee is not the equivalent of a private foundation<sup>15</sup>:

Step five: All grant funds must be maintained in a separate fund dedicated to one or more charitable purposes.<sup>16</sup> More specifically, the regulations require that the grantee agree "to maintain and, during the period in which any portion of the grant funds remain unexpended, does continuously maintain the grant funds (or other assets transferred) in a separate fund dedicated to one or more [charitable purposes]."<sup>17</sup> No additional reporting requirements for this separate fund are required beyond the normal reporting specified above.

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<sup>15</sup> Treas. Reg. Section 53.4945-6(c)(2)(i).

<sup>16</sup> As described in Section 170(c)(2)(B). See discussion in Part II-A.

<sup>17</sup> Treas. Reg. Section 53.4945-6(c)(2)(:).

### C. Grants to Governmental Units

This area of international grantmaking is relatively easy. The regulations state that a non-U.S. organization will be treated as "public charity" if it is "a foreign government, or any agency or instrumentality thereof, or an international organization designated as such by Executive Order<sup>18</sup>...even if it is not described in section 501(c)(3)."<sup>19</sup> However, any grant to such a governmental unit or to a designated international organization "must be made exclusively for charitable purposes."<sup>20</sup> In short, grants to organizations described in this paragraph do not require either an equivalency determination or expenditure responsibility. However, the grant file should include 1) documentation that the organization is a unit of a foreign government or a specially designated international organization; and 2) a copy of the grant letter clearly specifying the charitable purpose of the grant. Grants to support the general purposes of a foreign government are not considered by IRS to have been made for a charitable purpose.

The chart on the following page provides a quick summary of the information on international grants by private foundations:

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<sup>18</sup> Under 22 U.S.C. 288.

<sup>19</sup> Treas. Reg. Section 53.4945-5(a)(4)(iii).

<sup>20</sup> Ibid.

## International Grantmaking by Private Foundations

| <b>Grantee Organization</b>   | <b>Can You Fund?</b> | <b>Must You Make Equivalency Determination?</b>                                 | <b>Must You Assume Expenditure Responsibility?</b> | <b>Does Grant Count Towards Payout?</b>               |
|---|----------------------|---|--|---|
| 1. U.S. 501(c)(3) operating overseas  | Yes                  | No. Presumed by status, provided grant is in furtherance of grantee's purposes. | No, provided grantee is a public charity.          | Yes   |
| 2. "Friends of" organization  | Yes                  | No. Holds IRS 501(c)(3) determination letter.                                   | No, provided grantee is a public charity.          | Yes   |
| 3. Non-U.S. Gov't. Unit without 501 (c)(3) status                               | Yes                  | No, but grant must be limited to charitable purposes.                           | No.  | Yes   |
| 4. Non-U.S. entity with 501(c)(3) status from IRS                               | Yes                  | No. Holds IRS 501(c)(3) determination letter.                                   | No, provided grantee is a public charity.          | Yes   |
| 5. Non-U.S. Equivalent of 501(c)(3) organization that is a public charity       | Yes                  | Yes   | No, if grantee can qualify as a public charity.    | Yes   |
| 6. Non-U.S. Equivalent of a 501(c)(3) organization that is a private foundation | Yes                  | Yes   | Yes  | Yes, but only if "out-of-corpus" rules are satisfied. |
| 7. Other Non-U.S. organizations who cannot qualify as 501(c)(3) equivalents     | Yes                  | No. Not possible by definition.   | Yes. Also grant funds must be segregated.          | Yes   |