

**ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)**

**EXEMPT ORGANIZATIONS: RECOMMENDATIONS
TO IMPROVE THE TAX RULES GOVERNING
INTERNATIONAL GRANTMAKING**

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I know that we've only been in office for a little shy of a hundred days. But I'm even more convinced now than when I was when I became Secretary of State that the problems we face today will not be solved by governments alone... It will be in partnerships with philanthropy, with global business, partnerships with civil society. We have to find new ways to fill the space that is unfortunately left to create vacuums in too many places around the world.¹

Introduction

This year's project was selected in consultation with representatives of the IRS's Tax Exempt and Government Entities Division ("TE/GE") and responds to an IRS-wide initiative to address globalization. Newly appointed IRS Commissioner Douglas Shulman identified the "increasing globalization of tax administration" as one of his highest priorities:

Businesses are no longer defined by national borders. The cross border migration of capital and people has made this a more integrated world and the IRS needs to ensure it has the tax administration capabilities to deal with the fast pace of change.²

While the Commissioner's focus was primarily on challenges posed in a commercial context, his observation applies equally to the philanthropic sector.

Three decades ago, the primary examples of international philanthropy for many Americans were missionaries, the Red Cross, and "adopting" a child in an underdeveloped country for just pennies a day. In recent years, Bono, Presidents Carter, Bush, Clinton and Bush, Angelina Jolie, Oprah Winfrey, and countless other politicians, business leaders and celebrities have given their support to various international charitable causes.³ Star power has brought visibility, but the Bill and Melinda Gates Foundation and other foundations have brought billions of dollars to the table. We have seen a consortium of technology companies try to bring laptop

¹ Hillary R. Clinton, U.S. Sec'y of State, Remarks before the Global Philanthropy Forum (Apr. 30, 2009).

² Douglas R. Shulman, IRS Commissioner, Remarks Before the American Bar Association (May 9, 2008). Commissioner Shulman became the 47th IRS Commissioner on March 24, 2008.

³ It should be noted that politicians, business leaders and celebrities have long supported various charitable endeavors. For example, George Harrison with his August 1, 1971 concert for Bangladesh, Jerry Lewis' long support of the Muscular Dystrophy Association Telethon, Eleanor Roosevelt and Freedom House, etc.

computers to every child in the developing world.⁴ Similar efforts have been made in bringing pharmaceuticals and microfinance to the world's poor.

Events also have driven this trend. The 2005 tsunami in Southeast Asia saw an outpouring of money from the members of the public in the U.S. and other Western nations. When Hurricane Katrina hit New Orleans, we saw the world's generous response. At the same time, some have noted a link between charity and terrorism. This link often carries negative connotations, with the focus turning to how terrorists seek to hide behind purported "charities" to finance their violent activities.⁵ However, others assert that there can be a positive linkage. This group believes that one way to address the terrorist threat is to use carefully targeted initiatives in countries associated with terrorism to improve conditions in those countries, with the hope that the young people will turn their collective energy to more productive pursuits.

As the World Wide Web (the "Web") has reduced distances, people in the developed world find themselves unable to look away from the disease, poverty and strife that plague less developed areas of the world. The Web has had a similar effect on efforts to improve the planet's well-being. The result has been cross-border philanthropic efforts to address global warming, waterborne diseases, AIDS/HIV, and literacy. It is now possible for people in the U.S. to watch live international conferences such as the World Economic Forum in Davos, Switzerland, where these issues are discussed on a global stage. Once distant realities are now tangible. Many in the U.S. have responded by extending their hands and wallets beyond national borders. There is considerable focus today on enormous global challenges that confront all of humankind: the environment, health care, education, poverty and inequality, human rights, the mistreatment of women in many parts of the world, civil society and democracy movements, and national security—and to addressing these issues in new and innovative ways.

⁴ Steve Stecklow and James Bandler, *A Little Laptop with Big Ambitions*, Wall St. J., Nov. 24, 2007.

⁵ While these activities implicate the issue of tax exemption, they raise other, more significant law enforcement issues. Thus, for example, charities are covered by the scope of the Patriot Act and the government has devoted significant enforcement efforts in this area. While these activities respond to very real threats, we share the concern of others in the sector that the rules should avoid needlessly chilling certain types of philanthropic efforts. Thus, for example, it may be appropriate to clarify the "knowing" standard giving rise to criminal liability under the Patriot Act to make sure it is not triggered where charitable organizations are following Treasury Department guidelines, providing of emergency medical relief, and making broad-based community health care and educational services available.

The statistics bear out the anecdotal evidence. In 2007, U.S. foundations gave an estimated \$5.4 billion for international causes, up from \$1.6 billion in 1998.⁶ Much of this growth is attributable to the Bill and Melinda Gates Foundation, but by no means is all of it. From 2002 to 2006, international grantmaking exclusive of the Bill and Melinda Gates Foundation grew at 34.4% as compared to an overall 11.7% growth rate in foundation giving.

Private foundations are not the only organizations engaged in cross-border philanthropy. During 2007, other U.S. entities expended \$33.6 billion on philanthropic activities in the developing world. The other entities involved in this activity include corporations (\$6.8 billion), private and voluntary organizations (\$14.3 billion), colleges and universities (\$3.9 billion) and religious organizations (\$8.6 billion).⁷ By contrast, total U.S. official development assistance totaled \$21.8 billion.

Jonathan Fanton, the president of the John D. and Catherine T. MacArthur Foundation, recently remarked that “America has been the world leader in developing the independent sector at home and encouraging its growth abroad.”⁸ He continued by noting that, in his travels, he has observed that:

Americans are still warmly received, at least by the leaders in government, education, and the nonprofit sector with whom [his organization] works. That is partly because many of them have spent time here as students and know our country, our people, our values, directly. It is also because they have worked with [his] and other foundations, or with U.S.-based NGOs . . .⁹

Fanton then noted the international philanthropic work of U.S.-based charities provides “reassurance that the United States will remain true to its history as a beacon of hope, freedom, fairness, and respect for international law.”¹⁰

In recent years, the world has seen a new breed of organization proliferate. So-called public-private partnerships are often focused on global issues and intent on making a substantial impact on conditions in developing countries. The *Index of Global Philanthropy 2008* observed this trend:

⁶ Foundation Center, *International Grantmaking IV Highlights* (2007).

⁷ Center for Global Prosperity, Hudson Institute, *The Index of Global Philanthropy* (Apr. 2009). The basis for measuring this activity differs from that employed by the Foundation Center. This second set of data included just \$3.3 billion of expenditures by foundations, which differs significantly from the \$5.4 billion reported by the Foundation Center.

⁸ Jonathan F. Fanton, President of the John D. and Catherine T. MacArthur Foundation, Remarks before the Independent Sector (Nov. 6, 2004).

⁹ *Id.*

¹⁰ *Id.*

Global [p]hilanthropy is becoming a truly world wide phenomenon. Over the last two decades, the United States and Europe have led the dramatic growth in philanthropy and remittances to developing countries... The traditional “donor-to-recipient” model of foreign aid has been supplemented, if not supplanted, by public[-]private partnerships. The roles played by business, governments, charities and workers sending remittances back home have changed... Whatever it is called—social entrepreneurship, philanthrocapitalism, venture philanthropy, or...creative capitalism – the lines between business and philanthropy continue to blur... [The programs] focus on homegrown solutions by local entrepreneurs and grassroots organizations that work with their peers from developed countries in real partnerships, not as donors and recipients.¹¹

Recognizing these dynamic developments and in keeping with Commissioner Shulman’s focus, we surveyed the tax issues surrounding cross-border philanthropy. Our primary goals in pursuing this project were to identify significant tax issues confronting cross-border philanthropy and to develop specific proposals to address those issues, with a focus on areas that the IRS can address through administrative action. We consulted with more than 30 stakeholders, including representatives of organizations active in a broad range of cross-border charitable activities (including U.S.-based and international public charities and private foundations) along with practitioners, advocacy groups, academics and government representatives. These individuals and groups are identified at Appendix A of this report.

¹¹ Center for Global Prosperity, *Index of Global Philanthropy 2008*, <https://www.hudson.org/files/documents/2008percent20Indexpercent20percent20Lowpercent20Res.pdf> (last visited Apr. 7, 2009).

Overall Observations and Conclusions

Cross-border philanthropy is a vibrant and vital aspect of the American tradition of giving. It is an area of the tax law where the basic framework functions reasonably well and where structural compliance risks appear to be relatively modest. However, much of the guidance is decades old. Although grantmakers have been able to pursue legitimate activities, technical issues that have gone uncorrected unnecessarily increase the costs and impede legitimate transactions. We believe an update to the rules is warranted.¹²

The following is a summary of our observations and conclusions:

1. *Charitable endeavors that extend beyond our borders have long been part of the American approach to philanthropy.* For almost a century,¹² the tax law has embraced cross-border philanthropy by permitting U.S. charities to pursue their objectives in all corners of the globe and by generally providing income and transfer tax deductions for contributions to U.S. charities that go to support those efforts.¹³
2. *By and large, the tax law and tax administration have functioned well in addressing the special challenges of cross-border philanthropy.* As in many other areas of international tax law (e.g., foreign tax credits, transfer pricing, expatriate taxation, etc.), the rules applicable to cross-border philanthropy are complex. Nonetheless, we share the view expressed by those with whom we spoke that the basic tax law framework governing cross-border philanthropy is fundamentally sound and that no major overhaul is necessary.
3. *There is nothing we have learned based on information available at the present time to suggest that international philanthropy is especially or uniquely susceptible to widespread tax avoidance.* During the past decade, there have been widely publicized instances where charities have been used (knowingly or otherwise) to facilitate tax avoidance schemes that have

¹² As early as 1920, the IRS ruled that a U.S. organization building World War I museums in Europe could qualify as exempt based on its educational mission and project. A.R.R. 301, 3 C.B. 188 (1920). The IRS reaffirmed this conclusion in both informal and formal guidance over the next several decades in the context of specific charitable activities, and in 1971 stated a rule of general application: “since a [domestic corporation’s] activities are charitable within the meaning of section 501(c)(3) of the Code when carried on within the United States, the conduct of such activities elsewhere does not preclude the organization from qualifying as an exempt organization under that section.” Rev. Rul. 71-460, 1971-2 C.B. 231.

¹³ Charitable contributions eligible for deduction under § 170 of the Internal Revenue Code (the “Code”) must be made to U.S. organizations. In addition, contributions by corporations can only be used outside the U.S. if the charitable recipient is a corporation. Code § 170(c)(2) (2009). The Code does permit transfer tax deductions for contributions made directly to non-U.S. charities. Code §§ 2522(a)(2); 2055(a)(2) (2009).

prompted IRS enforcement efforts and legislative changes.¹⁴ It is important to note in the context of our report, however, that these particular compliance risks are a function of a charity's exempt status and are not affected by whether the charity is engaged in cross-border charitable activities.¹⁵ Those with whom we consulted who expressed views on the subject suggested that the nature of the international philanthropic activities and the parties performing those activities are such that the risks of widespread noncompliance are relatively modest. We encourage the IRS to maintain an enforcement presence in this area (and to establish such a presence to the extent it does not currently exist).¹⁶ However, it does not appear to be an area requiring a substantial and disproportionate allocation of enforcement and regulatory resources to address.

4. *While the longstanding framework for cross-border philanthropy functions well, it can and should be updated to simplify compliance and clarify areas of uncertainty.* Much of the guidance affecting cross-border philanthropy was provided long ago and fails to reflect developments of the past 15 or more years. As such, it does not address certain practices and structures that are common today. It is our belief that a modest expenditure of IRS and Treasury administrative resources spent making updates to certain guidance will yield an exceptionally high return by reducing compliance burdens, improving charitable organizations' ability to comply with our tax rules and enhancing their ability to fulfill charitable missions beyond our borders. We recommend that the government make this investment, and are confident that a broad array of stakeholders will contribute time and energy to facilitating the effort.

¹⁴ The IRS Web site lists abusive transactions involving charities. The list includes (i) the assignment of offsetting foreign currency options to a charity to claim substantial artificial losses; and (ii) abusive trust tax evasion schemes that sometimes involve a charity. The complete list of abusive transactions involving exempt organizations is available at <http://www.irs.gov/charities/article/0,,id=128722,00.html> (last visited May 7, 2009).

¹⁵ There are, of course, instances of non-compliance in the context of cross-border philanthropy, as in all areas of the tax law. We also recognize that detection and enforcement may be more difficult because the questionable activities (e.g., private benefit or private inurement) may take place outside our borders. However, none of those with whom we consulted expressed the view that within a cross-border context, non-compliance with the tax laws is either widespread or systemic. (There is considerable focus on the extent to which charities may be using the cloak of charitable status to promote or support terrorist activities. This concern implicates law enforcement issues that are more fundamental than compliance with tax-specific requirements and are beyond the scope of this report.)

¹⁶ The information being gathered by the IRS on the new Form 990, Return of Organization Exempt From Income Tax, and Schedule F, Statement of Activities Outside the United States, should facilitate these efforts both with respect to organizations with overseas operations and organizations which are making grants to foreign organizations.

Specific Recommendations

While we heard many recommendations for additional guidance, we focused on those that we believe will make a significant impact on cross-border philanthropy (either through enhanced compliance or relief of burden), can be implemented administratively by the IRS and can be done without consuming significant government resources. We recommend that the IRS:

1. *Equivalency Determinations—Repository Proposal.* Facilitate formation of Equivalency Determination Information Repositories (“EDIRs”) which would make equivalency determinations in accordance with the requirements of Revenue Procedure (“Rev. Proc.”) 92-94 (as updated from time to time) and procedures approved by the IRS that could be relied on by other charities.
2. *Public Support Test for Equivalency Determination Purposes and for Applying the Public Support Tests Pursuant to §§ 509(a)(1) and (2).*¹⁷ Publish guidance providing that for purposes of applying the foreign equivalency provisions of § 4945(d)(4)(A)(i) and Treas. Reg. § 53.4945-5(a)(5), and for purposes of applying the public support tests under §§ 509(a)(1) and (2), grants from the following sources are treated as grants from § 509(a)(1) organizations:
 - a. Foreign governments (excluding foreign governments on the list of sanctioned countries put forth by the Office of Foreign Assets Control (“OFAC”));
 - b. International organizations designated by executive order pursuant to 22 U.S.C. § 288¹⁸; and
 - c. Foreign organizations for which a good faith determination has been made that the grantor is an organization described in § 509(a)(1).
3. *Expenditure Responsibility Rules.* Simplify and enhance application of the expenditure responsibility requirements imposed by § 4945 by providing safe harbor reporting periods for grants of capital assets or used to acquire capital assets.

¹⁷ Unless otherwise indicated, all section references from this point forward are to the Code of 1986, as amended, or to the Treasury regulations thereunder.

¹⁸ 22 U.S.C. § 288 (2009).

4. *Program-Related Investment Rules.* Update guidance under the program-related investment rules by providing additional examples of permitted program-related investments, focusing on international activities and using the 2002 recommendations from the Committee on Exempt Organizations of the American Bar Association Section on Taxation and its Task Force on Program-Related Investments (“PRI Task Force”).

Each of these recommendations has a direct impact on the international activities of private foundations. As described below, we believe that each one has significant potential to improve compliance while reducing compliance costs and enhancing philanthropic efforts outside the U.S.¹⁹

¹⁹ While we recognize that recommendations (2), (3) and (4) will have application to domestic as well as international activities by private foundations, we have included them in our report because of their importance in the international context. Moreover, we believe that the recommendations are equally appropriate in the domestic context on technical, administrative and policy grounds.

In addition, we note that our recommendations have direct application to private foundations. Based on our interviews with public charities having activities outside the U.S. and their advisors, two issues did emerge. First, as discussed above, they highlighted the same concern raised by private foundations concerning the chilling impact of the legislation known as the “Patriot Act” and its implementation by Treasury. The second area they identified focused on the activities of a limited number of large organizations with truly global operations. Here, the concerns focused on the need for reforms such as uniform and consolidated financial accounting and bilateral and multilateral treaty arrangements designed to harmonize certain charitable rules. While these concerns are legitimate and growing based on information we received, they raise complex questions and are well beyond the scope of the IRS and Treasury acting on unilateral bases. As a result, we believe these concerns are beyond the scope of this report.

General Background

Each of our recommendations deals with an aspect of the requirements coming out of the Tax Reform Act of 1969 (the “1969 Act”). That legislation established a detailed framework for regulating private foundations that expands on the rules otherwise applicable to all charities. As explained in more detail below:

- *Minimum Distribution Requirements.* Section 4942, implemented in the 1969 Act, added the requirement that nonoperating private foundations distribute amounts equal to five percent of their noncharitable-use assets. Among other things, § 4942 provides rules for when grants to certain organizations (generally, public charities and public charity equivalents) are qualifying distributions for this purpose. Further, § 4942(g)(1)(B) provides that investments held in furtherance of a charity’s exempt purpose may be treated as qualifying distributions for purposes of the minimum distribution requirements. Section 4942 imposes punitive excise taxes on a foundation for violating its minimum distribution requirement, with potential liability extending to the foundation’s managers.
- *Prohibition on “Taxable Distributions.”* Section 4945, implemented in the 1969 Act, prohibited foundations from making “taxable distributions.” Among other things, § 4945 provides that private foundations are in compliance with these requirements either by making grants to certain types of organizations (generally, public charities and public charity equivalents), or by exercising “expenditure responsibility” with respect to their grants. Section 4945 imposes punitive excise taxes on a foundation for violating the prohibition on taxable expenditures, with potential liability extending to the foundation’s managers.
- *Excess Business Holdings.* Section 4943, implemented in the 1969 Act, limited the extent to which private foundations may own businesses. One of the exceptions to this rule provides that “program-related investments” are not considered a business holding subject to the § 4943 limitations. Thus, investments that are substantially related to the foundation’s exempt purpose (aside from the need to produce income) are not subject to the excess business holdings limitations.²⁰
- *Jeopardizing Investments.* Section 4944 of the 1969 Act prohibited private foundations from making “jeopardizing investments” -- generally, investments that “may jeopardize the carrying out of exempt purposes” by failing to “provid[e] for the long- and short-term financial needs of the foundation.”²¹ In addition, § 4944 provides that program-related investments do not constitute jeopardizing investments.

²⁰ Treas. Reg. § 53.4943-1.

²¹ Treas. Reg. § 53.4944-1(a)(2).

By 1973, the IRS and Treasury had provided substantial regulatory guidance in each of these areas, with the exception of jeopardizing investments.

As in many areas of the tax law, the rules are detailed and complicated. For our purposes, however, the grantmaking framework is rather straightforward. In its foreign grantmaking activities, a private foundation effectively must grant to one of the following:

- (a) A foreign organization that has been determined to be equivalent to a U.S. public charity (i.e., the organization must meet the charitable standards of § 501(c)(3), and must meet the public support tests of § 509 such that it would not be treated as a private foundation for U.S. tax purposes) (an “equivalency determination”);
- (b) A foreign government or instrumentality or agency thereof; or
- (c) An international organization designated as such by executive order pursuant to 22 U.S.C. § 288.²²

Otherwise, the private foundation must exercise expenditure responsibility over its grant. In other words, private foundations must either make an equivalency determination or exercise expenditure responsibility in their foreign grantmaking (unless one of the governmental or international organization rules applies).

The IRS and Treasury have not updated the regulations issued during the early 1970s and have provided little precedential guidance since that time. The one action taken was an effort to simplify equivalency determinations in 1992 through issuance of Rev. Proc. 92-94 setting forth a “simplified” safe harbor method for making such determinations.

During the intervening years, various stakeholders have encouraged the IRS and Treasury to address rules that were promulgated more than 35 years ago. Thus, for example, in 1984, Congress instructed the IRS and Treasury to review the expenditure responsibility rules with a view to simplifying them. Thereafter, in connection with the issuance of Rev. Proc. 92-94, there was an expectation (or hope) in some quarters that the IRS itself would begin making equivalency determinations of benefit to grantmaking organizations, or that one or more private sector initiatives would lead to some kind of repository or equivalency library conferring similar benefits.

²² It should be noted that a number of organizations not based in the U.S. have obtained determination letters from the IRS reflecting their public-charity status. Pursuant to Treas. Reg. § 53.4945-5(a)(1), for purposes of private foundation grantmaking activities, these organizations are treated as U.S. public charities.

In 2002, the PRI Task Force urged the IRS and Treasury to provide additional examples of activities satisfying the program-related investment rules, with a particular emphasis on international programs.

In some cases, these suggestions reflect difficulties that have emerged with the rules as they were originally promulgated. In other cases, they reflect the growth in foreign grantmaking activities and changes in the nature and conduct of international philanthropy. As referenced at the outset of our report, we believe these are important trends that will continue and accelerate. In our view, and the view of those with whom we consulted, these steps will have significant impact in improving compliance while reducing compliance burdens and improving the efficiency and effectiveness of international philanthropy. We also note that the IRS has authority to implement our first recommendation and that the IRS and Treasury have the authority to implement the other three. While we recognize that all guidance projects require a meaningful investment of resources by the IRS and Treasury, we believe that our recommendations can be implemented with a relatively modest expenditure of resources both because they are narrowly focused and because of the substantial ongoing efforts in the charitable sector to address these issues.

Recommendation 1: Equivalency Determinations–Repository Proposal

We encourage the IRS to facilitate formation of EDIRs which would make equivalency determinations in accordance with the requirements of Rev. Proc. 92-94 (as updated from time to time) and procedures approved by the IRS that could be relied on by other charities.

In furtherance of this recommendation, we encourage the IRS to give high priority attention to the proposal of the Council on Foundations and TechSoup Global and any other organization seeking to establish an EDIR. We have not reviewed this proposal and express no views regarding its merits. However, we believe that it presents an opportunity for the IRS to develop standards for EDIRs. Ultimately the IRS should publish guidance regarding standards and procedures for EDIRs to obtain IRS approval.

Background. To avoid excise taxes under § 4945, private foundations must exercise expenditure responsibility when making grants to foreign organizations that have not obtained a § 501(c)(3) determination letter classifying them as public charities (other than so-called “nonfunctionally integrated type III supporting organizations”).²³ Similarly, to avoid tax under § 4966, sponsoring organizations of

²³ § 4945(d)(4)(A).

donor-advised funds must exercise expenditure responsibility over distributions to foreign organizations that have not obtained determination letters classifying them as described in §§ 170(b)(1)(A) or 509(a)(2). As an alternative to exercising expenditure responsibility, the regulations permit private foundations to make their own “equivalency determinations” as to their grantees’ tax classification in lieu of relying on an IRS determination letter.²⁴ The legislative history to § 4966 indicates that the same option will be available to donor-advised funds. An equivalency determination can be based upon either (i) an opinion from legal counsel that the foreign corporation is described in § 501(c)(3) and is a public charity or (ii) an affidavit from the foreign organization that the private foundation can use to make its own determination that the foreign organization is the equivalent of a § 501(c)(3) public charity.

Equivalency determinations present a particular set of challenges for international grantmakers. Until 1992, foundations that relied on equivalency determinations had no practical guidance from the IRS regarding when a foreign organization qualified as the equivalent of a § 501(c)(3) organization. Since 1978, the IRS has only issued approximately 20 private letter rulings with a reference to Treas. Reg. § 53.4945-5(a)(5), which creates the equivalency determination option. While many of these rulings involve grants to foreign organizations, we were told that many foundations rely on a combination of opinions of counsel and affidavits from the foreign organization rather than private letter rulings.²⁵

In 1992, the IRS issued Rev. Proc. 92-94 to provide guidance to taxpayers regarding equivalency determinations. The Rev. Proc. sets forth a “simplified” procedure that private foundations may use to make equivalency determinations with regard to foreign organizations.²⁶ In essence, the Rev. Proc. provides one method by which private foundations ensure that their grants qualify as qualifying distributions under § 4942 and are not taxable expenditures under § 4945.

The Issue. Despite the IRS’s well-intentioned efforts when it issued Rev. Proc. 92-94, equivalency determinations continue to be time-consuming and costly. In many instances, multiple charities obtain affidavits or opinions of counsel with respect to the same foreign organization. The result is duplicative costs and a potential lack of uniform standards.

Rationale for Recommendation (General). We believe that the establishment of one or more EDIRs will reduce the overall cost of obtaining equivalency determinations by making the same determination available to multiple parties and through the development of institutional experience and expertise. We also believe that EDIRs will enhance compliance through higher quality and more consistent

²⁴ Treas. Reg. § 53.4945-5(a)(5); Treas. Reg. § 53.4942(a)-3(a)(6).

²⁵ Treas. Reg. § 53.4942(a)-3(a)(6). Treas. Reg. § 53.4945-5(a)(5).

²⁶ Rev. Proc. 92-94, 1992-2 C.B. 507.

determinations.²⁷ At the time Rev. Proc. 92-94 was issued, the IRS suggested that “grantors could rely on an affidavit or opinion about a particular recipient prepared by another grantor” under the procedure,²⁸ but no mechanism was developed by either the IRS or the charitable sector to enable that sharing to occur. With the growth in global grantmaking, the need for such arrangements has become more pressing. But without IRS assurance that individual grantmakers can appropriately rely on an EDIR’s collected information and equivalency determinations, many grantmakers will likely feel constrained to continue performing their own equivalency determinations for foreign grantees.

Rationale for Recommendation (Council on Foundations). One such effort began several years ago when the Council on Foundations (the “Council”) entered into a collaboration with the Foundation Center, Independent Sector and InterAction to develop and implement an EDIR.²⁹ The collaboration has been supported by grants from the Amgen Foundation, Annenberg Foundation, BP Foundation, Carnegie Corporation of New York, Christensen Fund, Firelight Foundation, Bill and Melinda Gates Foundation, GE Foundation, F.B. Heron Foundation, William and Flora Hewlett Foundation, W.K. Kellogg Foundation, Kresge Foundation, John D. and Catherine T. MacArthur Foundation, Rockefeller Brothers Fund and Rockefeller Foundation.³⁰ On November 6, 2008, it was announced that TechSoup Global was selected as the repository administrator by a review panel of experts and foundations assembled by the Council.

According to its website, TechSoup Global is an organization that “bring[s] technological empowerment and philanthropy to social benefit organizations—including nonprofits, nongovernmental organizations, libraries and other social change agents.”³¹ The goal of the EDIR is to

[s]erve as a platform to streamline the process of qualifying non-U.S. grantees as the equivalents of U.S. public charities, also known as an equivalency determination (ED) process, one of the principal

²⁷ As a group, we have debated whether an EDIR should be limited to § 501(c)(3) organizations (either all charities or just public charities), to other exempt organizations as well, or whether an EDIR could be effectively operated in a profit organization. Some were drawn to the thought that the IRS might provide oversight if conducted in a § 501(c)(3) organization, while others felt this was a level of oversight that is unnecessary.

²⁸ James F. Bloom, Edward D. Luft & John F. Reilly, *Foreign Activities of Domestic Charities and Foreign Charities*, 21, FY 1992 EO CPE Text.

²⁹ It should be noted that while we wholeheartedly endorse the concept of EDIRs, we do not specifically endorse either the Council or its proposal.

³⁰ Information Age Associates, *Repository of Equivalency Determination (ED) Information on Non-U.S. Based NGOs*, <http://www.iaa.com/ngorepository.html> (last visited May 5, 2009).

³¹ TechSoup Global, *About Us*, <http://www.techsoupglobal.org/about-us> (last visited Apr. 5, 2009).

ways prescribed by the IRS for making cross-border grants.³²

It is anticipated that the repository will be launched by the end of 2010.³³

As part of a feasibility study on the formation of this EDIR, Information Age Associates conducted a survey to gain information regarding the importance of the EDIR initiative to the sector. The survey reported that of those responding, 86% of grantmakers and 75% of service providers responded that the availability of a centralized repository of vetted non-U.S.-based NGO information would be a significant benefit to U.S. philanthropy. In addition, 98% of NGOs responded that they would submit key information about their organizations and officers to a central repository and keep it up-to-date. Further, 77% of grantmakers agreed that a letter ruling from the IRS approving the centralized repository would be a key factor in their decision to become a member.³⁴

It is our understanding that a private letter ruling request regarding this EDIR was recently submitted to the IRS.³⁵ We have not reviewed that request and take no position one way or the other on its merits. However, we believe the private letter ruling process is the proper vehicle for this purpose because it permits the IRS to explore the concept in as much detail as it believes appropriate. Once the IRS is comfortable with the concept, it should provide guidance in a Rev. Proc. so that other interested parties can establish EDIRs. Another group, for example, might want to establish an EDIR focused on a particular type of philanthropy (e.g., health care or the environment) or a particular country or region of the world (e.g., Ireland or sub-Saharan Africa).

Recommendation 2: Characterization of Support From Certain Foreign Organizations as Unrestricted Public Support

We recommend that the IRS and Treasury publish guidance providing that for purposes of applying the foreign equivalency provisions of Treas. Reg. § 4945(d)(4)(A)(i) and Treas. Reg. § 53.4945-5(a)(5), and for purposes of applying the public support

³² TechSoup Global, *TechSoup Global to Host New Centralized Repository to Better Enable International Philanthropy*, <http://www.techsoupglobal.org/press/pressreleases/globalrepository> (last visited Apr. 5, 2009).

³³ *Id.*

³⁴ Information Age Associates, *Potential of Creating a Centralized Repository of Information on Non-U.S. Based NGOs: Findings and Recommendations, December 2006*, <http://www.iaa.com/resources/NGOFeasibilityStudyFindingsandRecommendations-Dec2006.pdf> (last visited May 5, 2009).

³⁵ Information Age Associates, *NGO Repository Project Update: Establishing a Centralized Repository of Equivalency Determination Information on Non-U.S. Based NGOs*, <http://www.iaa.com/resources/NGORepositoryPresentation-March2009.pdf> (last visited May 5, 2009).

tests under §§ 509(a)(1) and (2), grants from the following sources are treated as grants from § 509(a)(1) organizations:

- 1. Foreign governments (excluding foreign governments on the OFAC list of sanctioned countries);³⁶*
- 2. International organizations designated by executive order pursuant to 22 U.S.C. § 288; and*
- 3. Foreign organizations for which a good faith determination has been made that the grantor is an organization described in § 509(a)(1).*

Background: Private Foundation Status.³⁷ The Code draws important distinctions between public charities and private foundations, both with respect to the deductibility of charitable contributions they receive and how their activities are regulated. Rules governing the deduction of contributions to private foundations are more restrictive,³⁸ and their activities are heavily regulated through the private foundation excise tax rules of §§ 4941-4946.³⁹

³⁶ It has been suggested that we include an OFAC carve-out as a way of acknowledging concern over terrorist and rogue nation activities. Others suggest that it is not necessary and would create serious practical difficulties (e.g., would it be necessary to track indirect contributions?).

³⁷ The primary provisions addressing public charity and private foundation status are contained in §§ 509(a), 170(b)(1)(A) and 170(c) and the regulations thereunder. These rules are quite detailed and complex. Useful descriptions can be found in the following treatises: Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* (9th ed. 2007); Bruce R. Hopkins and Jody Blazek, *Private Foundations: Tax Law and Compliance* (2d ed. 2003), Frances R. Hill and Douglas Mancino, *Taxation of Exempt Organizations* (2002).

³⁸ To take some examples, the adjusted gross income limitation on charitable contribution deductions is lower for contributions to private foundations in § 170(b)(1)(B). Deductions for contributions of tangible personal and real property generally are limited to tax basis unless the private foundation is an operating foundation or qualifies as a conduit or common fund foundation under § 170(b)(1)(A)(vii). Under § 170(e)(5), there are various conditions that must be met to deduct the fair market value of stock contributed to a private non-operating foundation.

³⁹ Section 4941 imposes sanctions on self-dealing transactions; § 4942 imposes sanctions on failures to satisfy minimum distribution obligations; § 4943 imposes sanctions on excess business holdings; § 4944 imposes sanctions on jeopardizing investments; and § 4945 imposes sanctions on “taxable expenditures” (grants where a private foundation fails to exercise expenditure responsibility or fails to make a good faith determination that the organization is equivalent to a §§ 509(a)(1), (2), or (3) organization). Section 4946 defines certain terms used in §§ 4941-4945, including “disqualified persons” (Treas. Reg. § 4946-1(a)) and “foundation managers” (Treas. Reg. § 4946-1(f)). Disqualified persons include substantial contributors and foundation managers, those with significant ownership interests in substantial contributors, organizations in which substantial contributors and foundation managers have substantial ownership interests, and family members of the foregoing. In general, a substantial contributor is defined in § 507(d)(2) as any contributor who provides more than two percent of the total contributions to the organization. A substantial contributor remains a substantial contributor unless, during any consecutive 10-year period: (i) neither the contributor nor any related person

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An organization described in §§ 509(a)(1) or (2) is not a private foundation.⁴⁰ In general, § 509(a)(1) organizations are: (1) charities whose activities are viewed as inherently “public” in nature (such as churches, schools and hospitals) (often known as “*per se* public charities”); (2) domestic governmental units (the U.S. and its possessions, states, and the District of Columbia, including political subdivisions); and (3) charities that normally derive a substantial part of their support from the public (often known as “publicly supported charities”).⁴¹ § 509(a)(2) organizations are charities that normally derive a substantial part of their support from the performance of their exempt purposes, together with gifts, grants and contributions from the public (often known as “activity-supported charities”).⁴²

In the case of § 509(a)(1) publicly supported charities, the regulations impose a two-percent limit on the amount of gifts, grants and contributions from the public that can be taken into account in computing the level of public support. Generally, this limitation does not apply to support received by § 509(a)(1) organizations from other §§ 509(a)(1)/170(b)(1)(A)(iv) organizations.⁴³

In the case of § 509(a)(2) activity-supported charities, the regulations restrict gifts, grants, contributions and program service revenue from disqualified persons (substantial contributors and other disqualified persons). § 509(a)(1) has no such limitation. In addition, § 509(a)(2) imposes a one percent limitation on contribution and program service revenue received from individuals and organizations that are not disqualified persons. Generally, the one percent limit does apply to support received from organizations described in § 509(a)(1).⁴⁴

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makes additional contributions to the organization; (ii) neither the contributor nor any related person is a foundation manager of the organization; and (iii) contributions from the substantial contributor and related persons are “insignificant” when compared to contributions by any one other person.

⁴⁰ § 509(a) also provides that supporting organizations described in § 509(a)(3) and organizations that test for public safety (§ 509(a)(4)) are not private foundations. Recently enacted legislation does subject so-called “non-functionally-integrated-type III” supporting organizations and donor-advised funds to certain of the private foundation rules (e.g., §§ 4943(e) and (f)).

⁴¹ §§ 170(b)(1)(A) (other than clauses (vii) and (viii)) and 509(a)(1). See also Treas. Reg. §§ 1.170A-9 and 1.509(a)-2 as well as the 2008 instructions to Schedule A of the Form 990.

⁴² § 509(a)(2). See also Treas. Reg. § 1.509(a)-3 and the 2008 instructions to Schedule A of the Form 990.

⁴³ The two-percent limitation does not apply to contributions or grants from organizations that are non-private foundations pursuant to §§ 509(a)(1)/170(b)(1)(a)(iv), governmental units described in 170(b)(1)(A)(v) and other organizations, such as the following, but only if they also qualify as publicly supported organizations under § 170(b)(1)(A)(iv): churches described in § 170(b)(1)(A)(i), educational institutions described in § 170(b)(1)(A)(ii), and hospitals described in § 170(b)(1)(a)(iii).

⁴⁴ Treas. Reg. § 1.509(a)-3(j)(1).

For convenience, gifts, grants, contributions and other forms of support that are subject to the two-percent and one-percent or disqualified-person limitations of §§ 509(a)(1) and (2) are hereafter referred to as “limited” and support that is not subject to those limitations is referred to as “unlimited.”

Background: Grants from U.S. Private Foundations to Foreign Organizations.

Treas. Reg. §§ 53.4945-5(a)(4) and (5) provide that grants to the following organizations will not be subject to the expenditure responsibility requirements of § 4945: (1) a foreign charity, if the private foundation makes a good faith determination that the organization is described in §§ 509(a)(1), (2) or (3); (2) a foreign government, including agencies and instrumentalities thereof; and (3) an international organization designated as such by executive order pursuant to 22 U.S.C. § 288 even if not otherwise described in § 501(c)(3). Examples of organizations so designated include the United Nations, UNICEF, UNESCO, the World Bank and the International Monetary Fund.

The Issue: Characterization of Support from Foreign and Designated Multinational Organizations.

If a U.S. charity receives support from a foreign organization, it must determine whether that support is limited or unlimited. Likewise, if a U.S. private foundation is making a § 4945 equivalency determination in connection with a grant to a foreign charity that receives support from other foreign organizations, it must determine whether that foreign organization support is limited or unlimited. This issue arises in three circumstances: i) grants from foreign organizations that have not received determination letters from the IRS but are equivalent to § 509(a)(1) *per se* or publicly supported charities; (ii) support from foreign governments; and (iii) support from international organizations designated by executive order.

Grants from Per Se and Publicly Supported Foreign Charities. While the IRS and Treasury have provided no published guidance that is directly on point, it is generally accepted that grants from foreign organizations that are equivalent to § 509(a)(1) organizations are not limited in determining whether the recipient charity is described in §§ 509(a)(1) or (2).⁴⁵ This conclusion applies to support provided to U.S. charities (where the issue is determining their status under §§ 509(a)(1) or (2)), and support provided to foreign charities (where the issue is making equivalency determinations).

- *Grants from Foreign Governments.* In 1975, shortly after the private foundation rules were enacted in 1969, the IRS and Treasury provided guidance regarding

⁴⁵ While there is no published authority specifically addressing this question, Treas. Reg. § 1.509(a)-2(a) (a charitable organization described in § 170(b)(1)(A)(i)-(vi) is not a private foundation despite failing to satisfy the requirements of § 170(c)(2) because it is a foreign organization) and Treas. Reg. § 53.4945-5(a)(5) support this conclusion. It is also supported by the holding and rationale of Rev. Rul. 75-435, 1975-2 C.B. 215, discussed below, as well as the policies giving rise to the private foundation rules.

the treatment of support provided by a foreign government to a foreign charity.⁴⁶ The ruling concluded that “[a]n exempt organization organized in a foreign country and receiving a substantial portion of its support from a foreign government is not a private foundation as defined in § 509(a) of the Code.”⁴⁷ The ruling does not contain geographic limitations (i.e., the holding is not limited to support provided by foreign country A to a charity organized in foreign country A). While not addressed on the facts in the ruling, the ruling’s rationale applies with equal force to grants by a foreign government to a U.S. charity for purposes of determining whether the recipient is described in § 509(a)(1) or (2).

Unfortunately, internal exchanges between two IRS offices in 1977 and 1980 cast something of a cloud over Rev. Rul. 75-435 when they were subsequently released during the 1980s.⁴⁸ Nonetheless, Rev. Rul. 75-435 has now been outstanding for 34 years and should be controlling authority regarding the treatment of support provided by foreign governments.

- *Support From International Organizations Designated by Executive Order.* Unlike the situation involving foreign governments, there is no guidance providing that designated organizations are not treated as private foundations. In the absence of such guidance, support provided by such organizations is limited.

Need for Guidance. During our review, we heard repeatedly that there is pressing need for guidance regarding the characterization of support from foreign governments, foreign charities that are equivalent to *per se* and publicly supported charities described in § 509(a)(1) and multinational organizations.⁴⁹ We will refer to these organizations as “Non-U.S. Public Organizations.”

⁴⁶ Rev. Rul. 75-435

⁴⁷ Issuance of the ruling was approved by the Interpretative Division of the Office of Chief Counsel in G.C.M. 36115 (Dec. 20, 1974).

⁴⁸ In G.C.M. 37001 (Feb. 10, 1977), the Interpretative Division of the Office of Chief Counsel did not approve of a ruling that the Assistant Commissioner (Employee Plans and Exempt Organizations) proposed issuing that would have explicitly extended Rev. Rul. 75-435 to support provided by foreign governments to U.S. charities. Thereafter, in G.C.M. 38327 (Mar. 31, 1980), the Interpretative Division “tentatively” concluded that Rev. Rul. 75-435 was incorrectly decided under the existing regulations, while concurring that the ruling should not be withdrawn and maintaining that the issue of foreign government support should be addressed in regulations. No action has been taken during the intervening 29 years and Rev. Rul. 75-435 remains outstanding.

⁴⁹ As evident from Rev. Rul. 75-435, the question of how to treat foreign government support of foreign charities has been an issue since the private foundation regime was first enacted. The ruling was a timely response to the fact that in many other parts of the world, governments have been a primary source of support for foreign charitable organizations. The same applies for grants from private foundations to foreign organizations, as evident from Treas. Reg. §§ 53.4945-5(a)(4) and (5). While these issues have been around for decades, they have

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As an immediate and practical matter, EDIRs require guidance on these issues to make appropriate equivalency determinations. Likewise, donor-advised funds and supporting organizations were recently made subject to the expenditure responsibility rules—they, too, need guidance on these issues. More generally, as noted at the outset of our report, cooperative efforts by nations, multinational organizations, and U.S. and foreign charities are increasingly common in efforts to address natural disasters and global challenges relating to the environment, health care, education, poverty and inequality, genocide, human trafficking and discrimination and civil society and security. The funding arrangements associated with these activities inevitably raise the question of how to characterize support provided by Non-U.S. Public Organizations under current law and as a policy matter.

Rationale for Recommendations. There was widespread agreement among private foundations, advisors and academics with whom we spoke regarding the following:

(1) grants from foreign charities that are equivalent to *per se* and publicly supported charities as described in § 509(a)(1) likely are and certainly should be treated for all purposes as unlimited; (2) support from foreign governments is and should be treated for all purposes as unlimited; and (3) while support from designated multinational organizations is currently limited, this result is not compelled by the statute, is inconsistent with policies underlying the private foundation rules, and should be changed. They further observed that while the law as described is reasonably clear, there is a lack of published guidance that is directly on point (except with respect to foreign government support provided to foreign charities), and that additional uncertainty has been caused by the guidance referenced above.

They also note that nothing in the statute or accompanying legislative history precludes treating support from Non-U.S. Public Organizations as unlimited. Following are among the primary policy arguments made by those with whom we spoke supporting this treatment:

- Support from domestic governmental entities and support from U.S. *per se* and publicly supported 509(a)(1) charities are considered unlimited. The same policy considerations apply with equal force to Non-U.S. Public Organizations (excluding support from foreign governments on the OFAC list of sanctioned countries).⁵⁰

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assumed far greater importance as international philanthropy has evolved during the past 40 years since enactment of the 1969 Act.

⁵⁰ As of the date of this writing, the OFAC list of sanctioned countries currently includes: the Balkans, Belarus, Burma, Ivory Coast, Cuba, Democratic Republic of the Congo, Iran, Iraq, the former Liberian Regime of Charles Taylor, North Korea, Sudan, Syria and Zimbabwe. Office of
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- Grants to Non-U.S. Public Organizations are not subject to the § 4945 expenditure responsibility rules under Treas. Reg. §§ 53.4945-5(a)(4) and (5). Because these organizations are treated as § 509(a)(1) organizations when they are **receiving** funds, the same logic suggests that they should be treated as § 509(a)(1) organizations when they are **providing** funds.
- Increasingly, U.S. and foreign charities involved in global philanthropy receive a meaningful portion of their support from Non-U.S. Public Organizations. Treating this support as limited for purposes of §§ 509(a)(1) and for purposes of § 4945 equivalency determinations could result in classifying the recipients as private foundations for U.S. purposes. In turn, this outcome (or risk of this outcome) would have several adverse effects. It would likely distort or undermine certain types of international philanthropic efforts, deter new organizations with these sources of support from organizing in the U.S. and marginalize the role of U.S.-based charities in important and evolving patterns of international philanthropy.
- More generally, treating as unlimited the support provided by Non-U.S. Public Organizations is consistent with important, non-tax international and diplomatic initiatives of the U.S. government.

Specific Recommendations. Based on the foregoing, our understanding is that the IRS will apply Rev. Rul. 75-435 as current law in issuing private letter rulings regarding equivalency determinations, including with respect to EDIR proposals, and in published guidance regarding EDIRs. To properly reflect its holding and analysis, the IRS should not read a same-country limitation into Rev. Rul. 74-435.

We recommend that the IRS confirm that it will apply the analysis of Rev. Rul. 75-435 to treat foreign government support as unlimited support for all purposes of § 509(a). For the reasons set forth above, we believe this is the right policy answer and is consistent with the holding and analysis in Rev. Rul. 75-435—a pronouncement that has now been on the books for 34 years.

We recommend that the IRS and Treasury provide guidance in a revenue ruling or through regulations that support from U.S. government-designated international organizations is treated as unlimited support for all purposes of § 509(a).

We further recommend that the IRS and Treasury provide guidance in a revenue ruling or regulations that for purposes of Treas. Reg. § 53.4945-5(a)(4) and Rev. Rul. 75-435 support from foreign governments on the OFAC list of sanctioned countries is not treated as unlimited support for purposes of § 509(a).

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Foreign Assets Control, *OFAC Country Sanctions Programs*,
www.ustreas.gov/offices/enforcement/ofac/programs (last visited May 5, 2009).

Recommendation 3: Expenditure Responsibility Reporting Requirements

We recommend that the IRS and Treasury simplify and enhance application of the expenditure responsibility requirements imposed by § 4945 by providing safe harbor reporting periods for grants of capital assets or used to acquire capital assets.

Background. A private foundation must exercise “expenditure responsibility” if it wishes to make a grant to a foreign organization that has not been determined to be equivalent to a U.S. public charity, is not a foreign government or instrumentality or agency thereof, and is not an international organization such as the United Nations, the World Health Organization, the Southeast Asia Treaty Organization, the International Monetary Fund, the International Labor Organization or the International Bank for Reconstruction and Development, designated by executive order pursuant to 22 U.S.C. § 288.⁵¹

The expenditure responsibility rules prescribe a detailed, multi-step process that the granting private foundation and the recipient grantee organization must complete over the course of the grant to ensure that the grant is not a prohibited taxable expenditure. In general, to exercise expenditure responsibility, a private foundation must exert all reasonable efforts and to establish adequate procedures (1) to see that the grant is spent solely for the purposes for which made, (2) to obtain full and complete reports from the grantee on how the funds are spent, and (3) to make full and detailed reports with respect to such expenditures to the IRS.⁵²

The regulations under § 4945(d) mandate a procedure by which a private foundation may conduct expenditure responsibility:

- *Pre-Grant Inquiry.* Prior to making the grant, the private foundation must conduct a “pre-grant inquiry” regarding the grant recipient and the anticipated use of the grant. This inquiry should be complete enough to provide reasonable assurance that the grantee will use the grant for the proper purposes. The granting foundation need not conduct a pre-grant inquiry if it has previous experience with a particular grantee and that grantee has properly used all prior grants and filed the required substantiating reports.⁵³
- *Grant Limitations.* The grant agreement must clearly specify the purposes of the grant, and, to account for differences between U.S. law and the law of the foreign jurisdiction, the agreement must impose restrictions on the use of the grant substantially equivalent to the limitations imposed on a U.S. private

⁵¹ Treas. Reg. § 53.4945-5(a).

⁵² § 4945(h).

⁵³ Treas. Reg. § 53.4945-5(b)(2).

foundation. To ensure that the agreement meets this requirement, the grantor or grantee must obtain an affidavit or opinion of counsel stating that the restrictions on the use of the grant under foreign law or custom are substantially equivalent to those imposed on a U.S. private foundation.⁵⁴

- *Grant Terms.* In addition, the grant agreement must provide that the grantee agrees to the following terms: (i) to repay any portion of the amount granted which is not used for the purposes of the grant; (ii) to submit full and complete annual reports on the manner in which the funds are spent and the progress made in accomplishing the purposes of the grant; (iii) to maintain records of receipts and expenditures and to make its books and records available to the grantor at reasonable times; and (iv) not to use any funds to influence legislation; to influence any specific public election or to carry on a voter registration drive; to make a grant to an individual for travel, study, or other similar purposes unless certain requirements are satisfied; or to undertake any activity for other than charitable purposes.⁵⁵
- *Segregated Account.* A foreign grantee organization that does not have a U.S. determination letter generally must hold grant funds in a segregated account dedicated exclusively for the charitable purposes unless the foundation manager can make a “reasonable judgment” that the foreign organization is described in § 501(c)(3).⁵⁶
- *Grantee Reporting—General.* Expenditure responsibility also requires extensive reporting from the grantee on the use of the grant funds. Specifically, the grantee must report on the use of the funds, compliance with the terms of the grant, and the progress made by the grantee toward achieving the purposes for which the grant was made.⁵⁷ The grantee generally must make such reports every year until the “grant funds are expended in full.” In addition, the grantee must make a final report with respect to all expenditures made from the grant funds (including salaries, travel, and supplies) and indicating the progress made toward the goals of the grant after the grant is completed. The grantor need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability.
- *Grantee Reporting—Capital Assets.* As noted above, grantees are required to report annually until the funds are expended in full. There is no guidance regarding the application of this requirement in the context of grants of capital assets or used to acquire capital assets. There are, however, special rules for reporting in connection with grants to private foundations for the purchase of

⁵⁴ Treas. Reg. §§ 53.4945-5(b)(3)-(5).

⁵⁵ Treas. Reg. § 53.4945-5(b)(3).

⁵⁶ Treas. Reg. § 53.4945-5(c).

⁵⁷ Treas. Reg. § 53.4945-5(c)(1).

capital equipment, for endowment, or for other capital purposes.⁵⁸ Under these rules, the grantor foundation may discontinue the requirement to obtain annual reports from the grantee foundation two years after the year in which the grant was made if it is “reasonably apparent” to the grantor foundation that neither the principal, the income, nor any equipment purchased with grant funds has been used for any purpose which would result in a taxable expenditure.

The exception only applies for grants to another private foundation—if the grantee is not a private foundation, the grantee must report for the life of the asset (and the foundation must provide reporting to the IRS as long as it is required to obtain reports from its grantee). Foreign organizations are not eligible for the exception to the grantee reporting requirements unless they have a determination letter that they are exempt from tax under § 501(a).

- *Grantor Reporting.* The grantor private foundation must provide information to the IRS regarding each grant requiring it to exercise expenditure responsibility when it files its annual Form 990-PF. The information must include: (i) the name and address of the grantee; (ii) the date and amount of the grant; (iii) the purpose of the grant; (iv) the amounts expended by the grantee (based upon the most recent report received from the grantee); (v) whether the grantee has diverted any portion of the funds (or the income from them in the case of an endowment grant) from the purpose of the grant (to the knowledge of the grantor); (vi) the dates of any reports received from the grantee; and (vii) the date and results of any required verification of the grantee’s reports.⁵⁹
- *Grantor Recordkeeping.* The grantor private foundation also must retain the following documents to provide to the IRS upon request: a copy of the grant agreement, copies of the grantor reports, and copies of reports made by the grantor’s personnel or independent auditors concerning any investigations made during the course of the grant.⁶⁰

Issues. There appears to be widespread recognition that the expenditure responsibility rules are potentially quite burdensome in many circumstances. For example, the legislative history to the Deficit Reduction Act of 1984 reflected congressional concern that the reporting requirements imposed on private foundations under Treas. Reg. § 53.4945-5(d) were too burdensome. The conference report accompanying the legislation explained the issue:

⁵⁸ Treas. Reg. § 53.4945-5(c)(2); *Charles Stewart Mott Foundation v. United States*, 938 F.2d 58 (6th Cir. 1991) (holding that a private foundation’s purchase of debentures from a community development corporation that was not a private foundation was a capital expenditure that was ineligible for the two-year reporting exception from the grantee and grantor reporting requirements).

⁵⁹ Treas. Reg. §§ 53.4945-5(d)(1)-(2).

⁶⁰ Treas. Reg. § 53.4945-5(d)(3).

The conference committee reaffirms the central purpose of the expenditure responsibility rules—to ensure that foundation grants will be properly used by the recipient organization solely for exempt purposes. At the same time, because the committee is concerned whether implementation of the statutory requirements in Treasury regulations may have added unduly burdensome or unnecessary requirements in some respects (which may operate to deter grants by some foundations to newly formed, community-based foundations), the conference agreement follows the approach under the House bill and the Senate amendment in directing the Treasury to review its expenditure responsibility regulations for purposes of modifying any requirements which are found to be unduly burdensome or unnecessary. As part of its review, the Treasury is to modify the required grantor reports to the IRS. The Treasury is to report to the tax-writing committees on its review and modifications.⁶¹

We have been unable to determine whether Treasury complied with this directive and, in any event, the relevant regulations have not been amended since issued in 1973 and to our knowledge, the IRS and Treasury have not issued any published guidance otherwise modifying or clarifying the rules.

During our review, the primary concern voiced by those dealing with the expenditure responsibility requirements was the lack of certainty in reporting periods applicable to grants of capital assets or for the acquisition of capital assets. Depending upon the particular circumstances, approaches used or considered by grantmakers and their advisors to establish reporting periods included, for example, the cost recovery period for financial (or tax) accounting purposes; the special two-year rule applicable to grants to private foundations; actual disposition through sale or abandonment of the asset; or, the point at which all funds are “expended” to acquire the asset.

⁶¹ H.R. Conf. Rep. No. 961, 98th Cong., 2d Sess., 1984 U.S.C.C.A.N. 1445, 1779. See also *Deficit Reduction Act of 1984—Private Foundation and Miscellaneous Provisions*, 12, 1985 EO CPE Text. (“Although no statutory change was made, the Conference Committee Report that accompanied H.R. 4170 directs the Treasury Department to review the expenditure responsibility requirements in the regulations underlying IRC 4945 to determine whether any of these requirements are unduly burdensome or unnecessary. As part of its review, the Treasury Department was specifically directed to modify the requirements for grantor reports to the IRS (Reg. 53.4945-5(d)). In requesting this review, Congress was concerned whether the existing regulations might operate to deter grants by some foundations to newly formed, community-based organizations. Until these modifications are made, the existing provisions of these regulations will remain in effect.”)

Three general observations emerged from our review. First, this uncertainty can deter or distort international grantmaking of capital assets or for the acquisition of capital assets. Second, as the focus of international philanthropy has shifted to issues such as the environment, health care and education, grants that provide or fund capital assets have become far more important, and the reporting requirements a far greater barrier to effective philanthropy. Following are examples of funding activities that can be impeded or distorted by the current rules: the installation of water purification systems and renewable energy equipment; the purchase and permanent dedication of land for environmental preservation; the acquisition of health care assets ranging from hospital beds to complex diagnostic equipment to mobile medical clinics; and funding for the construction of schools and the purchase of school supplies. Third, the rules can be especially harsh where funds expended for capital assets are small in absolute terms or relative to the overall focus of the grant (e.g., \$10,000 to purchase miscellaneous medical equipment for use in a hospital; a grant where the reasonable anticipation is that capital asset purchases will be less than five or ten percent of the entire grant amount).

Recommendation. We recommend that the IRS provide safe harbor reporting requirements for grants of or to purchase capital assets. Following is our suggested framework:

- Provide a “when expended” rule for capital assets whose use is inherently in furtherance of the intended charitable purpose. Examples in the environmental context include the installation of water purification systems and renewable energy equipment; medical equipment with limited non-medical use potential and the purchase and permanent dedication of land for environmental preservation. Consideration should be given to publishing a Rev. Proc. which contains a safe harbor list of such inherently charitable use assets.
- Provide a “when expended” rule for capital assets having relatively nominal cost expenditures.
- Provide a “when expended” rule for capital assets where the grantmaker reasonably expects that capital asset acquisitions will not exceed stated percentage of the total grant amount.

In situations where the first three approaches are not appropriate, provide one or more safe harbor periods for assets whose use is not inherently in furtherance of the intended charitable purpose and other assets not subject to the foregoing “when expended” rules. One approach would be to provide the same period for all capital assets (e.g., three years following the year the funds are expended). An alternative approach would be to provide several different reporting periods depending on the type of asset. For example, specified assets such as land and buildings could be subject to a longer reporting period (e.g., seven years).

Consistent with the purpose for the expenditure responsibility rules, the terms of grants of capital assets or funds used to purchase capital assets should require that grant recipients report to the grantmaker during any year in which the asset is used for a noncharitable purpose or is disposed of (in which case the grant recipient should report on the use of proceeds or other consideration received in exchange). The grantmaker would be required to report such information to the IRS for its taxable year in which such exception reporting occurs and take such circumstances into account in making any further grants to the recipient organization.

Recommendation 4: Program-Related Investments

We recommend that the IRS and Treasury update guidance under the program-related investment rules by providing additional examples of permitted program-related investments, focusing on international activities and using the 2002 recommendations from an informal working group made up of members of the PRI Task Force as a starting point.

Background. Private foundations sometimes engage in activities that are structured as investments, but that have a primary purpose other than the production of income. These are referred to as program-related investments (“PRIs”).

A PRI is an investment “the primary purpose of which is to accomplish one or more of [certain generally exempt-type] purposes . . . and no significant purpose of which is the production of income or the appreciation of property.”⁶² Permitted purposes include “religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.”⁶³ PRIs are not subject to the excess business holding rules of § 4943,⁶⁴ and may also be treated as “qualifying distributions” for purposes of the minimum distribution rules.⁶⁵ Moreover, if an investment qualifies as a PRI, it will not “be considered as [an] investment . . . which jeopardize[s] the carrying out of exempt purposes.”⁶⁶

⁶² § 4944(c).

⁶³ § 170(c)(2)(B).

⁶⁴ Treas. Reg. § 53.4943-10(b).

⁶⁵ Treas. Reg. § 53.4942(a)-3.

⁶⁶ § 4944(c).

The Issue. The regulations under § 4943 provide substantial detail about which investments qualify as PRIs.⁶⁷ In particular, the regulations rely on a series of examples to illustrate the relevant principles. However, these regulations date to 1972.⁶⁸ They do not explicitly address cross-border PRIs.⁶⁹ Moreover, the examples do not adequately reflect the evolution of PRIs over the last 35 years. David Chernoff, a prominent commentator and authority on private foundation grantmaking, refers to them as “stale.”⁷⁰ Chernoff, in a 2001 article, deplors the absence of examples in the PRI regulations regarding foreign activity, writing:

Today, there is considerably more grantmaking in foreign countries by U.S. charities than there was 30 years ago. One of the 11 projects on the Service’s guidance priority list for 2000 was guidance on private foundations’ assistance to foreign entities. That need continues.⁷¹

In 2002, the PRI Task Force convened on the subject submitted comments to the IRS proposing that the examples in the regulation should “be supplemented to reflect grantmaking philosophy and practices, international social and economic realities, and forms of doing business emerging in the 21st [c]entury.”⁷² The PRI Task Force proposed a series of new examples for the regulations that define PRIs.

The PRI Task Force’s suggested examples address a number of issues including several international ones. In fact, seven of the ten suggested examples pertain directly to the international context. The proposal asks the IRS to specify that “[i]f an activity is charitable when conducted in the U.S., it is likewise charitable when conducted in a foreign country.”⁷³ In addition, the proposed examples discuss several other points relating to cross-border investments. For instance, they would clarify that “[r]aising the living standards of needy families in underdeveloped or developing countries serves a charitable purpose,”⁷⁴ and that “[n]ot just the presence of a ‘significant’ financial return, but the presence of a seemingly high projected rate of return should not, by itself, prevent a foreign investment from qualifying as a program-related investment.”⁷⁵

⁶⁷ Treas. Reg. § 53.4944-3(b).

⁶⁸ Treas. Reg. § 53.4944-3.

⁶⁹ Treas. Reg. § 53.4944-3(b).

⁷⁰ David S. Chernoff, *Outdated Regulations Hamper Foundations Making Foreign Program-Related Investments*, 12 J. of Exempts 248 (May/June 2001).

⁷¹ *Id.*

⁷² Section on Taxation, American Bar Association, *Draft Examples of Program-Related Investments (“PRIs”) (for addition to Treas. Reg. Sec. 4944-3(b)) and Analysis of Each 1 (2002)*.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

Rationale for Recommendation. Based on our review, there is widespread agreement within the sector that the need to provide additional guidance under the PRI rules is even more pressing today than it was in the past. The IRS and Treasury should provide guidance that builds on the examples suggested by the examples proposed by the PRI Task Force. Providing additional guidance serves a compliance function. The PRI landscape has changed and will continue to evolve. By providing examples that reflect current practices, the IRS and Treasury can use the guidance as a way to help establish a useful framework for foundations and their advisors. While our focus is on international philanthropy, we believe the guidance should not be limited in that fashion because significant philanthropic innovations are also occurring domestically.

While the initial set of PRI examples was provided in the regulations, we recommend that the IRS issue additional guidance through one or more revenue rulings. The existing regulations and examples establish the basic guiding principles and we do not believe that they need to be modified. Rather, the examples proposed by the PRI Task Force are meant merely to clarify how those rules apply to new forms of PRIs. The virtue of the revenue ruling process, in addition to the fact that it is less resource-intensive, is that it provides the kind of flexibility that will be needed to respond to ongoing developments in the field.

Appendix A. Organizations and Individuals Consulted

Below is a list of organizations and individuals we have consulted. Not every organization or individual expressed views on every topic, nor did they express identical views on issues where they did voice an opinion. We have attempted to assemble and fairly reflect the views expressed, and take full responsibility for any errors or omissions. We also emphasize that we have not attempted to characterize or summarize the views of government representatives with whom we spoke regarding any aspect of our Report.

Organizations

Amnesty International USA, New York, NY

Church of Jesus Christ of the Latter-Day Saints, Salt Lake City, UT

Bill and Melinda Gates Foundation, Seattle, WA

GAVI Alliance, Geneva, Switzerland

William and Flora Hewlett Foundation, Menlo Park, CA

International Center for Not-for-Profit Law, Washington, DC

John D. and Catherine T. MacArthur Foundation, Chicago, IL

Rockefeller Brothers Fund, Inc., New York, NY

The Skoll Foundation, Palo Alto, CA

St. Jude Children's Research Hospital, Memphis, TN

Wheelchair Foundation, Danville, CA

Practitioners

Betsy Buchalter Adler, Adler & Colvin, San Francisco, CA

Jody Blazek, Blazek & Vetterling LLP, Houston, TX

Victoria B. Bjorklund, Simpson, Thacher & Bartlett, New York, NY

Michael W. Durham, Caplin & Drysdale, Washington, DC

John A. Edie, PricewaterhouseCoopers, Washington DC

Diara M. Holmes, Caplin & Drysdale, Washington, DC

Andras Kosaras, Arnold & Porter , Washington, DC

Douglas Mancino, McDermott, Will & Emery, Los Angeles, CA

Celia Roady, Morgan, Lewis & Bockius, Washington, DC

Suzanne Ross McDowell, Steptoe & Johnson, Washington, DC

Marcus Owens, Caplin & Drysdale, Washington, DC

Jane Searing, Clark Nuber, Seattle, WA

Randy Snowling, Deloitte Tax LLP, Washington, DC

Douglas Varley, Caplin & Drysdale, Washington, DC

Academics

Harvey P. Dale, New York University School of Law, New York, NY

Jill S. Manny, New York University School of Law, New York, NY

Christopher Stone, Kennedy School of Government, Harvard University,
Cambridge, MA

Governmental Officials

Tamara Ashford, Internal Revenue Service

David Fish, Internal Revenue Service

Karin Gross, Internal Revenue Service

Emily M. Lam, Department of the Treasury, Office of Tax Policy

Lois G. Lerner, Internal Revenue Service

Catherine E. Livingston, Internal Revenue Service

Theresa Pattara, U.S. Senate Committee on Finance

Ronald J. Schultz, Internal Revenue Service

Tiffany Smith, U.S. Senate Committee on Finance

Nancy Todd, Internal Revenue Service

Cindy Westcott, Internal Revenue Service