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Legal Framework of International Philanthropy: The Potential for Change

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This paper will review the state of federal tax rules that govern international philanthropy conducted by domestic organizations recognized as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code of 1986.[1] The article will also assess the potential for changes in those rules as a result of the efforts of the U.S. Department of Treasury and the Internal Revenue Service to ensure that charitable assets are not diverted to support terrorism.[2] The focus of the analysis will be on international philanthropy, defined for this purpose as the provision of financial or other support by a domestic organization

1. All statutory references are to the Internal Revenue Code of 1986, as amended, and all regulatory references are to the regulations promulgated thereunder.

2. *See* Treasury Press Release PO-3607, Response to Inquiries from Arab American and American Muslim Communities for Guidance on Charitable Best Practices, Nov. 7, 2002, *available at* http://www.treas.gov/press/releases/po3607.htm (last visited May 18, 2005); IRS Announcement 2003-29, 2003-1 C.B. 928; Treasury News Release JS-1219, Bush Administration Announces Creation of New Office in Ramped up Effort to Fight the Financial War on Terror, Mar. 8, 2004, *available at* http://www.treas.gov/press/releases/js1219.htm (last visited May 18, 2005).

exempt under section 501(c)(3) to a foreign recipient and collectively referred to as "grant making" in this analysis. The analysis will address both publicly-supported charities and private foundations.[3] In the interests of clarity and brevity, however, the definition of international philanthropy will not include the direct conduct of charitable activities outside the United States by domestic tax-exempt organizations, although the standards governing such activities in the Internal Revenue Code are similar to those applicable to grant making. The standards for asserting a deduction under sections 170,[4] 2025,[5] 2106[6] or 2522[7] will also not be addressed unless relevant for the standards applicable to behavior of tax-exempt organizations.

Background – Perception of the Rules

On May 19, 2003, the Internal Revenue Service issued Announcement 2003-29, requesting public comment on how the agency might "clarify existing requirements" regarding international grant making and other international activities with a particular focus on minimizing the potential for diversion of such funds to non-charitable purposes.[8] The Announcement explicitly referred to diversions for terrorist purposes and noted that measures that might impede diversions for personal gain may not be adequate to stop diversions for other inappropriate purposes.[9] Tax-exempt organizations were invited to

3. For purposes of the analysis, "publicly supported" organizations are those described in section 509(a) of the Internal Revenue Code.

4. I.R.C. § 170 (2004).

5. I.R.C. § 2025 (2004).

6. I.R.C. § 2106 (2004).

7. I.R.C. § 2522 (2004).

8. I.R.S. Announcement 2003-29, 2003-1 C.B. 928.

9. The experience of the federal government in addressing the use of charities to fund efforts to violently overthrow foreign governments, and cutting off charitable contributions to those organizations, is reflected in the difficulties faced in defending a denial of charitable contribution deductions in Margaret Salwasser v. Commissioner, T.C. Memo 1991-466 (1991). In *Salwasser*, the IRS alleged that the taxpayer claimed a charitable contribution deduction for amounts contributed to a tax-exempt charity, the National Endowment for the Preservation of Liberty ("NEPL"), that were then used to purchase weaponry, including missiles, for use by the Nicaraguan "Contras." The decision indicates that the tax-exempt status of NEPL was revoked based, at least in part, on a guilty plea by the President of NEPL, Carl Channell, to a Criminal Information asserting subversion and corruption of the charity's purposes for the improper purpose of soliciting contributions to purchase military and other types of non-humanitarian aid. The Tax Court's opinion suggests that much of the government's case was based on evidence that was classified and not available to the respondent or the Court. The Court

describe their current procedures for making grants and conducting activities outside the United States and to provide suggestions on how "existing guidance" could be expanded and "existing rules" improved to provide greater assurance that funds are used appropriately.[10] The Announcement also outlined existing rules as enunciated in a series of revenue rulings, the most recent of which is Revenue Ruling 71-460.[11] The revenue ruling on which the IRS placed the most emphasis, however, is Revenue Ruling 56-304,[12] issued nearly fifty (50) years ago to address record keeping involving grants to individuals.

Announcement 2003-29 drew a number of comments from the charitable sector, including comments from the Exempt Organizations Committee of the American Bar Association Tax Section,[13] the Charities Bureau of the New York State Attorney General's Office,[14] and organizations as diverse as the Howard Hughes Medical Institute[15] and OMB Watch.[16]

As part of their submissions, each of the four commentators all characterized the current state of the rules for foreign grant making and

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ultimately allowed deductibility of the contributions on the grounds that the government had not demonstrated that the taxpayer participated in the acts that gave rise to the revocation of exemption or had knowledge of such acts. Subsequently, the *Final Report of the Independent Counsel for Iran/Contra Matters* indicates that the material purchased by NEPL included SAM-7 missiles, Blowpipe missiles and C-4 explosives. LAWRENCE E. WALSH, *Final Report of the Independent Counsel for Iran/Contra Matters, at* www.fas.org/offdocs/walsh (quoting chapter 13 PRIVATE FUNDRAISING: THE GUILTY PLEAS OF CHANNELL AND MILLER).

10. On November 4, 2004, the IRS released its Implementing Guidelines for fiscal year 2005, a document that outlines the agency's enforcement concerns and initiatives dealing with tax-exempt organizations for the fiscal year. One of the initiatives included in the Guidelines is a project consisting of the examination of selected organizations with international grant making activities in order to ascertain the level and effectiveness of oversight.

11. Rev. Rul. 71-460, 1971-2 C.B. 231.

12. Rev. Rul. 56-304, 1956-2 C.B. 306.

13. Paul Streckfus, *American Bar Association Comments in Response to Internal Revenue Service Announcement 2003-29, 2003-20 I.R.B. 928 Regarding International Grant-making and International Activities by 501(c)(3) Organizations*, 8 EO TAX J. 5, Sept. - Oct. 2003, at 119 [hereinafter *ABA Comments*].

14. Paul Streckfus, *Comments of the New York Charities Bureau,* 8 EO TAX J. 5, Sept. - Oct. 2003, at 163 [hereinafter *New York Comments*].

15. Paul Streckfus, *Comments of the Howard Hughes Medical Institute,* 8 EO TAX J. 6 , Nov. - Dec. 2003, at 308 [hereinafter *Howard Hughes Medical Institute Comments*].

16. Paul Streckful, *Comments of OMB Watch Re: IRS Announcement 2003-29, International Grant-making and International Activities by Domestic 501(c)(3) Organizations*, 8 EO TAX J. 6, Nov. - Dec. 2003, at 272 [hereinafter *OMB Watch Comments*].

took a position on the need for new or expanded rules. It is interesting to note that to one extent or another, the commentators all suggested that the existing requirements for foreign grant making differ depending on whether the grantor organization is a publicly supported charity or a private foundation. For example, the American Bar Association comments noted, "[f]ederal income tax requirements, of course, vary depending on whether the charity in question is a public charity or a private foundation."[17] The Charities Bureau in New York opined "[p]ublicly supported United States charities should be subject to, at the least, the rules applicable to private foundation grants and other transfers of funds or other property to foreign organizations and individuals."[18] The Howard Hughes Medical Institute noted "we do not believe that it is necessary to extend the rules governing private foundation international grant making (i.e., requiring an equivalency determination or expenditure responsibility) to public charity grant making."[19] Finally, OMB Watch, in requesting that guidelines should distinguish between private foundations and public charities with regard to grant making, stated that "[p]rivate foundations and public charities are governed by different sets of IRS regulations, with substantial differences in allowable activities and reporting requirements."[20]

A careful read of the IRS Announcement 2003-29, however, does not reveal the agency drawing a similar dichotomy between the types of organizations and the applicable requirements for oversight of grants. Nowhere in the page of questions that the IRS uses to stimulate comment is there a suggestion that some different quantum of oversight is currently required for private foundations as opposed to publicly-supported charities.[21] In contrast, if one can assume that the four commentators reflect in some sort of rough way the state of understanding by the charitable sector, there is a clear view that two discreet bodies of rules for foreign grant making exist. The view is understandable in light of the differences in which the standards applicable to publicly-supported charities and those applicable to private foundations have been enunciated. The standards by which the grant-making program of a publicly-supported charity will be judged have evolved over a considerable period of time through the mechanism of

17. *ABA Comments*, *supra* note 13.
18. *New York Comments*, *supra* note 14.
19. *Howard Hughes Medical Institute Comments, supra* note 15.
20. *OMB Watch Comments, supra* note 16.
21. I.R.S. Announcement 2003-29, 2003-1 C.B. 928.

revenue rulings.

Revenue rulings are official IRS interpretations of the standards set forth in the Internal Revenue Code and Treasury regulations.[22] While many courts, including the Tax Court, view revenue rulings as merely the opinion or litigating position of the IRS,[23] therefore not having the force and effect of a statute or duly promulgated regulations, some courts have observed that revenue rulings should be accorded precedential value.[24] Whether or not revenue rulings are more than the opinion of the agency, they are clearly not regulations such as those under section 4945 addressing taxable expenditures for private foundations.[25] The IRS has made it clear that it is giving serious consideration to supplementing existing rules, or making them more explicit. As this occurs, it is important to understand the current state of the rules in order to better assess what might occur and the extent to which the IRS is likely to view it as a significant change worthy of administrative due process such as formal notice and comment and a public hearing or merely a clarification that should be issued in final form as a revenue ruling or revenue procedure.[26]

Current Tax Law Requirements

The core standard for tax-exempt organizations is found in the language of section 501(c)(3), which sets forth a requirement that organizations must be "organized and operated" exclusively for charitable purposes.[27] Treasury Regulation § 1.501(c)(3)-1(c)(1) interprets the "operated exclusively" standard as requiring that an organization must engage primarily in activities that accomplish a

22. Treas. Reg. § 601.201(a)(6) (2005); Rev. Proc. 2004-4, 2004-1 I.R.B. 125, § 3.07.

23. "[A revenue ruling] does not carry the force of law, nor bind this Court in the slightest degree . . . The revenue ruling is but a useful guide outlining some of the factors to be considered . . . ." Burck v. Comm'r, 63 T.C. 556, 561-62 (1975), *aff'd*, 533 F.2d 768 (2d Cir. 1978).

24. *See* Estate of McLendon v. Comm'r, 135 F.3d 1017 (5th Cir. 1998).

25. Treas. Reg. § 53.4945 (2005).

26. Although occasionally the IRS has issued revenue rulings and Internal Revenue Manual chapters in proposed form to enable the public to comment, recent revenue rulings, *e.g.* Revenue Ruling 2004-51, have been issued in final form, as have revisions to the Internal Revenue Manual.

27. The language setting forth the requirement of "operated" in furtherance of exempt purposes first appears in the Tariff Act of 1913, 38 Stat. 114, 166, although it was echoed in language in the Tariff Act of 1894, 28 Stat. 556, that required charities, as a condition of exemption, to be "conducted" solely for charitable purposes.

charitable, or other tax-exempt purpose, meaning that no more than an insubstantial part of its activities may be in furtherance of a non-exempt purpose.[28] The application of these requirements to international philanthropy is set forth in Revenue Ruling 71-460[29] and Revenue Ruling 68-489.[30] As reflected in Announcement 2003-29, the IRS also looks to Revenue Ruling 56-304, which addresses the record keeping requirements for organizations that make grants to individuals.[31] These requirements must be met to ensure that tax-exempt status is not jeopardized.[32] Read together, the revenue rulings provide that a section 501(c)(3) organization that distributes funds to organizations located outside the United States and are not themselves recognized as exempt under section 501(c)(3), will not be precluded from tax-exempt status under section 501(c)(3) so long as the organization takes and documents appropriate oversight. Revenue Ruling 68-489 sets forth the following key elements that must be met by the grantor entity:

1. the domestic charity must retain control and discretion as to the use of the funds;
2. it must maintain records establishing that the funds were used for section 501(c)(3) purposes; and
3. it must limit distributions to specific projects that are in furtherance of its own exempt purposes.[33]

The "control and discretion" requirement of Revenue Ruling 68-489 is illustrated by Revenue Ruling 75-65,[34] which describes a process consisting of a pre-grant investigation of the purposes for which the funds will be used, a written grant agreement with the recipient organization, and field investigations to ensure appropriate use of funds. An earlier revenue ruling, Revenue Ruling 56-304,[35] also provides useful insight into the nature of the substantiation requirement that must be met by section 501(c)(3) organizations that make distributions to recipients that are not similarly exempt. Revenue Ruling 56-304 specifically addresses distributions to individuals and notes that the grantor charity should keep "adequate records and case histories to show:

28. Treas. Reg. § 1.501(c)(3)-1(e)(1) (2005).
29. Rev. Rul. 71-460, 1971-2 C.B. 231.
30. Rev. Rul. 68-489, 1968-2 C.B. 210.
31. Rev. Rul. 56-304, 1956-2 C.B. 306.
32. I.R.S. Announcement 2003-29, 2003-1 C.B. 928.
33. *Id.*
34. Rev. Rul. 75-65, 1975-1 C.B. 79.
35. Rev. Rul. 56-304, 1956-2 C.B. 306.

1. the name and address of the recipients;
2. the amount distributed to each;
3. the purpose for which the aid was given;
4. the manner in which the recipient was selected; and
5. the relationship, if any, between the recipient and
   (i) members, officers, or trustees of the organization;
   (ii) a grantor or substantial contributor to the organization or a member of the family of either; and
   (iii) a corporation controlled by a grantor or substantial contributor."[36]

Both Revenue Ruling 56-304 and Revenue Ruling 68-489 antedate the Tax Reform Act of 1969 and the excise tax regimen made applicable to private foundations and are thus clearly applicable to all organizations exempt under section 501(c)(3) without regard to their foundation classification. Failure by a domestic section 501(c)(3) organization to establish that it maintained the requisite control and discretion over funds it distributed to foreign recipients, will have only adverse consequences for federal tax exemption if the amounts involved are only insubstantial in comparison to the clearly exempt activities of the organization.[37] Other adverse tax consequences may flow, however, from a failure to maintain adequate books and records.

The preceding revenue rulings defining the Internal Revenue Service's view of control and discretion do not have the force and effect of standards based in statute or regulation. As revenue rulings, the analysis and factors simply describe the Service's application of the tax law to a particular set of facts in a form upon which similarly situated taxpayers may rely. As such, the revenue rulings constitute a "safe harbor" rather than an explicit statement of the boundaries of behavior. Nevertheless, the Service will likely take an adverse position with regard to organizations that fail to establish that substantially similar actions have been taken to ensure appropriate use of funds.[38] A clear example of

36. *Id.*

37. *See* Treas. Reg. § 1.501(c)(3)-1(c)(1) (providing that an organization will not be regarded as operated exclusively for exempt purposes if "more than an insubstantial part of its activities is not in furtherance of an exempt purpose.").

38. *See* Gen. Couns. Mem. 35,319 (Apr. 27, 1973), affirming a conclusion by the Chief, Individual Income Tax Branch, in a tentative memorandum to the Exempt Organizations Branch, that "control and discretion" had not been maintained when the facts demonstrated that the domestic charity did not know the ultimate recipients of its funds in advance of transfers to foreign intermediary organizations. The facts did indicate that reports regarding the uses of funds were provided to the domestic charity

the position that the Service is likely to take can be seen in the 1978 Tax Court case, *Aid to Artisans, Inc. v. Commissioner*.[39] *Aid to Artisans, Inc.* involved an organization that described its proposed activities in its application for exemption as providing assistance to communities of disadvantaged artisans in the United States and abroad.[40] The Service denied the application for exemption on the grounds, in part, that Aid to Artisans had failed to establish that the individual artisans that would be assisted were, in fact, disadvantaged, even though the Service acknowledged that the communities in which the artisans lived and worked did qualify as disadvantaged. Unlike the Service, the Tax Court was willing to accept Aid to Artisans' assertions in its application for exemption, that assistance would be provided solely to the disadvantaged without requiring greater specificity at the application stage. In closing, however, the Tax Court clearly signaled that a different standard would be applied once actual operations had commenced by noting:

> This opinion is premised on the assumption that the administrative record contains an accurate representation of the facts concerning the petitioner's operations. The application was filed during an early period of the petitioner's existence and was based in large part upon operational projections. Needless to say, conformity with the requirements for exemption must be maintained in actual operations to assure continuity of exempt status.[41]

In contrast to publicly supported charities, private foundations are subject to both the private foundation excise taxes in Chapter 42 of the Code[42] and section 4945, an excise tax applicable to "taxable expenditures." Section 4945 is most important for this analysis. In particular, section 4945(d)(4) provides that a private foundation will have made a taxable expenditure exposing it to liability for an excise tax of ten percent of the amount involved if it makes a grant to a non-exempt organization, including foreign organizations, and fails to exercise

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after the funds had been expended by the ultimate recipients. Because GCM 35,319 reflects the review of an internal memorandum from the Service component with responsibility over interpretation of section 170 to the component with responsibility for interpreting section 501(c)(3), we cannot ascertain whether the recipient function, the Exempt Organizations Branch, ultimately found that the organization involved was entitled to tax exemption or not. We only have the interpretative piece relating to section 170 compliance.

39. 71 T.C. 202 (1978).

40. *Id.*

41. *Id.* at 216.

42. I.R.C. § 4940-48 (2005).

"expenditure responsibility."[43] "Expenditure responsibility" is defined as a set of procedures that ensure that:

1. the grant is spent solely for the purpose for which it is made,
2. the grantor foundation obtains full and complete reports from the grantee on how the funds are spent, and
3. the grantor foundation makes full and detailed reports with respect to such expenditures to the Internal Revenue Service.[44]

The section 4945 regulations further provide that the procedures must include a pre-grant inquiry of sufficient depth to give a reasonable person assurance that the grant funds will be used appropriately.[45] The terms under which the grant is to be made must be reduced to writing and signed by an appropriate officer, director or trustee of the grantee organization.[46] The agreement itself must provide for annual reports, maintenance of appropriate books and records to establish the uses made of grant funds, and repayment of any unused or misused funds.[47] Additional provisions must preclude the use of funds for political campaign intervention, lobbying, certain voter registration drives or non-charitable purposes.[48] Finally, the regulations mandate specific Form 990-PF reporting for all grants subject to "expenditure responsibility."[49]

The substance of the "expenditure responsibility" rules and the "control and discretion" standard is very similar and uses similar terminology, with the exception of some of the specific terms of grant agreements and the annual Form 990-PF expenditure responsibility grant reporting requirement. The key difference that thus emerges between the requirements for publicly-supported charities and private foundations is the form in which the standards are set forth, and the timing and nature of the sanctions imposed for failing to meet the requirements. The

43. I.R.C. § 4945(d)(4) (2005).

44. Treas. Reg. § 53.4945-5(b)(1) (2005).

45. Treas. Reg. § 53.4945-5(b)(2) (2005).

46. Treas. Reg. § 53.4945-5(b)(3) (2005).

47. *Id.*

48. *Id.* Interestingly, although the Service has explicitly taken the position in Revenue Ruling 73-440 that the term "legislation," for purposes of the restrictions on lobbying activity, includes foreign as well as domestic legislation, it has not issued a similar guidance statement with regard to intervention in foreign political campaigns, contenting itself with non-precedential statements that the prohibition on campaign intervention applies internationally in materials such as training publications. *See* JAMES F. BLOOM ET AL., K. FOREIGN ACTIVITIES OF DOMESTIC CHARITIES AND FOREIGN CHARITIES, *at* http://www.irs.gov/pub/irs-tege/eotopick92.pdf (1992) (last visited Feb. 17, 2005).

49. Treas. Reg. § 53.4945-5(d)(1) (2005).

distinction is not in the nature of the oversight that the IRS will expect to see demonstrated in the organization's books and records. A good faith effort to comply with the revenue rulings applicable to publicly-supported charities will likely generate the appropriate documentation to support a determination that the "expenditure responsibility" requirements of section 4945 have been met as well, with the exception of the Form 990-PF reporting aspects.

Implications for the Future

In view of the very real possibility that the IRS views the standards for publicly-supported charities and private foundations as substantially similar, but for the reporting aspect, some options that would be met with considerable surprise may very well be under consideration by the agency. For example, a revenue procedure that summarizes the nature of the documentation that the IRS will expect to see on examination, drawing from the existing revenue rulings, coupled with a new schedule for the Form 990 that echoes the expenditure responsibility reporting on the Form 990-PF, could be easily promulgated without the need for additional Congressional action or even revision of existing regulations.[50] Such a development would likely catch a number of publicly supported charities by surprise, if the implications of the commentators on Announcement 2003-29 have an actual basis in sector behavior.

50. An example of such an approach is found with regard to private schools and racial nondiscrimination. The operative principle is enunciated in Revenue Ruling 71-447, 1971-2 C.B. 230; the record keeping requirement is set forth in Revenue Procedure 75-50, 1975-2 I.R.B. 587; and the reporting mechanism is through Schedule B of the Form 1023, Application for Recognition of Exemption under Section 501(c)(3), and on the annual return, Form 990, on Schedule A, Part V.