



## LEGAL DIMENSIONS OF INTERNATIONAL GRANTMAKING

# Simpler Approaches to Cross-Border Giving through Domestic Collaborations: A Post-September 11 Update

By Timothy R. Lyman and Edgardo Ramos

In the post-September 11 world, the need for corporations and private foundations to make charitable expenditures abroad is more acute than ever. But some grantmakers who wish to make international grants must now comply with not only the U.S. tax rules that have always governed direct foreign grantmaking, but also with various anti-terrorism compliance measures. In this new operating environment, a collaboration with a domestic public charity may still offer U.S. corporations and private foundations the simplest way to accomplish their foreign funding objectives.

## THE NECESSARY COMPONENTS OF A SUCCESSFUL COLLABORATION

To work properly, such collaborations must involve a domestic 501(c)(3) corporation, organized and operated as a public charity. This organization accepts funding from corporations and private foundations. In turn, and in keeping with its own charitable objectives, it either (1) donates funds to foreign charities or to other foreign organizations engaged in charitable activities, or (2) expends the funds itself on charitable work abroad.

In either case, both the grantmaker and the domestic collaborative partner have new responsibilities to assure that the ultimate use of the funds does not involve material support for violence or terrorism. While corporate and private foundation funders probably cannot shift *all* of the compliance responsibilities to the collaborative partner in *all* circumstances, a well-structured relationship with the right collaborative partner can help put those responsibilities in the hands best suited to carry them.

## HOW CAN A COLLABORATION SERVE U.S. CORPORATE DONORS?—THE TAX ISSUES

U.S. corporations want to ensure that their charitable contributions are tax deductible. Donations by U.S. corporations that are destined for use outside the United States may be deducted from U.S. income only if they are made to a corporation formed in the United States.<sup>1</sup> Because a proper collaborative partner is a domestically formed corporation, U.S. corporate grants to it can be tax deductible, even if ultimately used abroad.<sup>2</sup>

## HOW CAN A COLLABORATION SERVE PRIVATE FOUNDATIONS?—THE TAX ISSUES

A private foundation must periodically distribute a certain minimum amount of cash or property, in the form of “qualifying distributions,” in furtherance of its charitable purposes.<sup>3</sup> Generally, a grant to a domestic public charity will be a qualifying distribution,<sup>4</sup> while a grant to a similar foreign organization generally will be a qualifying distribution only if it can be established that the foreign grant recipient is equivalent to a domestic public charity,<sup>5</sup> or if the U.S. private foundation exercises expenditure responsibility (described below). Despite efforts to simplify the process of establishing equivalency, it remains a potentially significant investment of time and money.<sup>6</sup> A grant to a domestic collaborative partner, even if the funds are used abroad, generally will not require an equivalency determination to be considered a qualifying distribution.

Exercising expenditure responsibility is an alternative route to ensuring that a private foundation grant to a for-

1. I.R.C. § 170(c)(2).

2. Rev. Rul. 69-80, 1969-1 C.B. 65.

3. I.R.C. § 4942.

4. I.R.C. § 4942(g)(1).

5. Treas. Reg. § 53.4942(a)-3(a)(6).

6. Rev. Proc. 92-94, 1992-2 C.B. 507.



foreign organization is a qualifying distribution (and is not “taxable expenditure”)<sup>7</sup> that could expose the foundation to penalty taxes.<sup>8</sup> A grant to a domestic collaborative partner that is a U.S. 501(c)(3), even if the funds are ultimately used abroad, generally will not require expenditure responsibility.

## TYPES OF COLLABORATIONS

A well-recognized type of cross-border charitable collaboration involves a so-called *friends of* organization, which are usually affiliated with a specific foreign organization, but have a separate U.S. presence in the form of an independent domestic 501(c)(3) corporation. While this model is popular, it has the obvious limitation of restricting funding options to those groups that have a viable “friends of” affiliate.

Internationally active U.S.-based charitable organizations that are well-established and broad-based also provide a potential model for simple cross-border collaborations. The choice among such potential collaborative partners is ample, especially in humanitarian and development fields. A particular organization may conduct its foreign programs directly, by setting up a local affiliate, by funding already existing foreign programs and organizations or by some combination of these methods. This type of collaboration works particularly well where the donor is interested in supporting a particular kind of charitable activity in a specific region, but does not care to support a particular foreign organization. Frequently, a foreign organization that a U.S. donor wishes to support may already be working with one or more suitable U.S.-based charitable organizations with which the potential donor could collaborate.

Over the last decade, a new model of cross-border collaboration—the *advised fund*—has been borrowed from well-established domestic practice. This model aims to overcome the tax-related impediments to direct foreign giving, while maximizing the donor’s input into the choice of the ultimate recipient of the gift. Under this approach, the donor relinquishes the legal right to determine the ultimate beneficiary of the charitable donation, but retains a legally unenforce-

able right to advise the initial recipient regarding use of the funds. For instance, the donor may make a donation to the collaborating domestic public charity and request (but not require) that the gift be used to support a particular foreign charitable organization. Alternatively, the donor might create an advised fund within the collaborating domestic public charity and, at a later point, suggest organizations that the fund should support.<sup>9</sup>

## GETTING THE MODELS RIGHT

To achieve the desired tax effect, all collaborative models require care in structuring. The success of each model depends on the legal independence of the collaborating domestic public charity, which must avoid being simply a legal extension of a foreign organization or a “puppet” of a domestic donor. Collaborations can be properly structured and administered a number of ways. For example, collaborative partners may accept non-earmarked donations and then distribute them to foreign charities or expend them for foreign charitable purposes; they may approve specific foreign charitable projects and then solicit funds for the projects; or they may conduct charitable activities in a foreign country through a subsidiary and accept funds to support these activities.

All of the foregoing approaches have been accepted by the Internal Revenue Service (IRS),<sup>10</sup> and there are numerous such collaborations in existence, the collaborative partners must always take care to exercise sufficient “discretion and control” over the funds they receive, rather than simply turning them over to a foreign affiliate. If the collaborating charity serves as a mere “conduit,” the IRS will ignore its existence and treat donations as if they were given directly to the foreign organization. Although perhaps best recognized in the context of “friends of” organizations, this concern extends potentially to any type of collaborating domestic charity.

Another important concern is the potential for inappropriate “earmarking” of funds.<sup>11</sup> *Earmarking* is any agreement, oral or written, that funds will be used for a particu-

7. I.R.C. § 4945(a).

8. I.R.C. § 4945(d)(4).

9. *National Found., Inc. v. United States*, 13 Cl. Ct. 486, 492 (1987).

10. Rev. Rul. 63-252, 1963-2 C.B. 101; Rev. Rul. 66-79, 1966-1 C.B. 48.

11. *Thomason v. Commissioner*, 2 T.C. 441 (1943); Rev. Rul. 63-252, 1963-2 C.B. 101; Treas. Reg. § 53.4942(a)-3(c)(4); Treas. Reg. § 53.4945-5(a)(6).



lar beneficiary selected by the grantor. To avoid earmarking, a donor's recommendations must be truly only suggestions and not legally binding, or else the IRS will ignore the collaborating charity's existence and treat donations as if they were given directly to the foreign organization.<sup>12</sup>

If a contribution is treated as having been made to an ultimate foreign beneficiary, either because the collaborating charity is held to be a mere conduit or because the funding in question is held to be legally earmarked by the donor for the particular foreign beneficiary, an individual or corporate donor will be denied a charitable deduction. A private foundation grantmaker risks denial of a qualifying distribution treatment for the payment and possible liability for making a taxable expenditure.

### ANTI-TERRORISM COMPLIANCE— WORKING WITH A DOMESTIC COLLABORATIVE PARTNER

While the tax rules of foreign grantmaking—and the related advantages of a well-structured domestic collaboration—have not changed much in recent years, new concerns have surfaced post–September 11. In this new environment, the focus is on avoiding expenditures that provide material support for terrorism.

Soon after the terrorist attacks of September 11, 2001, the president declared a national emergency and issued Executive Order 13224, “Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit, or Support Terrorism” (the “Executive Order”). The following month, Congress passed and the president signed into law the USA PATRIOT Act—“Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism” (the “Patriot Act”). Both the Executive Order and the Patriot Act prohibit financial transactions—potentially including both direct or indirect grantmaking—with individuals and organizations associated with terrorism. In addition to these new rules, various previously existing embargo-related rules have attracted new attention in the cross-border grantmaking context, as news stories circulate about criminal indictments for charitable organizations alleged to be violating existing embargoes.

The Executive Order and the Patriot Act provide serious possible consequences (asset blocking, criminal sanctions and exposure to civil law suits) for those—including grantmakers—who provide funding, as well as most kinds of in-kind assistance, to individuals and organizations associated with terrorism.<sup>13</sup> In the case of the criminal sanctions and exposure to possible civil litigation, some level of intent—or at least knowledge—is required. However, under the Executive Order, a grantmaker's assets theoretically could be blocked for making problem grants without any showing as to the grantmaker's knowledge or intent.

In this climate, it is more important than ever for grantmakers to know their grantees and how their grantees will use the funds they receive. Grantmakers are not necessarily well situated to conduct the level of due diligence regarding their potential foreign beneficiaries that law enforcement agencies may think appropriate. A well-structured collaboration with the right domestic collaborative partner can shift due diligence responsibilities onto parties better positioned to carry out appropriate inquiries and monitoring regarding the use of granted funds. Of course, more intensive due diligence activities carry a cost, regardless of which hands hold the primary responsibility. Grantmakers that want collaborative partners to carry out *meaningfully thorough* due diligence will have to be prepared, as well, to include these costs in their grant.

### ASKING THE RIGHT QUESTIONS

The following are some questions grantmakers should consider in choosing a collaborative partner and structuring the collaboration:

*How well does the collaborative partner know the operating environment?* In most situations, it will be possible to find potential collaborative partners with a field office in the country or region of interest or personnel with close connections to respected local organizations. Generally, the “closer to the ground” the collaborative partner is, the more likely the organization will be to be able to obtain the information needed to avoid problem expenditures.

12. Rev. Rul. 63-252; Rev. Rul. 66-79.

13. See *Legal Dimensions* articles “International Grantmaking Post–9/11: Dealing with Executive Order 13224 and the USA Patriot Act,” and “Grantmaking and Embargoed Countries: An Overview Using Kosovo As a Case Study.” ([www.cof.org/whatis/types/international/index.htm](http://www.cof.org/whatis/types/international/index.htm))



*How well equipped is the collaborative partner to handle the mechanics of anti-terrorism due diligence?* Avoiding violations of embargo rules, the Executive Order and the Patriot Act requires a lot of staff time to gather information about the proposed uses of the granted funds and check the information obtained against lists of persons and organizations associated with terrorism, which are maintained by various bodies of government and international organizations. Documenting the due diligence steps taken is also labor-intensive. If a particular potential collaborative partner seems well qualified for the collaboration in other respects, grantmakers may need to consider increasing their funding to include an appropriate number of staff and/or staff hours for the due diligence steps the collaborating partner will be expected to take.

*Are the collaborative partner's due diligence responsibilities clearly described in a written grant agreement?* In addition to describing the collaborative partner's use of the grant in ways that satisfy the tax rules against earmarking discussed above, both parties will want to make sure their grant agreement clearly describes the due diligence steps that the collaborative partner will conduct regarding its expenditures of granted funds. In November 2002, the U.S. Treasury Department published a document—*Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S. Based Charities* (Treasury Voluntary Guidelines). (For more information on the guidelines, visit the U.S. International Grantmaking website at [www.usig.org](http://www.usig.org).) The Treasury's voluntary guidelines have already been much criticized by internationally active organizations of many types, because of the guidelines' open-endedness and ambiguity. Moreover, some internationally active nonprofit organizations have questioned the usefulness of the Treasury's voluntary guidelines, pointing out that they were prepared by law enforce-

ment officials with limited experience in the complex reality of cross-border philanthropy. Nonetheless, they provide ideas for due diligence steps to consider being included in the grant agreement. Further ideas are outlined in "International Grantmaking Post-9/11: Dealing with Executive Order 13224 and the USA Patriot Act,"<sup>14</sup> Grantmakers may want to seek legal counsel in drafting their grant agreement with a collaborative partner, especially those provisions dealing with the specific due diligence responsibilities that the collaborative partner will assume.

### ABOUT THE AUTHORS AND EDITORS

Timothy R. Lyman is a partner in the Hartford, Connecticut, office of Day, Berry & Howard LLP, and a member of the firm's Tax Exempt Organizations Practice Group. He was assisted by Edgardo Ramos, a partner in the Stamford, Connecticut, and New York City offices of the firm and a member of the firm's Government Investigations Practice Group as well as the Council on Foundations Task Force on Anti-Terrorism Compliance. This article was edited by Betsy Buchalter Adler, a partner with the San Francisco law firm of Silk, Adler & Colvin, author of the Council publication, *The Rules of the Road: A Guide to the Law of Charities in the U.S.*, as well as a member of the Council on Foundations Treasury Guidelines Task Force.

The Council on Foundations coordinates the *Legal Dimensions in International Grantmaking* series with assistance from the Day, Berry & Howard Foundation ("promoting positive developments in the law, legal scholarship and legal education"). Inquiries may be addressed to the Council's International Programs staff at 202/466-6512 or to Timothy R. Lyman, president of the Day, Berry & Howard Foundation, at 860/275-0329.

14. See *Legal Dimensions* articles "International Grantmaking Post-9/11: Dealing with Executive Order 13224 and the USA Patriot Act," and "Grantmaking and Embargoed Countries: An Overview Using Kosovo." ([www.cof.org/whatis/types/international/index.htm](http://www.cof.org/whatis/types/international/index.htm))