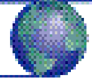

LEGAL DIMENSIONS OF INTERNATIONAL GRANTMAKING

Bar Association Task Force Revisits Private Foundation Rules: Implications for Foreign Grantmaking

by Richard S. Gallagher

A task force of the Exempt Organizations Committee of the Section of Taxation of the American Bar Association is working on suggestions for revising the rules governing U.S. private foundations, including rules on international grantmaking. As the first comprehensive look at a set of rules that have been in place without fundamental overhaul for more than 30 years, the task force's work could have a significant impact if Congress and the Internal Revenue Service (IRS) enact its proposals. The Tax Reform Act of 1969 (and Treasury regulations adopted under it) created a system of penalty taxes on all organizations defined as "private foundations" as well as, in some cases, their "disqualified persons" (foundation managers, major contributors and all of these individuals' spouses, descendants and ancestors, as well as companies, trusts and estates in which they have a substantial interest) for commission of various acts that compromise the charitable purpose or activities of the foundation. There has been significant tinkering with certain of the private foundation rules since 1969, such as creating the current annual distribution requirement of 5 percent of average investment asset value and lowering the tax on investment income from 4 percent to 2 percent (or 1 percent under certain circumstances). However, there has been no comprehensive attempt to review the system of rules in its entirety during this period—a period during which much has changed in the world of grantmaking.

The task force has been charged by the chair of the Exempt Organizations Committee with proposing revisions to the private foundation rules that (1) deal with the most vexing and frustrating problems for private foundations and their counselors; (2) have a reasonable probability of receptive treatment on the part of Congress, the Treasury Department and IRS; and (3) reflect considerations of simplification, fairness and relevance to the situation of private foundations today.

Because of the comprehensiveness of the task force's mandate, many of the issues being considered are of interest to all types of organizations treated as private foundations. Among these are the excise tax on investment income, the definition of disqualified persons (who, under current law, are generally prohibited from engaging in a wide variety of transactions with a private foundation), the possible expansion of circumstances under which the IRS could permit certain transactions with disqualified persons, the permissible percentage a private foundation can own in a particular company, the investment standards with which a private foundation must comply, and even the basic definition of a private foundation.

Some issues the task force is considering, however, hold particular interest for private foundations involved in international grantmaking and activities. These include the rules on expenditure responsibility and program-related investments.

Section 4945 of the Internal Revenue Code imposes penalty taxes on foundations making grants to organizations that are not described in Section 501(c)(3) of the Internal Revenue Code and classified as public charities under the Code (rather than as private foundations). Because relatively few non-U.S. organizations have received their own 501(c)(3) determination letters from the IRS, a private foundation wishing to make grants to a non-U.S. organization must generally secure an opinion of counsel or make its own "equivalency" determination (based on information and affidavits from the foreign organization) that the foreign organization would, if it applied to the IRS, be regarded as a Section 501(c)(3) organization and a public charity, rather than a private foundation.

Making equivalency determinations can present challenges. In all cases, there must be review of the governing documents (which must often be translated and will only rarely contain the specific language required under U.S. law). If the potential grantee is to qualify as the equivalent of a public charity because it is publicly supported, a review of financial data (often in foreign currencies) will be needed to assure the organization meets the mathematical public support tests set forth in the applicable Treasury regulations. In the case of foreign hospitals and schools, a review of patient admission and student racial discrimination standards will be required. (For further information on equivalency determinations, see B. Adler and I. Mittermaier's "What's Behind the Foreign Public Charity Equivalence Affidavit?" Legal Dimensions January 1999.)

Often, an equivalency determination will not be possible with respect to a prospective foreign grantee. If this is the case, a private foundation may opt to make a grant to a

foreign organization under the expenditure responsibility rules. (For further information on expenditure responsibility, see T. Chomicz's "Grantmaking by Private Foundations in the International Arena," Legal Dimensions November 1998.) Such an expenditure responsibility grant must be preceded by a pre-grant inquiry and a grant agreement in which the grantee agrees not to use the funds in ways the U.S. private foundation could not (i.e., engaging in prohibited transactions with disqualified persons, intervening in political campaigns and legislative lobbying).

Perhaps the most significant source of frustration for international private foundation grantmakers with respect to exercising expenditure responsibility has been the reporting requirements involved. A foreign expenditure responsibility grantee must report annually to the foundation on the use of funds until the grant is entirely expended. In the case of grants made for capital purposes, such as endowment or capital equipment, the rules are unclear as to how long reports are due. With respect to all its expenditure responsibility grants, a foundation must continue to report progress on its annual IRS Form 990-PF return and must pursue the foreign grantee if it doesn't receive the required reports. Failure to comply with these requirements can result in penalty taxes.

The task force is taking a comprehensive look at expenditure responsibility, with particular attention focused on reporting obligations. In this context, the task force will consider whether uncertainty over the duration of reporting requirements and concern that a U.S. private foundation may be penalized for a foreign grantee's failure to submit reports may discourage international grantmaking.

A second issue the task force is considering, which holds potentially significant interest for internationally active private foundations, is the treatment of so-called "program related investments" (PRIs). PRIs are private foundation expenditures that have the character of investments but are motivated primarily by charitable rather than profitmaking considerations. If properly structured, PRIs are permitted under the private foundation rules and will not expose the investing foundation to penalty taxes. Moreover, nothing in rules governing PRIs limits their use outside the United States. (For further information on PRIs in the international context, see D. Chernoff's "Program Related Investments: Domestic and International" Legal Dimensions July 2000.)

However, it has been reported to the task force that many in the private foundation world are hampered in their efforts to make foreign program-related investments for at least two related reasons: first, the terms of the applicable Treasury regulations, with respect to explicitly permissible forms of program-related investments, are extremely limited; second, the sparse examples cited in the applicable Treasury regulations do not provide sufficient guidance. Especially in a foreign context, a particular proposed investment may not easily correspond to any of the limited terms and examples cited. As with expenditure responsibility, the task force is taking a comprehensive look at PRIs, with particular attention focused on fleshing out permissible terms and examples. Due attention will be paid by the task force to the fact that the investments in question may be foreign investments.

The task force has not yet completed its deliberations and the Exempt Organizations Committee itself has not yet received final recommendations for discussion. Despite the breadth of the task force's mandate, its members remain specifically conscious of the desirability of simplifying the procedures for foreign grantmaking to encourage and support the important role of U.S. foundations in today's globalized environment. The task force graciously invites the views, thoughts and experiences of members of the foundation community with respect to the challenges the current rules present to foreign grantmaking and activities.

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