

DADE COMMUNITY FOUNDATION *Professional Notes*

April 2003

Grants by Dade Community Foundation to Foreign Organizations

ISSUES IN THE NEXT SERIES:

Investment Standards of Charities

Uniform Principal and Income Act

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INTRODUCTION

Donors with international interests inevitably come up against a rule that dates back to 1938, which allows a charitable income tax deduction only for a contribution to a charity organized under the laws of the United States or any state or any possession of the U.S. As a result, individuals cannot claim charitable deductions for gifts to charities organized under the laws of other countries and so will look for ways to meet those interests through U.S. charities.¹

One way individuals may support international programs while claiming an income tax deduction is to identify a U.S. charity carrying out programs overseas. Another way is to support a public charity that makes grants to foreign organizations. This column will examine foreign grantmaking by U.S. public charities.

U.S. charities may easily approve grants that benefit foreign programs if made to a U.S. organization working abroad, to a foreign organization approved by the Internal Revenue Service, or to a so-called "friends of" organization established to support the mission of a foreign charity.

IRS Recognition. Foreign charities may apply to the IRS for exempt status. In this case, the review before approving a grant to such an organization should be the same as for a domestic charity. Unfortunately, very few foreign charities seek such recognition. Moreover, because these charities are created under non-U.S. laws, individual donors cannot claim deductions for direct contributions.

U.S. "Friends of" Organizations. Many foreign charities create "friends of" organizations, which are organized under U.S. law and recognized by the IRS as public charities. The key issue in becoming a "friends of" organization is whether the U.S. entity has full control of the donated funds and discretion over their use. It can not be a mere conduit. Once the IRS has recognized their tax exempt status, these organizations pose no unusual challenge to grantmaking. The procedure for reviewing and approving them should be the same as for any other 501(c)(3) public charity.

Grants to Foreign Organizations. Charities are respon-

sible for seeing that their assets are used for charitable purposes; otherwise they risk the loss of their tax exempt status. This responsibility poses one of the biggest challenges to U.S. charities when they are contemplating a grant directly to a foreign organization. Private foundation rules provide an IRS-approved process, which does not apply to public charities. However, an understanding of the prohibition of deductions for direct gifts by individuals, an examination of the rules for grants by private foundations, and the reasons behind them, enable public charities to develop appropriate policies for making grants

GRANTS BY PRIVATE FOUNDATIONS TO FOREIGN CHARITIES

Very specific rules govern grants by private foundations to foreign organizations. If a private foundation does not meet the requirements, it may find that the grants are considered to be taxable expenditures, subject to a 10 percent tax. A 2-1/2 percent tax also will be imposed on any foundation manager who agrees to the expenditure, unless the violation was not willful and was due to reasonable cause. In addition, if the expenditure is not corrected, a tax equal to 100 percent of the taxable expenditure will be imposed on the foundation, and a 50 percent tax on the manager.

There are two ways for a private foundation to avoid these penalty taxes on grants to foreign charities. One is to make an "equivalency determination." The other is to make a project grant and exercise "expenditure responsibility."

Equivalency determination. An equivalency determination requires a private foundation to make a determination that the grantee organization is the equivalent of a U.S. charity. A good faith determination ordinarily will be considered made where the determination is based on (i) an opinion of counsel of either the grantee or the foundation that the grantee would be a public charity or (ii) an affidavit of the grantee organization. The affidavit or opinion must set forth sufficient facts about the operations and support of the grantee for the grantor to determine whether the grantee would be likely to qualify as a U.S. public charity. See, Treas. Reg. Sec. 53.4945-5(a)(5). This essentially requires the foreign charity to provide the same information and financial data to the foundation as it would to seek an

¹This article addresses the income tax restrictions. There are no similar jurisdiction limitations for contributions to foreign charities for the estate tax charitable deduction. There are however complex rules to determine whether a non U.S. entity is qualified for charitable gift or estate tax purposes.

**ABOUT
DADE
COMMUNITY
FOUNDATION**

For 36 years, Dade Community Foundation has been the community foundation for Miami-Dade County, an aggregate of funds created by individuals, families, and corporations to benefit the world around them -- especially the people of our community.

Grants made from these funds meet the changing needs of children, youth, and families; aid in community development; improve the environment; promote health; assist people with special needs; and support education, arts, and the humanities.

The Foundation also has taken the initiative in responding to urgent problems -- such as Hurricane Andrew, the AIDS epidemic, and the needs of recent immigrants.

IRS determination. The information must be in English, or in a language readily translated by the foundation.

Some private foundations rely on counsel to give written opinions; this has the added advantage of protecting the managers of the foundation from becoming subject to penalty taxes, because it constitutes "reasonable cause" under Code Section 4942. (These penalty taxes do not apply to public charities.) Obtaining a legal opinion can be a very expensive process, and probably could not be justified for small grants. The information the lawyer will review is largely that described below for the grantee affidavit.

The grantee affidavit procedure is less burdensome for the grantor foundation than an equivalency opinion. In a 1992 ruling, Revenue Procedure 92-94, the IRS set out the requirements for relying on such an affidavit to make a reasonable judgment that the grantee is the equivalent of a U.S. charity and a good faith determination of the grantee's public charity status. The original affidavit should be kept on file, or a copy of it if the original was provided to another U.S. foundation. The facts in the affidavit must reflect the last complete accounting year. The affidavit must be in English, and it must be signed by a principal officer of the organization. An English translation must be provided for any supporting documents.

Organizations that do not need to meet a public support test to qualify as public charities-religious organizations, educational institutions, medical institutions-or private foundations may provide updated information for an existing affidavit by a statement updating any facts in the original affidavit that have changed, or by providing an attested statement that the facts have not changed.

Revenue Procedure 92-94 provides a safe harbor for making a good faith determination of foreign organizations' status under U.S. tax law. It describes the contents of the affidavit:

- A statement that the charity is operated exclusively for specific charitable purposes, and identifying the purposes.
- A description of past and planned activities.
- Copies of the organization's charter, bylaws, and other governing documents.
- A statement that either the laws and customs, or the organization's governing documents, do not permit any of its assets or income to benefit a private person.
- A statement that it has no shareholders or members with a proprietary interest in the income or assets of the organization.
- A statement that if the grantee were liquidated or dissolved, under applicable laws and customs, or under the governing instruments, all its assets would be used for charitable purposes. A copy of the relevant law or governing instruments must be attached.
- A statement that either the laws or customs or

the organization's governing documents do not permit non-charitable activities or lobbying except to an insubstantial extent.

- A statement that either the laws or customs or the organization's governing documents strictly prohibit any direct or indirect intervention in any political campaign.

- If the foreign charity would have to meet a public support test, its affidavit must include an attested statement containing sufficient financial information to demonstrate that it passes the public support test. The financial information required for the four most recent taxable years is essentially that required of U.S. charities on Schedule A of Form 990.

In addition, a school ("an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are carried on") must state that it does not discriminate based on race. If the grantor foundation has information suggesting the affidavit may not be reliable, it cannot ignore that information.

Expenditure Responsibility Alternatively, the foundation may elect to make a project grant and exercise expenditure responsibility. Many foundations exercise expenditure responsibility even where the grantee appears to be the equivalent of a U.S. public charity. This requires establishing adequate procedures to (i) see that the grant is spent solely for the purpose for which it was made, (ii) obtain full and complete reports from the grantee on how the funds are spent, and (iii) make detailed reports with respect to such grants to the IRS.

Private foundations must exercise expenditure responsibility for grants to a non-U.S. grantee when the grantee can qualify as equivalent to a 501(c)(3) charity but would be a private foundation, either because it does not meet the public support test or because its financial support documentation is inadequate. In this case, it is treated as a grant to another private foundation, which always requires expenditure responsibility. In addition, expenditure responsibility must be exercised where the grantee operates in part to affect the outcomes of political campaigns, or to influence legislation, or is a for-profit business.

Under Treas. Reg. Sec. 4945-5(b), expenditure responsibility requires five steps:

1. A pre-grant inquiry in which the foundation makes a reasonable determination that the intended grantee is capable of fulfilling the charitable purposes of the grant.
2. A written grant agreement signed by an officer or director of the grantee specifying the charitable purposes of the grant. The agreement must commit the grantee (i) to repay any funds not used for the grant's purpose, (ii) to submit annual reports, (iii) to maintain books and records

that are available to the grantor foundation at reasonable times, and (iv) not to use the funds to carry on propaganda, or otherwise attempt to influence legislation; to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive; or to undertake any activity for a non-charitable purpose. (It is common for private foundations exercising expenditure responsibility to prohibit the grantee from regranteeing the funds to individuals or other organizations. Otherwise, further rules come into play.)

3. Reports on the status of the grant including 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 grant's purposes. These 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 subsequent accounting periods until the grant funds are fully expended or the grant otherwise is terminated.

4. Notification to the IRS that an expenditure responsibility grant has been made or is outstanding during the tax year. This normally is provided on Form 990-PF, and a brief description of the status of the grant is required.

5. If the grantee is not a charitable equivalent, the grant funds must be maintained in a separate fund dedicated to one or more charitable purposes. Under the regulations, the grantee must agree "to maintain and, during the period in which any portion of the grant funds remain unexpended, does continuously maintain the grant funds in a separate fund dedicated to one or more charitable purposes." This step is required only if the grantee is not the equivalent of a private foundation.

GRANTS BY PUBLIC CHARITIES TO NON-U.S. ORGANIZATIONS

The private foundation rules for foreign grants do not apply to grants by public charities, such as Dade Community Foundation. However, charities are responsible for seeing that their assets are used for charitable purposes;² otherwise they risk the loss of their tax exempt status. Therefore, many public charities, such as Dade Community Foundation, write their policies on grants to foreign charities with a careful understanding of the private foundation rules. In addition, public charities must also take into account the administrative burden involved with these grants.

General support grants. Many organizations make grants for general support, endowment, or capital purposes and may wish to do so for foreign grantees as well. A public charity, such as the Foundation, is not restricted to making grants only to other public charities, but

may make a grant to a foreign organization, provided its purpose is charitable. Because a general support grant may be used for any of the grantee's purposes, a general support grant (or capital or endowment grant) to a foreign organization requires a judgment, akin to an equivalency determination, that the foreign organization is the equivalent of a U.S. charity, whether based upon an opinion of counsel, the availability of a grantee affidavit, or some other procedure. There is no prescribed way for a public charity to make this determination, but the charity may want to review information similar to that provided in the affidavit. The affidavit can be useful and represents a safe harbor. A large or well-known foreign grantee may already have prepared an affidavit for other U.S. funders, which can be shared. Otherwise, the affidavit may be too complicated for many foreign charities. Where the complete affidavit is available, the only burden on the grantee would be to update it. Once this equivalency determination is made, no other reporting requirement or special grant letter language would be required, apart from the grantor charity's own desire for reports. In establishing an internal procedure, the affidavit has the advantage of including information about requirements upon liquidation, information about lobbying, and other needed information. If the grantor public charity concludes that the foreign organization is the equivalent of a U.S. charity, it can comfortably make a grant for general support.

Public charities that make general support or endowment building grants, may want to adopt all or part of the equivalency determination requirements. But where the foreign organization is unwilling or unable to provide the affidavit, the grantor charity will have to consider whether to attempt a case-by-case evaluation, and if so, consider at what size grant does this task make sense. Should outside counsel be used, with the attendant cost?

Project grants Otherwise, adoption of a policy of project support grants largely following expenditure responsibility rules helps the grantor charity make certain its grants are used for charitable purposes, and would not seem to unduly increase work if grants are made for specific projects, with timetables, and reports that would otherwise be required. The grant letter should include many of the terms and conditions required by the private foundation regulations and commit the grantee (i) to repay any funds not used for the grant's purpose, (ii) to submit annual reports, (iii) to maintain books and records that are available to the grantor foundation at reasonable times, and (iv) not to use the funds to influence the outcome of any specific public election or to undertake any activity for a non-charitable purpose.

This approach avoids the need for an affidavit or for review of the grantee's organizational documents, as the proposal and grant letter together demonstrate the charita-



ABOUT DADE COMMUNITY FOUNDATION

The Foundation is governed by a 21 member Board of Governors composed of community leaders. Its staff is recognized for experience in grant making, financial administration, and donor services.

Dade Community Foundation has made grants of over \$70 million to Greater Miami's nonprofit agencies.

For more information about the Foundation call Joe Pena, Director of Development and Communications at 305-371-2711.

²To be exempt from income tax under Section 501(c)(3), the organization 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."

Treas. Reg. 1.501(c)(3)-1(d)(2) expands on the definition of charitable and includes the following purposes: "Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments or works; lessening of the burden of government; and the promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; (iv) to combat community deterioration and juvenile delinquency."

ble purpose of the grant. Requiring that the grantee hold the grant in a separate fund designated for charitable purposes is not necessary, but may be desirable under certain circumstances. Similarly, the lobbying restriction is not required in the grant letter, unless it is desired by the grantor.

Preparing a detailed grant letter and requiring a report may not make sense for the smallest grants. A public charity will want to consider whether a floor should be set on foreign grants to justify the time to prepare a special grant letter and track and review a report.

Dade Community Foundation's policy. At Dade Community Foundation, as a general matter, we do not make *support* grants to foreign organizations that do not complete the affidavit. It is difficult to justify the time and expense to do an equivalency determination. Rather, we prefer to make grants to foreign organizations to support specific programs that are charitable in nature. In this case, we obtain basic information about the organization, as we do from all prospective grantees. In addition, we require a grant letter, signed by the grantee, and a report on the use of the grant. Typically, our grant letter provides that (i) the grant is used for a specific, stated charitable purpose, within 12 months, (ii) the grant may not be used to attempt to influence legislation or to influence the outcome of any specific public election, (iii) any amount not expended for the stated purposes within 12 months will be repaid, (iv) the grantee organization will make its books and records

available, and (v) a report confirming the use of the grant will be provided to us within 18 months of the date of the grant letter (or 6 months from the date the funds are required to be expended). In some instances, we require a separate account be maintained so the grant monies are not commingled with other funds.

Grants to foreign governments. The regulations in the private foundation area treat grants to foreign governments, agencies or instrumentalities, or an international organization designated as such by Executive Order, as grants to a public charity. To qualify, the grant must be exclusively for charitable purposes. No equivalency determination or expenditure responsibility is needed. But it will be important to document that the grantee is a unit of foreign government, and the grant letter must clearly show the charitable purpose of the grant. General support grants to foreign governments are not protected by this rule.

CONCLUSION

Public charities, such as Dade Community Foundation, have far greater flexibility in setting policy for international grantmaking than do private foundations. Public charities' procedures will vary, but because of the latitude allowed, can often be helpful to donors who wish to contribute to foreign charities.

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