

## Contribute to a Foreign Charity and Get a Tax Deduction (Terrorist Traps for the Unwary)

By David J. Berardo

*The following is an edited excerpt from a longer article, at [www.abanet.org/intlaw/ILNSpr04article.doc](http://www.abanet.org/intlaw/ILNSpr04article.doc). The editors encourage you to read the complete article, which features discussion of case studies that apply the rules spelled out below.*

**I**nternational philanthropy is growing. And while more U.S. donors are making international grants than ever before, they are seeking guidance to determine how to get tax deductions for their contributions.

The U.S. Internal Revenue Code imposes rigid rules that make it difficult for U.S. donors to deduct donations to foreign charities. The Internal Revenue Service justifies rigid rules as the price for deductibility. Professional advisors, including lawyers, must be prepared to answer client questions such as: "Since 9/11, how do I make a foreign charitable donation without triggering an audit and being accused of supporting international terrorist activities?" They must also be able to advise foreign charities that ask: "How do we collect donations from U.S. donors?"

### The Rules

**Income Tax Rules.** For income tax purposes, a donation by a U.S. donor to any charitable donee is eligible for a U.S. income tax deduction under Section 170 as long as all the following requirements are satisfied:

- The donee must be "created or organized" in the U.S. or a subdivision.
- The donee must be "organized and operated" exclusively for religious, charitable, scientific, literary, or educational purposes; to foster national or international amateurs' sports competition; or to prevent cruelty to children or animals.
- The donee must use the donation only for charitable purposes and avoid private benefit.
- The charity cannot support political activities.

While the tax rules encourage the use of domestic intermediaries, U.S. donors can make direct donations to a for-

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foreign charity and receive a U.S. income tax deduction.

**Gift Tax Rules.** There are ways for U.S. individuals who want to donate to a domestic or foreign charity to avoid U.S. gift taxes. In the United States, gift taxes are generally imposed on the donor. Section 2522 permits a tax-free gift if the donation meets the requirements set forth in Section 170, but the charity does not have to be "created or organized" in the United States. Thus, a direct donation by a U.S. individual to a charity organized under foreign law generally does not necessitate a U.S. gift tax as long as the other requirements of Section 170 are met.

**Estate Tax Rules.** A donation by a U.S. estate to a foreign charity is permitted and deductible for purposes of calculating U.S. death or estate taxes. A charitable deduction is permitted under provisions of the U.S. Internal Revenue Code that are similar to, but different from, the income and gift tax rules. Donations may be made directly to a foreign charity "created or organized" under foreign law as long as the foreign charity is "organized and operated" exclusively for charitable purposes.

**Corporate Rules.** A donation by a U.S. corporation directly to a foreign charity that is organized as a foreign trust or a foreign foundation is deductible only if the donated funds are used within the United States or a U.S. subdivision. A donation to a foreign charity that is organized as a foreign corporation, however, does not have to be used in the United States. Thus, most corporate donors ask the proposed donee for a certificate of formation and where the money will be used. Donors are most comfortable if the foreign donee is a corporation. Corporate donations, however, are deductible only up to 10 percent of adjusted gross income (AGI); in contrast, donations by individuals are deductible up to 50 percent of AGI. The limited deduction discourages most corporate donations except to donees in the United States.

**Trust Rules.** Trusts are allowed to make distributions for charitable purposes and deduct such distributions for purposes of calculating "distributable net income." Distributions to foreign charities are unlimited and permitted without regard to geographic limitations. The foreign charity does not have to be "created or organized" in the U.S. or use the donated funds in the United States. So United States citizens who want to make a donation to a foreign charity often use a U.S. trust that expressly permits such donations.



**Private Foundation Rules.** All U.S. exempt organizations are presumed to be "private foundations" and are subject to excise taxes unless the IRS classifies them as "public charities." Section 509 classifies certain exempt organizations as per se public charities because of the type of work performed (e.g., a church or school) or because the organization receives a broad base of public support. The vast majority of the estimated 400,000 U.S. exempt organizations are private foundations, not public charities.

A U.S. private foundation is not concerned whether a donation to a foreign charity is deductible because a private foundation is already exempt from income taxes, but it is subject to excise taxes. The private foundation, however, must determine if the foreign charity is the U.S. equivalent of a "public charity" or a "private foundation." If the foreign charity is a public charity, there is no risk of the U.S. private foundation's being exposed to excise taxes; if the foreign charity is a private foundation, the U.S. private foundation making the foreign donation must comply with a host of additional regulations to avoid an excise tax on the donation.

A U.S. private foundation is not prevented from making a donation to a foreign charity that is the U.S. equivalent of a private foundation. This is true even if the foreign charity has not applied for and received a determination letter from the IRS that it is the equivalent of a U.S. exempt private foundation. The U.S. private foundation may make its own good-faith determination of the foreign charity's organizational status. After years of struggle, the IRS issued Revenue Procedure 92-94 and explained how a U.S. private foundation determines that the foreign charity was an eligible donee. Revenue Procedure 92-94 states that if a U.S. private foundation makes a donation to a foreign charity that is the equivalent of a U.S. private foundation, which 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 U.S. private foundation donor will be subject to an excise tax on the nonqualifying distribution.

**Public Charity Rules.** Public charities in the United States and abroad are exempt organizations that engage in per se charitable activities (e.g., a church or school) or have a broad base of financial support. If a U.S. donor is a "pub-

lic charity" and makes a donation to a foreign charity, the U.S. public charity does not have to determine where the foreign charity is "created or organized" or whether the foreign charity is publicly or privately supported. If the foreign charity is not the equivalent of a U.S. public charity, however, the U.S. donor risks its own tax exemption if the foreign charity uses the donation for noncharitable purposes (i.e., the donated funds inure to the benefit of a private person or are used to finance political activities).

### Lessons for the New Millennium

After finally mastering the inconsistent rules that govern U.S. donations to foreign charities, along came the events of 9/11. Since 9/11, new and more confusing rules have been in play.

First, the Office of Foreign Assets Control of the U.S. Department of Treasury proposed "voluntary best practices" for foreign charitable donations, without consultation with the IRS. Second, the IRS issued Notice 2002-92 asking for comments on how the IRS approves and obtains reports from nonprofit organizations generally. Third, the IRS issued Notice 2003-29 inviting comments on improving international grant making and activities by U.S. charities. Fourth, the Sarbanes-Oxley Act requires full disclosure of corporate gifts to affiliated persons (e.g., wives of executives who serve on the boards of U.S. exempt organizations). As of this writing, there have been no major revisions to Revenue Procedure 92-94, the "Expenditure Responsibility" guidelines, or the procedures for applying for and reporting on the activities of exempt organizations. But changes will come, and professional advisors must remain diligent in this area.

Finally, the above information has focused on the U.S. federal rules. Various states and foreign countries are also active in the field, largely because of pressure from the United States. These must also be examined for conformity. There is increased emphasis on international charitable activities at a time when international need is great. There are truly terrorist traps for the unwary. Proceed with caution.

*For an excellent discussion of IRS Notice 2003-29, see The Tax Lawyer, Fall 2003, Page 195, published by the ABA's Section of Taxation.*