

International Charitable Giving and Estate Planning

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INTRODUCTION

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

The U.S. Congress failure in 2009 to preserve the federal estate and generation-skipping tax for 2010 has created uncertainty for estate planning purposes. However, unless Congress acts in 2010 the estate and gift taxes will automatically return in 2011 at the 2001 rates: 55 percent (with a 5 percent surcharge on estates or cumulative gifts between \$10 million and \$17.18 million) with only a \$1 million exemption for lifetime transfers and a \$1 million exemption for the generation-skipping transfer (GST) tax.¹

With the globalization of the world market place, the redefinition of historical geopolitical borders, the increasing mobility of U.S. and foreign managers of multinational companies, and the emergence of substantial new venture capital fortunes, international charitable giving is evolving as a tax planning area of significant importance.² The return of the estate tax in a currently unknown form will require that individuals review their foreign giving plans in 2011.

Many U.S. citizens and U.S. residents are acquiring assets physically located in foreign jurisdictions. Those assets may be subject to taxation in the country where located when gratuitously transferred within the family. Such a gratuitous transfer of assets held by a U.S. citizen or a U.S. resident is also subject to U.S. transfer taxes. Accordingly, the applicability of U.S. estate tax to non-U.S. assets of U.S. citizens or residents may be one of the most important considerations of U.S. estate planning for domestic citizens holding foreign-based assets.

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

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

A. Federal Income Tax Rules

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

1. The donee must be organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part

¹ For a comprehensive discussion on the impact of the repeal of the federal estate and generation skipping tax, see *Estate Planning in Uncertain Times* prepared by the Private Wealth Services Group of McGuireWoods LLP.

² In a recent report issued by Giving USA, 2009 giving for international affairs was up 6.6 percent. This was the largest percentage increase of any of the major giving categories.

of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.³

2. The donee must be created or organized in the U.S. or in any possession thereof or under the law of the U.S., any state, the District of Columbia, or any possession of the U.S.⁴
3. The donee must avoid the prohibition against political campaign activity and substantial lobbying activity.
4. The donee must not allow private inurement or private benefits to individual entities.

For purposes of international philanthropy, the most significant requirement is the second, which limits the charitable deduction to gifts made to entities organized under U.S. law. Until the passage of the Revenue Act of 1938, U.S. individual taxpayers were allowed to make deductible contributions to charitable organizations regardless of where the organization was organized. After enactment of that legislation, the charitable deduction was available to U.S. individual taxpayers only if the contribution was to a U.S. charitable organization. For corporations, the deduction had always been limited to organizations established in the U.S. that used the contribution within the United States.

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

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

³ All section references are to the provisions of the Internal Revenue Code of 1986, as amended (Code), and all regulatory references are to the United States Department of Treasury Regulations thereunder.

⁴ The Tax Court held that contributions made to a foreign church were not tax deductible because they were not made to a qualified U.S. charity. See *Anonymous v. CIR*, T.C. Memo 2010-87 dated 4/22/2010.

1. Income tax charitable deduction for individuals

a. General deduction rules

A donor who itemizes deductions is generally entitled to an income tax charitable deduction for contributions to qualified charitable organizations, subject to any general limitations on itemized deductions under the Code.⁵

For a gift of cash or unappreciated property to a “50 percent-type” organization (generally 509(a)(1), (2), or (3) organizations, private operating foundations, and conduit private foundations but not private foundations), the donor is generally entitled to deduct the full amount of the contribution up to 50 percent of the donor’s adjusted gross income (the “50 percent ceiling”).⁶

For a gift of cash or unappreciated property to a “30 percent-type” organization (a private foundation, other than a private operating foundation or a conduit private foundation) and gifts *for the use of* a 50 percent-type organization, the donor is generally entitled to deduct the full amount of the contribution up to 30 percent of the donor’s adjusted gross income.

For gifts to a 50 percent-type organization of appreciated long-term capital gain property that has appreciated, the donor may deduct the full fair market value of the gift only up to 30 percent of the donor’s adjusted gross income.⁷ For gifts of such property to a private foundation, the deduction is limited to 20 percent of the donor’s contribution base.⁸

In addition to the deduction limitation discussed above, the deduction for gifts of appreciated property to private foundations is further limited. If an individual contributes capital gain property, such as real estate held for more than one year, the amount of the deduction is limited to the lesser of the property’s basis and its fair market value.⁹ However, there is an exception that allows a deduction at fair market value for a contribution of “qualified appreciated stock,” which is generally stock for which market quotations are readily available on an established securities market.¹⁰

⁵ Section 170(a). *But see* section 68(a).

⁶ Section 170(b)(1)(A).

⁷ Section 170(b)(1)(C).

⁸ Section 170(b)(1)(D).

⁹ I.R.C. § 170(e)(1)(B)(ii).

¹⁰ I.R.C. § 170(e)(5).

The amount of the charitable deduction for gifts of ordinary income or short-term capital gain property is reduced by the amount of the ordinary income that would have been recognized had the donor sold the property on the date of the gift.¹¹ Included in this category are inventory, crops, dealer property and works created by the donor. In the case of a painting donated by the artist, for example, the deduction is limited to the artist's cost of materials. Normally, this means that the deduction for these types of assets is limited to the property's basis.

A donor is entitled to a charitable deduction equal to the greater of fair market value or basis for a contribution of tangible personal property, the use of which is related to the donee's exempt purpose. If the property is not related, the donee's deduction is limited to the property's basis (or fair market value if less). Tangible personal property that is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the donor made the contribution and with respect to which the donee has not in a written statement signed by an officer of the donee under the penalties of perjury either (a) certified that the use of the property was related to the donee's exempt purpose or function and described how the property was used and how such use furthered such purpose or function of the donee or (b) stated the intended use of the property by the donee at the time of contribution and certified that such use has become impossible or infeasible to implement is deemed to be "unrelated use" property. If the property is disposed of after the close of the taxable year of the contribution and within three years of the date of the contribution (unless the donee makes the certification described above), the donor must recapture the charitable deduction in an amount equal to the difference between the amount claimed as a deduction and the property's basis. The donor must include this amount in ordinary income in the year in which the disposition occurs.

b. Carryovers of excess contributions

If the U.S. income tax charitable contribution percentage limit is exceeded, the excess nondeductible portion may be carried over for up to five years.¹² A donor may want to make excess charitable gifts when the value of donated property is high but that value is anticipated to decline in the future.¹³ Immediately after receipt of the property, the charity could dispose of it realizing the fair market value of the property. That property disposition would be without federal income tax effect to the charity. If the property received is in a foreign jurisdiction, the U.S. charity would need to be concerned about whether the charity will be recognized as having tax-exempt status for foreign income tax purposes. If the donated property is capital gain property, a capital gain is realized on the disposition. That gain may not be subject to tax in the foreign jurisdiction as many jurisdictions do

¹¹ I.R.C. § 170(e).

¹² See section 170(d)(1) (for 50 percent category deductions), 170(b)(1)(ii) (for 30 percent category deductions), and 170(b)(1)(D)(ii) (for 20 percent category deductions).

¹³ For example, in the international estate planning context, this might occur where the property is located in a foreign country, its value is determinable in terms of a foreign currency, and, although the property may continue to appreciate in value, that foreign currency is anticipated to decline in value in an amount greater than the potential property appreciation.

not impose income tax on property dispositions.

2. Special rules for contributions by nonresident aliens

By reason of a taxpayer's status as a nonresident alien, U.S. gross income is limited to certain specified amounts not connected with a U.S. trade or business and income that is connected with a U.S. business.¹⁴ Ordinarily deductions available in computing U.S. taxable income are only those connected with the conduct of a trade or business within the United States subject to the prescribed apportionment rules.¹⁵ The deduction for charitable contributions and gifts is allowed, however, regardless of whether it is related to income that is effectively connected with the conduct of a trade or business in the United States.¹⁶

A nonresident alien becomes entitled to the benefits of the charitable contribution deduction (and other deductions) only by filing an accurate U.S. income tax return.¹⁷ The filing of a U.S. income tax return is required when the nonresident alien has U.S. trade or business income but does not ordinarily occur with respect to income not connected with a U.S. trade or business and subject to the 30 percent withholding at source (or a lower tax treaty rate).

A charitable contribution could be taken into account when filing a U.S. income tax return with respect to U.S. trade or business income. A charitable contribution deduction is not taken into consideration by a withholding agent when the only source of income exposed to U.S. income tax is subject to gross withholding tax at source. This situation will thus necessitate a U.S. income tax return to claim the deduction, which the nonresident alien client may not be willing to file.¹⁸

B. Estate and Gift Tax Rules

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

As a threshold matter, a deduction is allowed for contributions by U.S. citizens or residents to any foreign organization that is not a foreign governmental unit for both estate and gift tax purposes so long as the funds will be used exclusively for charitable purposes and the foreign organization satisfies the prohibitions against private inurement and political campaign activities.¹⁹ The

¹⁴ See sections 871(b), 872(a)(2).

¹⁵ Section 873(a).

¹⁶ Section 873(b)(2). In applying this provision, Treas. Reg. § 1.873-1(e)(2)(iii) reminds taxpayers that the deduction for charitable contributions is available only for contributions or gifts made to domestic corporations, community chests, funds, or foundations created in the United States.

¹⁷ Section 874(a).

¹⁸ See *generally*, William P. Strang, U.S. INTERNATIONAL ESTATE PLANNING, ¶¶ 20.04[3] and 20.04[4], pp. 20-17, 20-19.

¹⁹ See sections 2055(a)(2), 2106(a)(2)(A)(ii), 2522(a)(2).

lobbying limitations applicable to domestic tax-exempt charitable organizations extend to foreign associations as well.²⁰

In the case of nonresident aliens, however, the deduction is allowed for charitable gifts and bequests under the U.S. estate and gift tax rules only if the contribution is to a U.S. charitable corporation or a U.S. governmental entity or will be used exclusively in the United States by a U.S. or foreign charitable trust, community chest, fund, or foundation.²¹ If the contribution is a testamentary bequest, the contributed assets must be included in the decedent's U.S. estate.²² Thus, there is no estate tax charitable deduction for testamentary bequests of non-U.S. assets by nonresident aliens.

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

There are a number of methods that private individuals, public charities, and private foundations can use to engage in international philanthropy while preserving the deductibility of donations by U.S. citizens and residents. These methods will become increasingly important as U.S. charities and foundations move away from direct development in foreign countries and move toward supporting local groups engaged in charitable activities.²³ A U.S. income tax treaty may expand the scope of eligible charitable donees to include recipients in the tax treaty partner country on a reciprocal basis.

Discussed below are the major planning opportunities that address the statutory prohibitions against income, gift, and estate tax deductibility described thus far: (1) gifts that take advantage of favorable tax treaty provisions; (2) gifts to U.S. charities with overseas operations; (3) gifts to U.S. "friends of" organizations that support foreign charitable activities; (4) gifts to U.S. private foundations that make grants to support foreign charitable activities; and (5) gifts to charitable entities or units organized by foreign governments and international organizations which are generally exempt from U.S. income tax under section 892.²⁴

A. U.S. Tax Treaty Provisions

1. Income tax treaties

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

a. United States-Mexico Tax Treaty

The United States-Mexico Tax Treaty provides that U.S. individuals and corporations can deduct *against their Mexican source income only*

²⁰ Sections 2055(a)(2), 2522(b).

²¹ Treas. Reg. § 20.2106-1(a)(2).

²² Section 2106(a).

²³ See Stephen G. Greene, *Rethinking International Assistance*, THE CHRONICLE OF PHILANTHROPY, Apr. 3, 1997, at 1, 8.

²⁴ Treas. Reg. § 1.509(a)(2); Rev. Rul. 66-177, 1966-1 C.B. 132.

contributions to Mexican public charities (but not Mexican private foundations).

The treaty further provides for mutual recognition of the income tax exemptions of qualifying charities, for grantmaking by U.S. foundations to Mexican charities without a need for exercising expenditure responsibility, and for chapter 42 excise tax exemption for Mexican private foundations if they receive substantially all of their support from non-U.S. sources.²⁵

Various regulatory and interpretative matters are also still being resolved by the Mexican government that affect the implementation of the treaty, although the procedures for formally registering as a Mexican charity are apparently in place.

In order to implement the treaty, a simultaneously executed protocol provides that, except for churches or conventions of churches, the Mexican and United States tax laws provide essentially equivalent standards for public charities.²⁶

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

In order to take advantage of the treaty's provisions, more than 50 percent of an exempt organization's beneficiaries, members, or participants must be themselves entitled to receive benefits under the treaty, for example by being an individual resident of the U.S. or Mexico.²⁷ This limitation on benefits applies to *both* the reciprocal exemption provision *and* the deductibility of contribution provision.²⁸

b. United States-Israel Tax Treaty

The United States-Israel Tax Treaty provides that contributions by a U.S. citizen or resident to an Israeli public charity or private foundation are deductible under U.S. law if the Israeli charity would qualify as a

²⁵ Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992 ("United States-Mexico Tax Treaty"), art. 22.

²⁶ Protocol, Sept. 18, 1992. The tax treaty with Mexico recognized that Mexican charities could choose to be governed by Article 70-B of Mexico's tax laws, which law was identical to the rules established by the IRS for U.S. public charities and thus made the Mexican charity the equivalent of a U.S. public charity. In 2001, Article 70-B, with some minor modification, became Article 97. The IRS has not determined whether the same treaty rights will apply under the new Article 97.

²⁷ United States-Mexico Tax Treaty, art. 17(e).

²⁸ Treasury Department Technical Explanation of the Convention and Protocol Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on Sept. 18, 1992, art. 22.

public charity under U.S. law and if the contributions would otherwise be deductible under U.S. law.

The deductions are limited to 25 percent of an individual U.S. donor's Israel source gross income and to 25 percent of a corporate U.S. donor's Israel source taxable income. A reciprocal rule applies to Israeli donors who contribute to U.S. public charities or private foundations.²⁹ The treaty does not provide, however, that a charitable organization that is recognized as tax-exempt in one country will be recognized as tax-exempt in the other country.

Similar to the United States-Mexico Tax Treaty, an exempt organization can take advantage of the deductibility of contribution provision only if more than 50 percent of an exempt organization's beneficiaries, members, or participants are themselves eligible to receive benefits under the treaty, for example by being an individual resident of the United States or Israel.³⁰

c. United States-Canada Tax Treaty

The United States-Canada Tax Treaty provides that a charitable organization that is recognized as tax-exempt in one country will be recognized as tax-exempt in the other country as long as the organization meets the tax-exempt requirements of the other country.³¹

Further, contributions by a U.S. citizen or resident to a Canadian public charity or private foundation are deductible under U.S. law if the Canadian charity would qualify as a public charity under U.S. law and if the contributions would otherwise be deductible under U.S. law.³²

²⁹ Protocol Amending the Convention Between the Government of the United States of America and the Government of Israel with Respect to Taxes on Income Signed at Washington on November 20, 1976, May 3, 1980, art. X (adding art. 15-B (Charitable Contributions) to the Convention).

³⁰ Second Protocol Amending the Convention Between the Government of the United States of America and the State of Israel with Respect to Taxes on Income Signed on Nov. 20, 1975, as Amended by the Protocol Signed May 30, 1980, Jan. 26, 1993, art. XII (adding art. 25 (Limitations on Benefits) to the Convention).

³¹ Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Sept. 26, 1980, art. XXI (as amended by art. X of the 1983 protocol); see also PLR 9120026 (Feb. 21, 1991) (holding that in order for a Canadian nonprofit organization to be tax -exempt in the United States, it must meet the criteria under U.S. law for tax exemption as well as the criteria under Canadian law). Article XXI also provides, however, that exemption will be denied for income derived from "related" persons or from the conduct of a trade or business.

³² In Notice 99-47 (Sept. 7, 1999) the IRS indicated that the Competent Authorities have entered into a mutual agreement under which Canadian and U.S. charities automatically receive reciprocal exemption. Under the agreement, every Canadian registered charity, as determined by Revenue Canada, is now automatically treated as a section 501(c) organization, regardless of whether the Canadian charity has filed a Form 1023 Application for Recognition of Exemption with the Service. The Notice also states that all such organizations are presumed to be private foundations, unless they demonstrate otherwise. Accordingly, if a Canadian registered charity does not provide the U.S. with the financial information needed to establish public charity status, the

The deductions under U.S. law for contributions to Canadian charities are limited by the normal percentage limitations on charitable deductions, with the limitations being applied to Canada source income. The deductions under Canadian law for contributions to U.S. charities are also subject to the normal Canadian limitations, with the limitations being applied to U.S. source income. A reciprocal rule applies to Canadian donors who contribute to U.S. public charities or private foundations.

The United States-Canada Tax Treaty also provides that Canadian private foundations are exempt from chapter 42 excise taxes if they receive substantially all of their support from non-U.S. sources.

Under a 1994 protocol, taxation of property that passes on death to a charity will be governed by the law of the decedent's country of residence, with the charity treated as if it were a resident of that country.³³ For a U.S. resident who dies and leaves property to a Canadian charity, no tax would therefore be owed on that property because U.S. law has an unlimited charitable deduction for bequests to charity.³⁴

For a Canadian resident who dies and leaves property to a U.S. charity, however, three-quarters of the gain, if any, on that property is taxed, although this tax is offset by a charitable contribution tax credit calculated by multiplying the amount of the contribution, up to a limit of 50 percent of the year's U.S. source income, by the highest marginal tax rate.³⁵

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

d. United States-Germany Tax Treaty

The United States-Germany Tax Treaty provides that a charitable organization recognized as tax-exempt in one country will be recognized as tax-exempt in the other country as long as the organization meets the tax-exempt requirements of the other country. There are no provisions for allowing a resident or citizen of one country to deduct from income a contribution made to a tax-exempt

organization will be presumed to be a private foundation under U.S. law. As discussed below, some commentators have questioned whether this Notice helps or hinders grants by U.S. private foundations to Canadian charities. See LaVerne Woods, "IRS Notice 99-47: A Help or Hindrance for Foundation Grants to Canadian Charities?", *THE EXEMPT ORGANIZATION TAX REVIEW*, Vol. 28, No. 2 at 203 (May 2000).

³³ Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980 as Amended by the Protocols Signed on June 14, 1983 and March 28, 1984, Aug. 31, 1994, art. 19 (adding art. XXIX B (Taxes Imposed by Reason of Death) to the Convention).

³⁴ See section 2055(a)(2).

³⁵ See sections 38 and 118.1 of the Canadian Income Tax Act, Ch. 1 (5th Supp.), R.S.C. 1985 (1997). Canada has no estate tax.

organization of the other country.³⁶

There is also no applicable limitations on benefits provision, such as that contained in the treaties with Mexico, Israel, and Canada, with regard to either the income tax exemption or the estate and gift tax exclusion provisions.³⁷

e. United States-Netherlands Tax Treaty

The United States-Netherlands Tax Treaty provides similar exempt organization provisions as the United States-Germany Tax Treaty, although it does not have a comparable estate tax treaty provision.³⁸

Unlike the United States-Germany Tax Treaty, however, the United States-Netherlands Tax Treaty does contain a limitation on benefits provision similar to the one contained in the treaties with Mexico, Israel, and Canada.³⁹

2. Estate and gift tax treaties

With the repeal of the federal estate tax in 2010, and without Congressional action to reintroduce the tax for 2010, there is a question of whether the estate and gift tax treaties remain valid for either 2010 or in 2011 and beyond when the estate tax in some form will return. However, we will assume for purposes of this discussion that Congress will either act or the 2001 level of estate and gift tax exemption of \$1,000,000 and the 55% tax rate will be reinstated in 2011, and that the following treaties remain in effect. Currently there are only five U.S. bilateral tax treaties in force that contain references to the deductibility of charitable gifts and bequests. The U.S.'s agreement with Canada regarding charitable transfers is part of the United States-Canada Income Tax Treaty, while the U.S. has separate estate and gift tax treaties with Denmark, France, Germany, and Sweden. The treaty with Sweden closely follows the language recommended in the U.S. Treasury Department's 1980 model treaty.

a. United States-Canada Tax Treaty

Contributions to qualifying tax-exempt organizations in either the U.S. or Canada are treated as though made to tax-exempt organizations of the taxing country.⁴⁰ The treaty defines an "exempt" organization as a

³⁶ Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and Certain Other Taxes, Aug. 29, 1989 ("United States-Germany Tax Treaty"), art. 27.

³⁷ Article 28 of the United States-Germany Tax Treaty does contain a limitations on benefits provision applicable to exempt organizations (section (1)(f)), but Article 27 of the same treaty makes that provision inapplicable to the treaty's reciprocal exemption provision.

³⁸ See Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18, 1992 ("United States-Netherlands Tax Treaty"), art. 36. Article 36 denies the exemption to income derived from the conduct of a trade or business, however.

³⁹ United States-Netherlands Tax Treaty, art. 26(1)(e).

⁴⁰ United States-Canada Tax Treaty, art. XXIX (B)1.

religious, scientific, literary, educational, or charitable organization.⁴¹ With respect to the United States, this means that the Convention permits a Canadian resident who is not a citizen or domiciliary of the United States to claim a charitable contribution deduction for testamentary transfers of property includible in the U.S. taxable estate to a Canadian charitable organization.

b. United States-Denmark Tax Treaty

Provision is made for exemption or deduction from tax when a transfer is made to a qualifying tax-exempt institution in the other treaty country.⁴² To qualify for the exemption, the transfer must be exempt from tax or taxed at a reduced rate in the other country, and the entity must be operated exclusively for religious, charitable, scientific, literary, or educational purposes. If this test is met, the taxpayer can apply the exemption or deduction as if the transfer was to a domestic entity. This provision applies to transfers to political subdivisions of a country, as well as transfers to a corporation or organization operated exclusively for religious, charitable, scientific, literary, or educational purposes.

c. United States-France Tax Treaty

Provision is made for exemption from tax or full deduction when a transfer is made to a qualifying tax-exempt institution in the other treaty country.⁴³ Essentially, it must be shown that a transfer to the same entity in the taxing country would have also qualified for the exemption or deduction. To qualify, the entity must (1) be tax-exempt in its home country; (2) be organized and operated solely for religious, charitable, scientific, literary, or educational purposes; and (3) receive a substantial part of its support from public or government funds. Accordingly, as the Senate Foreign Relations Committee Report points out, a contribution to a private foundation, which is deductible in the United States, might not be deductible in France.⁴⁴

d. United States-Germany Tax Treaty

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

⁴¹ *Id.* art. XXI(1).

⁴² Convention Between the Government of the United States of America and the Government of the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritances, Gifts and Other Transfers, Apr. 27, 1983, art. 9(1).

⁴³ Convention Between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritances, and Gifts, Nov. 24, 1978, art. 10(1).

⁴⁴ See art. 10(2), and S. Ex. Rep. No. 96-3, 2 Tax Treaties (CCH) ¶ 3095, at 27,279 (Dec. 1998).

amount that would have been allowed if organized and operating in the country imposing the tax.⁴⁵

e. United States-Sweden Tax Treaty

Provision is made for exemption from tax or full deduction when a transfer is made to a qualifying tax-exempt institution in the other treaty country.⁴⁶ To qualify for the exemption, the entity must be organized and operated solely for religious, charitable, scientific, or educational purposes; the entity must be tax-exempt in its home country; and the transfer must be tax-exempt if made to a similar entity in the other country.

B. Gifts to Public Charities with Overseas Operations

Domestic organizations such as the American Red Cross and various religious relief societies coordinate their relief efforts with similar organizations around the world. Even though donors are well aware that their contributions will often, or—in the case of specific fundraising drives—almost certainly be used outside of the United States, their contributions remain deductible. An activity that is charitable if carried out in the United States is also a charitable activity if carried out in a foreign country.⁴⁷

However, if a contribution to a U.S. public charity is earmarked for a foreign donee rather than for a U.S. charitable use, the contribution will not be deductible as it will be considered to have been made directly to the foreign donee and not to the U.S. charity.⁴⁸ Thus, a U.S. public charity cannot serve as a conduit for foreign philanthropic activities.

But if a domestic charity exercises sufficient discretion and control over the funds, the contribution will be deductible even if it is ultimately transferred by the domestic charity to a foreign donee.⁴⁹ For these purposes, an activity that is charitable if carried out in the United States is also a charitable activity if carried out in a foreign country.⁵⁰

⁴⁵ Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts, Dec. 3, 1980, art. 10(2).

⁴⁶ Convention Between the United States of America and Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritances, and Gifts, June 13, 1983, art. 8(7).

⁴⁷ See *supra* n, 7. Also see Milton Cerny and Adam Damerow, Charitable Giving and Disaster Relief Efforts in Response to the Haitian and Chilean Earthquakes, *THE EXEMPT ORGANIZATIONS TAX REVIEW* Vol. 65 No. 5 (May 2010).

⁴⁸ See *S.E. Thomason v. Commissioner*, 2 T.C. 441 (1943) (denying a charitable contribution deduction for payments made for the benefit of a particular individual who was in the care of a public charity); Rev. Rul. 54-580, 1954-2 C.B. 97 (denying a charitable contribution deduction for tuition payments to church-sponsored schools).

⁴⁹ Rev. Rul. 75-65, 1975-1 C.B. 79; Rev. Rul. 66-79, 1966-1 C.B. 48; Rev. Rul. 63-252, 1963-2 C.B. 101.

⁵⁰ Treas. Reg. § 1.170A-8(a) (“A charitable contribution by an individual to an organization described in section 170(c) is deductible even though all, or some portion, of the funds of the organization may be used in foreign countries for charitable or educational purposes.”); *Bilingual Montessori School of Paris, Inc.*, 75 T.C. 480 (1980) (holding that a U.S. nonprofit organization that conducts all or part of its activities

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

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

1. General rules

“Friends of” organizations are usually nonprofit corporations, with several members of the board associated with the supported organization. A majority of the board, however, should be independent of the supported organization. “Friends of” organizations generally qualify as section 509(a)(1) publicly supported charities, but they can also qualify as section 509(a)(2) public charities (public fee-for-service supported) if they are funded from the sale of goods or services.

For support purposes, support from foreign governments is treated the same as support from a domestic government entity and so is not subject to the two percent limit on certain support under sections 509(a)(1) and 170(b)(A)(vi).⁵¹

Qualification as a supporting organization under section 509(a)(3) is problematic because, in order for the contributions to be deductible, the “friends of” organization cannot be controlled or supervised by the supported foreign charity. Moreover, a section 509(a)(3) can not be operated in connection with an organization that is organized under foreign law.

Responsiveness can be shown by having a single director, officer, or trustee overlap.⁵² Significant involvement can be shown by having the “friends of” organization paying substantially all (85 percent) of its income to the foreign entity.⁵³ But, under changes made by the Pension Protection Act of 2006, this type of supporting organization (referred to as a Type III supporting organization) may not support a foreign organization.⁵⁴ Thus, it is likely that “friends of” organizations will need to be public charities under section 509(a)(1) or (a)(2).

2. Example of a “friends of” organization

A good example of a “friends of” organization is the Coalition for International Justice, a U.S. public charity established to support the International War Crimes Tribunal that was created by the United Nations to prosecute persons responsible for violating international human rights laws in the former Yugoslavia and Rwanda. The Coalition supports the Tribunal in four significant ways:

- a. Securing and coordinating financial and in-kind support for the Tribunal;

outside the U.S. is still exempt from tax under section 501(c)(3), assuming that it meets the other requirements of that section); Rev. Rul. 71-460, 1971-1 C.B. 231 (same).

⁵¹ See Rev. Rul. 75-435, 1975-2 C.B. 215.

⁵² Treas. Reg. § 1.509(a)-4(i)(2).

⁵³ See Treas. Reg. § 1.509(c)-4(i)(3); Rev. Rul. 76-208, 1976-1 C.B. 161 (holding that “substantially all” means 85 percent).

⁵⁴ Section 509(f).

- b. Coordinating activities of non-governmental organizations that support the Tribunal's mission;
- c. Providing technical and legal assistance as requested by the Tribunal; and
- d. Providing grants to organizations and individuals to carry on its charitable and educational programs.

The Coalition received tax-exempt status as a section 501(c)(3) organization because it lessens the burdens of the U.S. government (a major supporter of the Tribunal)⁵⁵ and defends human and civil rights secured by law.⁵⁶ The organization is a publicly supported organization under section 170(b)(1)(A)(vi).

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

D. Gifts to U.S. Private Foundations

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

1. Expenditure responsibility for grants to foreign charities

Perhaps the most significant of these rules, at least with respect to the operations of the private foundation, is the requirement that the private foundation exercise expenditure responsibility over grants to foreign charities that have not been recognized as such by the IRS.⁵⁷

Under applicable regulations, a private foundation must exercise expenditure responsibility with respect to all grants to foreign organizations that are not recognized as charitable by the IRS. If such responsibility is not exercised by the private foundation, the grant will be treated as a

⁵⁵ See Treas. Reg. § 1.501(c)(3)-1(d)(2) (defining "charitable" to include lessening the burdens of government); Rev. Rul. 85-2, 1985-1 C.B. 178 (holding that an organization lessens the burdens of government if the organization's activities are activities that a government unit considered to be its burdens, and if such activities actually lessen such government burdens); Rev. Rul. 85-1, 1985-1 C.B. 177 (same).

⁵⁶ See Treas. Reg. § 1.501(c)(3)-1(d)(2) (defining charitable to include "defend[ing] human and civil rights secured by law"); PLR 9223054 (Mar. 12, 1992) (holding that fostering freedom of speech and freedom of the press through grants in Eastern European countries is a charitable activity); GCM 38468 (Aug. 12, 1980) (holding that "human and civil rights secured by law" includes rights other than those guaranteed by the U.S. Constitution); GCM 30945 (July 26, 1997) (assuming that "human and civil rights secured by law" include rights secured by international law).

⁵⁷ See section 4945(d)(4).

taxable expenditure. A taxable expenditure is not only subject to a series of tiered excise taxes but also must be corrected.⁵⁸

Exercising expenditure responsibility requires (1) a pre-grant inquiry, (2) a written grant agreement binding the grantee to repayment of funds not used for the purposes of the grant, (3) submission of annual reports by the grantee to the donor, (4) maintenance of books and records by the grantee that are available to the donor, (5) a commitment by the grantee not to use the funds for political, legislative, or non-exempt activity, (6) provision by the grantee of periodic reports to the grantor on the use of funds, and (7) provision by the donor foundation of information about the expenditure responsibility grant to the IRS as part of the donor foundation's annual information return.⁵⁹

For grants made to a non-public charity or private foundation, including a foreign charity that has not filed for U.S. recognition of its public charity status, the grantee must also agree to keep the funds provided in a separate fund dedicated to charitable purposes.⁶⁰

The need to exercise expenditure responsibility can be avoided if the foundation determines after a good faith effort that the foreign organization would qualify under sections 501(c)(3) and 509(a)(1), (2) or (3) if it had applied for U.S. recognition as a public charity.⁶¹

A good faith effort is demonstrated either by an equivalency determination or an affidavit. Expenditure responsibility can also be avoided if the grantee is a foreign government, or any agency or instrumentality thereof, or an international organization recognized under 22 U.S.C. § 288.

a. Equivalency determination – opinion of counsel

An equivalency determination is an opinion of counsel (retained by either the grantor or the grantee) that the foreign grantee organization, except for its place of organization, is equivalent to a U.S. public charity.

While the IRS has not provided explicit guidelines regarding the information on which such an opinion should be based, the requirements for affidavits described in the next section indicate that the opinion should be based on at least the following information and documents:

- (1) Organizational documents of the foreign grantee, including bylaws, articles, governing rules, etc.
- (2) A detailed description of the grantee's purposes.
- (3) A copy of the relevant statutory law — dissolution, powers, etc.

⁵⁸ See section 4945.

⁵⁹ See section 4945(h); Treas. Reg. § 53.4945-5(b), (c)(1), (d). See also *Principles of International Charity*, developed by the Treasury Guidelines Working Group & Charitable Sector Organizations and Advisors (March 2005).

⁶⁰ Treas. Reg. § 53.4945-6(c)(2)(i).

⁶¹ Treas. Reg. § 53.4945-5(a)(5).

- (4) A demonstration that the grantee does not grant any individual private benefits and does not engage in non-charitable activity.
- (5) A demonstration that the grantee does not engage in legislative or political activity.
- (6) Financial support data.

b. Grantee affidavit: underused but vital vehicle

Another option is to obtain an affidavit from the grantee. The affidavit must be in English, be attested to by a principal officer of the grantee, and contain or be accompanied by the following:

- (1) A statement that the grantee is operating exclusively for charitable purposes.
- (2) A description of the grantee's past and present activities.
- (3) Copies of the grantee's charter, bylaws, and other governing instruments.
- (4) A statement that the country's laws and customs do not allow the grantee's assets to benefit private parties.
- (5) Dissolution provisions guaranteeing that remaining assets will be distributed for charitable and public purposes.
- (6) A statement that the country's laws or customs do not allow the grantee to engage in substantial lobbying or any political activity.
- (7) For a grantee other than a church, hospital, or educational institution, a showing that it meets the public support test under section 170(b)(1)(A)(vi) or section 509(a)(2) by furnishing current financial information.
- (8) A statement identifying what other organizations, if any, control or operate with the grantee.⁶²

2. Capital equipment and endowment grants to foreign charities

It is possible to make capital equipment and endowment grants to foreign grantees, but the following cautions should be observed because the IRS will closely monitor these transactions:

- a. The grantor foundation should obtain an equivalency determination if the donee is a public charity.
- b. For non-charity grantees, the grantor foundation should exercise expenditure responsibility with the grantee agreeing to keep the funds in a separate fund dedicated to charitable purposes.

⁶² Rev. Proc. 92-94, 1992-2 C.B. 507.

- c. Endowments that are established from grant funds will require written reports from the grantee to the grantor at the end of each accounting period until the funds are spent.
- d. Grants to private foreign foundations will require reporting from the grantee foundations on how the principal was spent for the taxable year and the succeeding years.

3. Special rules for non-operating private foundations making grants to foreign charities

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

a. Out of corpus grants

There may be a temptation for non-operating private foundations with little international experience to make grants to other non-operating private foundations, either domestic or foreign, that have the required expertise. Or, the non-operating private foundation may be concerned about the fate of funds sent overseas and so make the grant to an organization, perhaps even a public charity, controlled by the private foundation.

In either case, the grant will be considered as being made out of corpus and therefore will be ineligible to count towards the minimum distribution requirements imposed on the foundation, unless certain conditions are met:

- (1) The grantee must pay out the grant in full by the end of the first taxable year after the grantee's taxable year in which the grant is received.
- (2) The grant must be paid out either to a public charity or for a charitable purpose; in the latter instance, the previously described expenditure responsibility requirements apply.
- (3) The grant must be paid out of the corpus of the grantee—that is, the grantee must have made qualifying distributions sufficient to exhaust its minimum distribution requirements for the current and preceding tax year.
- (4) An adequate record must be kept that these requirements have been satisfied.⁶³

b. Regranting of funds

Expenditure responsibility concerns also arise if a grant is made from one non-operating private foundation to another. Such grants are

⁶³ Treas. Reg. § 53.4942(a)-3(c)(1). If the grantee is not a private foundation, the grant must still be made out of corpus as if the grantee is treated as a private foundation. See also Milton Cerny and Douglas Varley, *The Out of Corpus Rule Reviewed*, LEGAL DIMENSIONS OF INTERNATIONAL GRANTMAKING, Council on Foundations, 1999.

subject to the previously described expenditure responsibility requirements.⁶⁴ In addition, if the second foundation in turn re-grants the funds, and the first foundation has some control over what recipient is selected for the re-grant, the first foundation has a responsibility to obtain the required periodic reports from the secondary grantee.⁶⁵

E. Grants to International Organizations and Foreign Governments

Grants to non-U.S. organizations will be treated as if made to a public charity if the non-U.S. organization is a foreign government, or any agency or instrumentality thereof, or an international organization designated as such by Executive Order under 22 U.S.C. § 288 even though not described in section 501(c)(3).⁶⁶ But, such a grant must be made exclusively for section 501(c)(3) purposes.⁶⁷ Grants to support the general purposes of the government are not allowed.

For such grants, no equivalency determination or grantee affidavit is required nor is any expenditure responsibility necessary. The grant file should, however, include (1) documentation that the grantee is a unit of a foreign government or specially designated international organization, and (2) a copy of the grant letter clearly specifying the charitable purpose of the grant.

F. Additional Underused But Effective Planning Tools

Other tools exist for engaging in international philanthropy, but they are often overlooked.

1. Program-related investments

A program-related investment (PRI) is a special type of social investment which, unlike many other investments, meets the criteria for qualifying distributions for private foundations, is not subject to the excise tax on excess business holdings by private foundations, and is not subject to the excise tax on jeopardizing investments by private foundations.⁶⁸

An investment satisfies the statutory requirements for a PRI as long as: (1) the primary purpose in making the investment is charitable, (2) there is a charitable effect that would not have occurred without the investment, and (3) such charitable effect is commensurate with the investment.⁶⁹

⁶⁴ See section 4945(d)(4).

⁶⁵ See Treas. Reg. § 53.4945-5(b)(1). See also PLR 9717024 and Milton Cerny & Beth Sellers, Private Ruling Takes Pragmatic Approach to International Regranting, LEGAL DIMENSIONS OF INTERNAL GRANTMAKING, Council on Foundations 1997.

⁶⁶ Treas. Reg. § 53.4945-5(a)(4)(iii).

⁶⁷ *Id.*

⁶⁸ See section 4944(c) (defining a PRI and excluding it from consideration as a jeopardizing investment); Treas. Reg. § 53.4942(a)-3(a)(2)(i) (including a PRI within the definition of a “qualifying distribution”), Treas. Reg. § 53.4943-10(b) (excluding PRIs from the definition of “business holdings” for purposes of the excess business holdings excise tax); Rev. Rul. 78-90, 1978-1 C.B. 380 (holding that loans to blind persons who were otherwise unable to obtain the necessary funds to go into business for themselves were PRIs).

⁶⁹ Treas. Reg. § 53.4944-3(a). A PRI also cannot have as a purpose the furtherance of political activities or substantial legislative activities. Treas. Reg. § 53.4944-3(a)(iii).

A PRI should not exhibit a significant purpose of producing income or the appreciation of property, which leads the IRS to generally look at two factors in order to determine whether such a significant non-charitable purpose is present: (1) whether the interest rate is substantially below market; and (2) if the interest is at market, whether the risk would be higher than that a conventional lender would take on.⁷⁰

Examples of PRIs include investment in minority-owned businesses in deteriorated neighborhoods, investment in businesses that employ low-income persons from such neighborhoods, and low-interest loans to media organizations in former Communist countries.⁷¹

PRIs may be made to foreign charities. If a private foundation makes a PRI that, if it were a grant, would be subject to the expenditure responsibility requirements, the PRI is also subject to the expenditure responsibility requirements.

The required written agreement must also include several additional terms: (1) an agreement to only use the funds provided for the agreed upon investment, (2) an agreement to repay any funds not so used, and (3) a specification that the annual report and records maintained by the recipient must be equivalent to those that would ordinarily be required by commercial investors under similar circumstances.⁷²

2. Microcredits and venture capital funds

One popular form of international philanthropy is microcredits, which are small loans to budding entrepreneurs in impoverished areas. The first microcredit apparently originated in Bangladesh, where in the 1970's a banker named Muhammad Yunus pioneered the practice of giving poor people—mostly women—small loans to help them start businesses.⁷³

Microcredits have since seen an incredible boom. For example, Accion International of Somerville, Massachusetts has seen the loans made by it and its affiliates in Latin America and the United States grow to \$331 million as of 1995.⁷⁴

⁷⁰ See, e.g., PLR 8710076 (Dec. 10, 1986); PLR 8637120 (June 19, 1986); PLR 8141025 (July 20, 1981); see also Treas. Reg. § 53.4944-3(a)(2)(ii) (existence of profit not determinative); GCM 33906 (Aug. 7, 1968) (concluding that the making of loans to for-profit entities or individuals may serve a charitable purpose under certain circumstances). Similar factors are examined for equity investments. See, e.g., PLR 8807048 (Nov. 23, 1987); GCM 39720 (Mar. 30, 1988).

⁷¹ See Treas. Reg. § 53.4944-3 (giving examples of PRIs); Rev. Rul. 74-587, 1974-2 C.B. 162 (holding that an organization that provided loans to and purchased equity interests in various business enterprises in economically depressed areas was charitable); PLR 9551005 (Sept. 15, 1995) (loans to media outlets); GCM 39883 (Oct. 16, 1992) (discussing charitable community development organizations).

⁷² Treas. Reg., § 53.4945-5(b)(4).

⁷³ Byron Yank, *The Clintons' Brewing Micro-Scandal*, THE AMERICAN SPECTATOR, Sept. 1997. Milton Cerny, *Microcredit Lending In South Africa*, THE EXEMPT ORGANIZATION TAX REVIEW, Vol. 20, No. 2 May 1998.

⁷⁴ Stephen G. Greene, *Tiny Loans Power a Global Campaign to Aid the World's Poorest People*, THE CHRONICLE OF PHILANTHROPY, Apr. 3, 1997, at 9, 10.

Microcredits are often also linked with the concept of community banks, such as the South Shore Bank in Chicago (also known as Shorebank), which concentrate their lending in poor and run-down neighborhoods.

Microcredit programs tend to rely heavily on foundation grants, government programs, and private donations for their capital. To avoid this reliance, some U.S. charities are now seeking to develop venture capital funds to invest in projects that are too costly for microcredit programs to handle, such as a food-processing plant that can serve scores of small farmers, but which also serve poor communities. The capital for these funds would come primarily from private investors.⁷⁵

3. Debts for development

Domestic charities can purchase debt of foreign countries in which they operate so that payments from that country's government will remain in the foreign country to be reinvested in social, humanitarian, educational, or ecological needs.

Recent examples of such purchases include the purchase of debt instruments in exchange for rain forest preservation in Panama and the purchase in exchange for low-cost housing in the Czech Republic. Such arrangements can be more attractive to many countries than direct subsidies, as retirement of debt improves the financial standing of the country internationally while at the same time the government retains complete control over the resulting charitable programs.

4. Establishing a foreign foundation

According to published reports, hundreds of private foundations have been formed in recent years in such out-of-the-way places as Bermuda, Barbados, Malta, Gibraltar, and the Channel Islands.⁷⁶ Establishing charities or foundations in countries other than the United States and major Western European countries, where extensive regulations govern such entities, can have a number of advantages for an individual. Organizations that would not qualify as exempt from tax in the United States might qualify as such elsewhere in the world. Restrictions that apply to U.S. private foundations, such as limits on business holdings and the tax on investment income, do not exist in many other countries.

Privacy can also be a big concern. In the United States and many European countries, financial, director and compensation information must be reported to the government and is often available to the public. In contrast, these disclosures do not exist in many other countries.

The tradeoff, of course, is that contributions to such foreign charities and foundations are not tax deductible unless a reciprocal agreement or treaty of some type exists. An individual may consider, however, the lack of a deduction to be a fair cost for the ability to pursue his or her charitable goals anonymously with little or no government oversight or interference.

⁷⁵ See *id.*

⁷⁶ Stephen G. Greene, et al., *For Anonymous Donors, Offshore Philanthropy Can be Appealing*, THE CHRONICLE OF PHILANTHROPY, Feb. 6, 1997, at 13.

III. WITHHOLDING AND REPORTING ISSUES

A. Withholding on Grants to Nonresident Aliens

If a private foundation or a public charity makes payments to a nonresident alien to conduct research or engage in other activities, those payments *may* be subject to withholding. Generally, anyone who makes a fixed or determinable annual or periodic payment, which includes grants, to a nonresident alien is required to withhold a percentage of that payment if that income is considered as coming from a U.S. source.⁷⁷ Scholarships, fellowship grants, and other types of grants paid by U.S. private foundations or public charities are generally considered to be U.S. source income and so are subject to withholding if paid to nonresident aliens.⁷⁸ If all of the grant-related activities will be conducted outside of the United States, however, the payments will instead be considered foreign source income and so will not be subject to withholding.⁷⁹

B. Withholding and Reporting for Foreign Private Foundations

Foreign private foundations are subject to a four percent withholding rate on their gross investment income derived from sources within the United States.⁸⁰ The four percent rate is available to the foreign private foundation on the basis of an opinion of counsel or qualifying affidavit as to its charitable status (discussed above) without having to file a Form 1023 seeking and IRS determination letter.

However, the foreign organization is subject to the same annual reporting requirements as a U.S. private foundation because the tax must be reported on a Form 990-PF for the taxable year, and paid at the time prescribed for filing such return (determined without regard to any extension of time for filing).⁸¹

The major difference in treatment between the foreign and U.S. private foundation is that the foreign foundation may not have to report all of its U.S. income if an applicable treaty provides exclusions. In addition, if the foreign foundation receives substantially all its support (at least 85 percent), other than its support from its gross investment income, from sources outside the U.S., it is exempted from the chapter 42 excise tax restrictions altogether except for the four percent tax on gross investment income.⁸²

IV. FOREIGN INVESTMENTS AND TAXATION

A. Apportionment of Charitable Deductions Between U.S. and Foreign Source Income Under Treas. Reg. Section 1.861-8(c)(12)

⁷⁷ See section 1441.

⁷⁸ See Treas. Reg. § 1.863-1(d)(2)(i).

⁷⁹ See Treas. Reg. § 1.863-2(d)(2)(iii).

⁸⁰ Sections 4948(a), 1443(b). "Investment income" is defined in section 4940(c)(2) as the amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties, but not including any such income to the extent included in the tax imposed by section 511. The term also includes income from sources similar to those listed under an expansion to the definition made by the Pension Protection Act of 2006.

⁸¹ Treas. Reg. § 53.4948-1(a)(1).

⁸² Treas. Reg. § 53.4948-1(b).

1. These regulations, intended to encourage charitable giving, apply both to U.S. and foreign donors and address the apportionment of charitable deductions under sections 120, 873(b)(2), and 882(c)(1)(B).⁸³
2. They create an actual foreign tax credit benefit for charitable giving. Under the temporary and proposed regulations, a taxpayer who makes a section 170 charitable contribution can use more foreign tax credits than an identical taxpayer who does make a charitable contribution.

B. Foreign Corrupt Practices Act, Terrorism and Embargo Issues

1. U.S. nonprofit organizations must be careful in granting funds to foreign charities under the rules prescribed in the Foreign Corrupt Practices Act (FCPA) regarding distributions to charities that may have officers or directors who are government officials in order to gain access.⁸⁴
2. Executive Order 13224 prohibits transactions between a domestic charity and foreign organizations deemed by the federal government to be a terrorist group or individuals associated with such groups. Embargoed countries are listed by the Treasury Department of Foreign Asset Control.⁸⁵
3. The Supreme Court upheld in *Holder v. Humanitarian Law Project*⁸⁶ a ban on material support to groups designated as foreign terrorists by the Secretary of State. The Federal law banning material support for foreign terrorist organizations includes not only money or material but also “training” and “expert advice or assistance.” At issue an attempt to instruct the Kurdish separatist party known as the PKK to advance its goals through the peaceful use of international law. The Court noted that some terrorist groups may conduct both peaceful and violent activities, but Congress found that they may be so tainted by their criminal conduct that any contribution to such an organization facilitates their conduct. U. S. citizens remain free to advocate for the political aims of these groups under the constitutional protected free speech, as long as they did not coordinate with them. Chief Justice Roberts also wrote in his opinion that there may be cases where some interaction with foreign terrorist groups could be constitutionally protected but those “difficult cases” would have to be addressed in the future as they arise. What this means for international grant making is that presently any provision of charitable assistance to a terrorist organization, including humanitarian aid, would be considered “material assistance” precluded by Federal law until the Court rules otherwise.

⁸³ Milton Cerny and Rebecca Rosenberg, *U.S. Issues Guidance on Apportionment of Charitable Contributions to U.S.-Source Income*, TAX NOTES INTERNATIONAL, Aug. 9, 2004.

⁸⁴ Mark Brzezinski, *Obama administration gets tough on business corruption overseas* WASHINGTON POST, May 28, 2010.

⁸⁵ Milton Cerny, *Virginia Gift Planning Council Program on International Philanthropy*, May 13, 2010. Prohibited transactions include financial support, in-kind support, and technical assistance. Humanitarian assistance to persons associated with terrorists or acts of terrorism is also covered.

⁸⁶ U.S. No. 08-1498, 6/21/10, 78 U.S.L.W. 1835.

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

1. The IRS has directed its field agents to scrutinize the use of equity swaps and other offshore investments in hedge funds and private equity funds to determine whether “dividend arbitrage” is being practiced to avoid tax on so-called dividend income.
2. The Senate Finance Committee is especially attuned to nonprofit offshore investments that may be serving as abusive tax shelters and tax avoidance schemes in their efforts to find funding offsets for various legislative programs.⁸⁷
3. Section 4965, applicable to tax exempt entities, designates certain transactions as prohibited tax shelters and includes an entity-level excise tax on the party that engaged in the prohibited tax shelter transaction. IRS gives the example of a tax-exempt entity that enters into a transaction with an S corporation receiving the S corporation stock and aids the S corporation and its shareholders in avoiding taxable income because it facilitates the transaction by reason of its tax-exempt status.

V. CONCLUSION

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

⁸⁷ See BNA Daily Tax Report, 101 DTR 6-8, 5/27/2010.

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The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about this white paper. Please feel free to contact any member of the Group.

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