

Being charitable in the United States

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The US Council on Foundations estimates that there has been a 500% increase in donations to foreign charities by US persons since 1990. The US Census Bureau estimates that the number of immigrants to the US has increased only 200% since 1990. Support of foreign charities by US donors will continue despite the obstacles placed on such donations by the US law.

Rigid, inconsistent rules on such donations are imposed by the US Internal Revenue Code (the “Code”) and act as obstacles to foreign charities collecting donations from US donors. The rules are justified by the US Internal Revenue Service (“IRS”), as the price for allowing US tax payers to claim a deduction for charitable donations and reduce the donors’ US net taxable income. The rules are neither rational nor justified.

Because of experiences with foreign charities linked to Al Qaeda, donations to all foreign charities are now suspect. US donors are asking: “How do I make a foreign charitable donation in the present environment?” Foreign charities are asking: “How do we collect donations from US donors?” The purpose of this paper is to explain the rules in the context of cases handled by the author.

Determined Dancer

Dancer defected from a Russian ballet company (the “Ballet”). Because of her training, Dancer earned substantial worldwide income and wanted to donate USD200,000 of US earnings to support the Ballet after state subsidies declined. Can Dancer make a donation directly to the Ballet? Is the donation deductible in

calculation of Dancer’s US taxable income? How does the Ballet collect the donation from Dancer?

Obligated Orphan

Orphan was raised in a Vietnamese orphanage run by a church (“Orphanage”). The biological father brought Orphan to the US where he became a US citizen, started a corporation and made lots of money. Orphan wants the corporation to donate funds to the Orphanage. Can the corporation make a USD500,000 deductible contribution directly to the Orphanage? How does the Orphanage collect the donation without registration as a US charity?

Samoa All-Stars

A Samoan All-Star Rugby Club (the “Club”) asked the Southern California Rugby Federation to finance a tour. A former US Eagle (“Eagle”) was the administrator of assets of a former teammate who died in an auto crash when the Eagles toured Samoa in 1988. Eagle agreed to pay expenses from assets under Eagle’s administration. Can Eagle pay the travel expenses of the Club to the US? Pay for uniforms? The post game party? How does the Club collect the donation?

Rabbi Rob

Rabbi grew up in Brooklyn, NY and became an Israeli citizen. Rabbi runs a religious school in a West Bank settlement (the “School”) and asked one of his childhood friends, David, to support the School from his US family foundation (“Foundation”). David agreed to donate USD100,000 to the School. How does the

School collect the donation from the Foundation?

Herbal Hazel

Hazel was injured while visiting Mexico on a church tour. Her eyesight was saved by a doctor at a local clinic. Upon her return to the US, Hazel wanted to make a donation to the doctor. Can Hazel donate USD10,000 to the doctor? Can Hazel’s Church donate to the clinic? How does the clinic collect?

Sabbatical Sam

Sam did not follow his father into religious life. He stayed behind in the US when his father started a mission in Liberia (the “Mission”). Sam continued his biomedical studies, invented a device, and built a US company worth millions (the “Company”). After 20 years of running the Company, Sam took a leave to help his father reorganise mission activities, which had expanded throughout Western Africa. Returning from sabbatical, Sam decided to sell the Company and use the proceeds to support his father. Can Sam donate shares of his Company to his father? To the Mission? How does the Mission take title to the shares of the Company?

Income tax rules

For income tax purposes, a donation by a US donor to a foreign charity is eligible for a US income tax deduction under s170 if the following requirements are satisfied:

- The foreign charity must be “created or organised” in the US or a sub-division.
- The foreign charity must be “organised and operated” exclusively for religious, charitable, scientific, literary or

educational purposes or to foster national or international amateur sports competition or for the prevention of cruelty to children or animals.

- The foreign charity must use the donation only for charitable purposes and avoid private benefit.
- The foreign charity cannot support political activities.

For an individual, the charitable deduction, generally, cannot exceed 50% of the donor's adjusted gross income ("AGI"); donations to some foreign charities cannot exceed 30% of AGI. For US corporations the donation cannot exceed 10% of AGI, for US trusts or estates there is no limit, for the foreign charity, the donation is not US source income, but earnings are on certain donations are fully fixable.

Gift tax rules

A US individual who wants to donate to a foreign charity must also avoid US gift taxes. In the US, gift taxes are generally imposed on the donor. Section 2522 permits a tax-free gift if the donation meets the same criteria set forth in s170, except the foreign charity does not have to be "created or organised" in the United States.

Estate tax rules

A donation by a US estate is permitted and is deductible for purposes of calculating US death or estate taxes. A charitable deduction is permitted under provisions of the Code, which are similar to, but different from, the gift tax rules. Foreign donations may be made directly to a foreign charity created or organised under foreign law. A gift to a foreign government, however, is deductible only if used for charitable and not public purposes.

Corporate tax rules

Donations by US corporations are subject to different rules and have territorial restrictions. Section 170(c)(2) provides that a donation by a US corporation to a foreign charity, which is a trust or foundation, is deductible only if used within the United States or a US subdivision. A donation to a foreign charitable corporation, however, does not have to be used in the US. Moreover corporate gifts are deductible only up to 10% of AGI.

Trust or estate income tax rules

Trusts are allowed to make distributions for charitable purposes and deduct such distributions for purposes of calculating the trust's annual net taxable income. Under s642(c) foreign donations are unlimited and are permitted without regard to geographic limitations - the foreign charity does not have to be created or organised in the US or use the donation in the US.

Private foundation rules

All s 501(c)(3) exempt organisations are classified as private foundations and are subject to excise taxes unless they are "public charities". Section 509 classifies certain exempt organisations as public charities *per se*, because of the type of work performed (eg, a church or school), or because of the amount of public support. The vast majority of the estimated 400,000 US exempt organisations are private foundations, not public charities.

It makes no difference to a US private foundation whether a donation is deductible; a private foundation is already income tax exempt. A private foundation that makes a donation to a foreign charity, however, must determine if the foreign charity is a "public charity" or a "private foundation". If the foreign charity is a "public charity" there is no further regulation on the donation; if the foreign charity is a "private foundation" there are many regulations. A US private foundation is not prevented from making a donation because the foreign charity has not applied for and received a determination letter from the IRS that it is tax exempt or publicly supported. The private foundation may make its own good faith determination of the foreign charity's organisational status. The regulations explain:

"...good faith determination ordinarily will be considered made where the determination is based on an affidavit of the donee organisation or an opinion of counsel of the distributing foundation or the donee organisation that the donee is an organisation described in s509 (meaning a public charity)."

After years of struggling to interpret the above regulation, the IRS and the US charitable community worked out a method to comply with the above regulation. In Revenue Procedure 92-94, the IRS

explained how to make a determination by a US private foundation that the foreign charity was an eligible donee. Revenue Procedure 92-94 states that if a donation is made by a US private foundation to a foreign charity that does not have an IRS ruling, a "qualifying distribution" will be permitted if the requirements of Revenue Procedure 92-94 are met. If not, the distribution will be disallowed and the US private foundation donor may be subject to an excise tax on the non-qualifying distribution.

Although Revenue Procedure 92-94 significantly eases the burden on US private foundations making foreign donations, it does not completely eliminate them. The donor must obtain a "currently qualified affidavit" on the status of the foreign donee. Further, the affidavit will not protect the donor with actual knowledge that it is unreliable. Still further, foreign schools must practice racial non-discrimination.

Public charity rules

Public charities are exempt organisations which engage in charitable activities *per se* (such as a church or school or hospital) or exempt organisations which have a broad base of financial support. If the US donor is a "public charity", there are no restrictions, generally, on whether the foreign charity is a domestic or foreign person or whether the foreign charity is publicly or privately supported. If the foreign charity is not a public charity, but private foundation, the US donor risks its own tax exemption if the foreign charity uses the donation for non-charitable purposes.

Determined dancer

Dancer cannot contribute directly to the Ballet and claim a US income tax deduction. The Ballet is not "created or organised" in the US. Moreover, Dancer is not a US taxpayer, she is a stateless defector. Therefore, donations by Dancer to a foreign charity must be allocated between Dancer's US and foreign source income.

Dancer offered to make a donation to a US public charity called a "community foundation" which would act as a grant administrator. The community foundation agreed to "earmark" the donation for foreign use as "the Ballet". The community foundation accepted the donation with the

understanding that it would be re-granted to a foreign charity recommended by Dancer. The community foundation agreed to accept a single donation but would not do so on a regular basis. The community foundation properly determined that international donations are beyond their regional purpose.

Dancer looked for different US exempt organisations and discovered that the IRS had ruled that organisations which serve as conduits, merely funneling “earmarked” donations to foreign charities without any independent oversight control, are not eligible to receive deductible charitable donations from US taxpayers. However, Dancer also learned that the IRS had ruled that a “Friends of Organisation” formed to benefit a foreign charity can qualify for a tax deduction if the organisation demonstrates that it has full control of donated funds and full discretion as to use. Therefore to receive the donation from Dancer, the Ballet had to form a “Friends of Organisation” and:

- The Friends of Organisation had to have complete control and discretion over how to use Dancer’s donation.
- The Friends of Organisation and the Ballet could not have identical or substantial overlapping managers.
- The Friends of Organisation had to have some independent purpose other than just remitting funds to the Ballet.
- The Friends of Organisation had to use some portion of its funds in the US or for purposes that may be of mutual benefit to the Friends of Organisation and the Ballet.
- The fund-raising material must tell potential donors that the funds are subject to the independent control of the Friends of Organisation.

Dancer and the Ballet formed a Friends of Organisation, a California non-profit corporation, controlled by Dancer. It was classified by the IRS as a private foundation, which means all grants to the Ballet had to be “qualifying” not taxable distributions. After the Ballet failed to provide regular accounts on the use of donated funds, Dancer restricted donations to the US expenses of the Ballet when it toured the US.

Obligated orphan

For the Orphanage to receive a donation, Orphan had to determine how the Orphanage would be classified in the US before Orphan’s corporation could determine if a donation had to be used in the US. The Orphanage disclosed that it was the Vietnamese equivalent of a foundation. Because the funds would be used in Vietnam, the corporation would receive no tax deduction.

If Orphanage converted its legal status to the equivalent of a corporation, the donation becomes fully deductible, but if the donation is more than 10% of the donor’s AGI, the excess has to be claimed as a deduction next year. Orphan also set up a Support Organisation for the Orphanage. A “Support Organisation” is different from a “Friends of Organisation”. A Friends of Organisation is usually a private foundation, a Support Organisation is usually a public charity.

Once the Support Organisation was set up, Orphan’s corporation made a donation directly to the Support Organisation and the donation was fully deductible for US income tax purposes because the donation was to a Support Organisation created and organised in the United States. Transfers from the Support Organisation to the Orphanage, the Vietnamese supported foreign charity, were made without further supervision by the Support Organisation.

In order to obtain IRS approval that the Support Organisation met the requirements of §509, it was necessary to demonstrate that the supported Vietnamese Orphanage was run as part of a church or had a broad base of financial support from a wide cross-section of the general public, rather than from one person, one company or one family. Orphan now regularly organises fund-raising activities for the Orphanage by soliciting donations to the Support Organisation.

Samoan All-Stars

Section 501(c)(3) defines charitable purpose to include activities which foster international amateur sports (but not the provision of athletic facilities or equipment). Section 501(c)(3) also limits sport activities to those carried out by corporations, and any community chest, fund, or foundation organised and operated exclusively for

athletic purposes. Therefore, in order for Eagle to support the Samoan all-star Club, the team itself must be a separate corporation, community chest, fund, or foundation.

Eagle determined that, unfortunately, the Club was not a separate legal entity, but with Eagle’s encouragement, became a corporation. Next, Eagle had to make sure that financial support to the Club would be used only for proper activities; donated funds could not be used for new uniforms. Finally, Eagle had to determine whether the Club was from the independent country of Samoa (formerly Western Samoa administered by New Zealand) or the US possession, American Samoa (“AS”).

After Eagle established these facts, Eagle examined the documents which created the estate Eagle administered. Fortunately, Eagle drafted those documents and had made sure that charitable donations were permitted by the enabling documents and were eligible distributions for purposes of both US income and estate tax purposes. Unfortunately, Eagle drafted the documents to permit gifts to the US Rugby Federation, the Supporting Organisation for the US Eagles, the official US team. The documents permitted gifts for US charitable purposes but not for foreign charitable purposes.

Eagle then formed an exempt organisation in American Samoa (AS), under AS law, which mirrors the Code. In other words, it has the identical provisions as the Code, but is administered by AS tax officials. Because of the limited experience in AS with exempt organisations (only a few missionary activities), the IRS in Cincinnati, Ohio (a real international centre) approves all applications for AS tax exemption. Approved AS charities are turned over to AS officials for administration.

Once the AS charity was formed, it was an exempt organisation “created and organised” in a US possession, an eligible donee. However, since the AS charity was not a “per se” public charity, and since it did not have a broad base of public support, it was classified by the IRS as a private foundation. Therefore, donations from the estate were fully deductible, but the AS charity had to make sure its donations to the Club were “qualifying expenditures” and the AS charity had to exercise “expenditure

responsibility” on all grants to the Club.

The basic requirements for the AS charity to exercise “expenditure responsibility” are:

- Pre-grant inquiry: the AS charity must make a reasonable investigation of the Club to make sure that it is carrying out charitable activities.
- Written agreement: the Club must sign a written agreement with the AS charity which set out what is to be accomplished with the donation and prohibiting the use of the donation for lobbying or personal benefit.
- Separate account: the Club must establish a separate account for deposit of the donation and promise not to commingle charitable donations with other funds.
- Regular reports: the Club must provide the AS charity regular status reports on the use of the donation.
- Report to the IRS: the AS charity must indicate on its annual IRS Form 990-PF that it made an “expenditure responsibility” grant and must add a schedule to the tax return describing the name of the foreign charity, the amount of the donation, the charitable purpose of the donation, and the when the funds were used up.

The AS charity determined, with the help of Eagle, that it could make travel grants to individual players, but not to the Club. Grants for travel expenses did not create taxable income under the Code; therefore, no US source taxable income to the All-stars. So Eagle was able to finance travel and beer, but no balls.

Rabbi Rob

To fund Rabbi Rob’s School, the Foundation had to determine, first, whether the School was the equivalent of public charity or private foundation. Schools generally are “per se” public charities under s 170, but only if they have a regular faculty and curriculum and had a regularly enrolled body of pupils in attendance at the place where educational activities were regularly carried on. Rabbi Rob asked his friends for help because the School had been damaged during the Intifada and needed repair. Therefore, the School was conducting classes in public places and attendance was sporadic.

Fortunately, the US and Israel have a tax treaty which allowed the Foundation to rely

on the US definition of exempt purpose under US law, not Israeli law. Unfortunately, however, the IRS has ruled that an educational institution requires that there be no discrimination. The School only provided religious training to selected Israeli youths from West Bank settlements. Therefore, the Foundation could not make a donation directly to the School.

The Foundation consulted various international Jewish organisations and asked them to administer a “friends of” grant. Unfortunately, the School did not teach orthodox theology; moreover, the administrative fee to accept the donation and transfer it to the School would be 45% of the total sum contributed by the Foundation.

The Foundation then approached an Israeli hospital, which had recently hired another of Rob’s childhood friends, Jacob, as a development officer. Aware of current fund raising practices in the US, the hospital agreed to accept the Foundation’s donation and act as a “Friends of Organisation” for the School, extracting a lesser fee. The hospital’s philosophy was that a small fee was better than no fee. However, the hospital was not a public charity; therefore a US private foundation was making a donation to a foreign private foundation. To avoid loss of its tax exemption, the Foundation had to exercise “expenditure responsibility” and require Rabbi Rob to report to Jacob in order that Jacob could report to the Foundation.

Herbal Hazel

Hazel learned that she could not make a US tax deductible donation to the doctor - he was not organised or created in the US and he would receive personal benefit. Therefore, she asked that her Church, which sponsored the tour, make the donation. Since several members of the Church were injured on the same tour, the elders agreed to accept a donation from Hazel and use it as requested by Hazel. The elders, however, consulted counsel and learned that even though the Church was a “per se” public charity, the Church would risk its exempt status if it made a donation, which was not used for charitable purposes.

The elders also learned that charitable purpose under s501(c)(3) prohibited private

benefit. Therefore, the Church could not make a grant directly to the doctor. The elders asked Hazel to inquire whether the clinic was a “medical research organisation”. Hazel confirmed that the clinic did indeed do research in connection with a local hospital. The elders then learned that the medical research was on indigenous herbs which reduced visual distortion in certain eye diseases like glaucoma. Afraid that the Church would be sponsoring drug research, the elders declined to fund Hazel’s request and kept the money for church repairs.

Hazel was determined to make good on her promise to help the Doctor. Therefore Hazel discovered that the US had a tax treaty with Mexico which, unlike the Israeli and Canadian treaties, allowed Mexican law to determine charitable purpose. Hazel also discovered that the Hacienda (the equivalent of the Inland Revenue and IRS) had classified the clinic as a hospital under Mexican law. Therefore, Hazel was confident that she could make a donation directly to the clinic, which would use the donation to support the research of Doctor. What Hazel failed to discover was that she was unable to deduct the Mexican donation against her US taxable income. Hazel was able to deduct the donation only against her Mexican source income.

Therefore, Hazel set about the task of buying and reselling herbs supplied by the Doctor. In order to get approval from the appropriate regulatory authorities, Hazel was required to form a Mexican company and get an export license. Therefore, Hazel’s company had Mexican source income against which a donation to Doctor could be offset.

Sabbatical Sam

Sam was the sole trustee of a US private foundation called Save Souls (“SS”) to which he regularly tithed. SS was a US private foundation, which made regular donations to Father’s Mission in Africa. The donations were qualifying distributions for SS and Sam exercised expenditure responsibility and made sure that Father used the donated money for charitable purposes and got regular reports from Father on the use of donations.

Sam learned that SS did not have to exercise expenditure responsibility because

the Mission was a “per se” public charity, a church. Therefore, Sam wanted to transfer shares of the Company to SS so that when Sam sold the Company, the gain would be captured by an exempt organisation. The net proceeds from the sale of the Company could then be used by SS to fund Father’s Librarian International Mission Saving Youth (“Flimsy”).

Sam learned, however, that he could not transfer his shares in the Company to SS because there are restrictions on US Private Foundations having “excess business holdings”. Due to the Ford Foundation’s ownership of an auto assembly line, the Code imposed restrictions on how much of a private for-profit company a US private foundation could own. Moreover, if the Company distributed cash other than dividends, the wrong kind of income pays a special unrelated business income tax (“UBIT”).

Therefore, Sam proposed to transfer the shares of the Company directly to Flimsy. Since Sam owned only founders shares without any cost base, and since Sam did not want to claim a tax deduction that would alert the IRS, Sam was not interested in a US charitable tax deduction. Besides, since the shares were not yet publicly traded, they had no ascertainable value.

Moreover, if Flimsy sold its shares in Sam’s Company to the potential purchaser, there would be a tax-free, capital gains transaction. Before the date of sale, however, all of the income Flimsy received from the Company would be fully taxed in the US because Flimsy was a member of the Company, a US LLC, which is taxed as a partnership. Under the Code, a partner takes on the trade or business of the partnership. Therefore, Flimsy was engaged in the trade or business of the Company. Therefore, all income was subject to US tax plus UBIT.

Dan learned, however, that if Flimsy obtained an exemption ruling from the IRS that it was a private foundation, the tax rate on investment income earned from US sources was reduced to 4%. Moreover, if the IRS classified Flimsy as a public charity, there would be no tax, since Flimsy was engaged exclusively in missionary work, it was a church which was a “per se” public charity. Therefore, Flimsy would have no income tax on interim distributions from the

Company and the net sales proceeds from the sale of the shares of the Company would also be tax-free. However, it would take months for Flimsy to get a ruling from the IRS and Sam was impatient to sell the Company and join Father in Africa.

Sam decided to convert SS into a Support Organisation for Flimsy. Section 507 permits such a conversion, but Sam learned that the IRS had not seen such an application in years and decided to abandon that strategy. Instead, Dan formed a new non-profit corporation designed exclusively to support Flimsy, a public charity. The new Support Organisation, SS II, could own the shares of Dan’s Company, sell them to the buyer, and take the net sales proceeds free from US tax. Moreover, SS II could distribute the net sale proceeds to Flimsy and join Father in Africa.

Dan was pleased to learn, moreover, that the grant from SS II to Flimsy could be invested on Wall Street by Flimsy and Dan could serve as the investment adviser for the Flimsy endowment fund. Dan was also learned that Flimsy was not regulated in Africa the same as SS and SS II were regulated in the US, even though Liberia adopts the Delaware non-profit statute on a regular basis, it does not adopt the Code or the Regulations. Under Liberian law, as long as Flimsy conducted charitable activities as defined by the Delaware non-profit statute (and missionary work was definitely charitable), Flimsy was exempt from Liberian tax on investment income even without a ruling. Therefore, sales of shares on Wall Street are tax-free capital gains in both Liberia and the US. Flimsy could employ Dan, and all members of his family, and pay them salaries out of the endowment. Moreover, Flimsy could provide a retirement plan for Dan for reorganising Flimsy missionary activities in Western Africa. Further, Dan learned that Flimsy could assist Dan relocate back in the US, lend him money for a new home, and make an investment in Dan’s new company free from Liberian regulation.

Recommended regulatory changes

It is impossible to justify the rigid, inconsistent complexity, of the rules which govern US donations to foreign charities. There is no rational reason for the current pattern. At a minimum, the following steps

should be taken:

- Congress should repeal s 170(c)(2)(A) that requires that a donation be made to an organisation “created or organised in the United States or its political subdivisions”.
- Charitable contributions should be permitted to any kind of a legal entity whether corporation, trust or community chest, fund or foundation so long as it is devoted to charitable purposes. US corporate donors should not be restricted to giving only to domestic corporations to avoid the “use” in the United States requirement.
- The IRS should extend the rules set forth in Revenue Procedures 92-94 to all parts of the Code; currently it is limited only to excise taxes. The rules should apply to income taxes and withholding taxes.
- Congress should conform the deduction for gift tax purposes to the deduction for charitable contributions by trusts or estates. There should be no difference between whether the donor is a trust or an estate, and there should be no geographic limitations.
- The IRS should make it clear that a donation to a foreign charitable trust is fully deductible even if it may have a US beneficiary; at present a potential US beneficiary eliminates the charitable donation deduction.
- The IRS should make it clear that foreign charities may be s 501(c)(3) organisations without regard to whether they file an application for tax exemption, under IRS form 1023, as presently required by s 508.
- The IRS should confirm that the withholding rules of s 1443 should apply to foreign charities under all circumstances; the separate rule for withholding on foreign partner share of partnership distributions or effectively connected income should conform to the 4% withholding on gross investment income.

There is no reason why the Code has different rules for individuals, corporations, trusts, estates, and foundations. They could and should be uniform.

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Archive link: “What is a charity under US law?” - *May 1995, Issue 56*