O. DOMESTIC ORGANIZATIONS WITH FOREIGN OPERATIONS

1. Introduction

This article discusses the treatment of domestic charitable organizations with foreign operations. It focuses on exemption under IRC 501(c)(3); foundation status under IRC 509; deductibility of contributions, bequests and gifts under IRC 170, 2055, and 2522; and the treatment of domestic foundations making grants to foreign organizations.

2. Exemption and Foundation Status Issues

Historically, the Internal Revenue Code has implicitly sanctioned the operations of U.S. charities in foreign countries. IRC 170(c) provides that a contribution by a corporation to a qualifying IRC 170(c)(2)(B) organization is deductible but only if the contribution is used within the United States or any of its possessions exclusively for IRC 170(c)(2)(B) purposes. There is no similar restriction imposed upon the use of an individual's contributions under IRC 170. Also, the exemption and foundation provisions do not contain limiting language.

The Service confirmed this position in 1971 with the publication of Rev. Rul. 71-460, 1971-2 C.B. 231. Rev. Rul. 71-460 held that a domestic charity qualified for exemption under IRC 501(c)(3) even though it carried on some of its activities abroad. The revenue ruling was not intended to limit the extent of a domestic organization's foreign activities. In fact, 71-460 states that exemption will not be jeopardized even if the domestic organization carries on all of its activities in foreign countries. Grants to foreign organizations were clearly contemplated by Rev. Rul. 71-460. Although the Service had not published specifically on the point, the revenue ruling did not place any restrictions on foreign operations. (Further, the two revenue rulings -- Rev. Rul. 63-252, 1963-2 C.B. 101 and Rev. Rul. 66-79, 1966-1 C.B. 48 -- that discussed the deductibility of contributions to domestic organizations making grants to foreign organizations had already been published.)

Organizations making grants to foreign organizations have one procedural problem that is not usually encountered with grants to domestic organizations. Since most foreign organizations have not been recognized under IRC 501(c)(3), the domestic organization in this situation is required to exercise supervision and control over the use of the funds as provided for in Rev. Rul. 68-489, 1968-2 C.B. 210. Rev. Rul. 68-489 also requires sufficient records that grants have been used

for IRC 501(c)(3) purposes. In some respects these requirements parallel the requirements organizations must meet in order to assure the deductibility of contributions by domestic donors. (This topic will be discussed later in this paper.)

The central exemption issue in these cases, as with any other exemption case, is whether an organization is organized and operated for charitable purposes under IRC 501(c)(3). Generally, the characterization of a particular activity under foreign law is not controlling. It should be noted, however, that the Service has not yet ruled in a situation where an organization's activity is illegal under foreign law. If a case contains this issue, technical advice should be sought from the National Office.

One further issue involves grants to foreign governmental organizations. The Service has ruled in several specific circumstances, that direct grants to foreign governments do not serve IRC 501(c)(3) purposes. This position has not been published, however. Further, the Service may have to address the situation where a domestic charity makes a grant to a foreign organization that is a governmental entity but does not have governmental powers, i.e., hospitals, schools, etc. These kinds of issues should be referred to the National Office for consideration.

It is clear that domestic organizations can be involved in programs with foreign governments. For example, in Rev. Rul. 68-117, 1968-1 C.B. 251, the Service held that an organization assisting needy families in "developing" countries may be exempt. The organization participated in self-help programs for social and economic development and worked in cooperation with the U. S. and foreign governments.

There are several additional rulings that deal with foreign activities. Rev. Rul. 68-165, 1968-1 C.B. 253, held that a domestic organization that joins with a counterpart group in Latin America to provide assistance for self-help projects qualifies for exemption under IRC 501(c)(3). Also, Rev. Rul. 73-440, 1973-2 C.B. 177, held that an organization that attempts to influence and advocates changes in the laws of a foreign country does not qualify for exemption. For purposes of IRC 501(c)(3) the term "legislation" includes foreign as well as domestic laws.

Generally, there are no special IRC 509 rules for domestic organizations with foreign operations. There is one published revenue ruling that relates to this issue. Rev. Rul. 74-229, 1974-1 C.B. 142, holds that a domestic organization, organized and operated in support of a foreign organization meeting the requirements of IRC 509(a)(1) or (2), that otherwise meets the requirements of IRC

509(a)(3) qualifies as a supporting organization. (Reg. 1.509(a)-2(a) provides that an organization may qualify as an IRC 509(a)(1) or (2) organization regardless of the fact that it does not satisfy IRC 170(c)(2) because it was created or organized other than in or under the law of the United States, any state or territory, the District of Columbia, or any possession of the United States.)

3. Contributions to Domestic Organizations for Foreign Operations

IRC 170(c)(2)(A) provides that a charitable contribution to be deductible must be made to an organization "created or organized in the United States or in any possession thereof, or under the law of the United States, any state, the District of Columbia, or any possession of the United States."

In S. E. Thomason v. Commissioner, 2 T.C. 441 (1943), the court held that amounts paid to provide special advantages for a particular child in the Illinois Childrens' Home and Aid Society were not deductible when earmarked for the benefit of that child. This case, and Rev. Rul. 54-580, 1954-2 C.B. 97, established the principle that "an inquiry as to the deductibility of a contribution need not stop once it is determined that an amount has been paid to a qualifying organization; if the amount is earmarked, then it is appropriate to look beyond the fact that the immediate recipient is a qualifying organization to determine whether the payment constitutes a deductible contribution." (Rev. Rul. 63-252.)

Rev. Rul. 63-252 applied these principles to the question of deductibility of contributions to foreign organizations and concluded:

> "A given result at the end of a straight path is not made a different result because reached by following a devious path." Minnesota Tea Co. v. Helvering, 302 U.S. 609, at 613, Ct. D. 1305, C.B. 1938-1, 288; George W. Griffiths v. Helvering, 308 U.S. 355, at 358, Ct. D. 1431, C.B. 1940-1, 136. Moreover, it seems clear that the requirements of section 170(c)(2)(A) of the Code would be nullified if contributions inevitably committed to go to a foreign organization were held to be deductible solely because, in the course of transmittal to the foreign organization, they came to rest momentarily in a qualifying domestic organization. In such case the domestic organization is only nominally the donee; the real donee is the ultimate foreign recipient."

Rev. Rul. 63-252 illustrated the point with the following five examples:

(1) In pursuance of a plan to solicit funds in this country, a foreign organization caused a domestic organization to be formed. At the time of formation, it was proposed that the domestic organization would conduct a fund-raising campaign, pay the administrative expenses from the collected fund and remit any balance to the foreign organization.

(2) Certain persons in this country, desirous of furthering a foreign organization's work, formed a charitable organization within the United States. The charter of the domestic organization provides that it will receive contributions and send them, at convenient intervals, to the foreign organization.

(3) A foreign organization entered into an agreement with a domestic organization which provides that the domestic organization will conduct a fund-raising campaign on behalf of the foreign organization. The domestic organization has previously received a ruling that contributions to it are deductible under section 170 of the Code. In conducting the campaign, the domestic organization represents to prospective contributors that the raised funds will go to the foreign organization.

(4) A domestic organization conducts a variety of charitable activities in a foreign country. Where its purposes can be furthered by granting funds to charitable groups organized in the foreign country, the domestic organization makes such grants for purposes which it has reviewed and approved. The grants are paid from its general funds and although the organization solicits from the public, no special fund is raised by a solicitation on behalf of particular foreign organizations.

(5) A domestic organization, which does charitable work in a foreign country, formed a subsidiary in that country to facilitate its operations there. The foreign organization was formed for purposes of administrative convenience

> and the domestic organization controls every facet of its operations. In the past the domestic organization solicited contributions for the specific purpose of carrying out its charitable activities in the foreign country and it will continue to do so in the future. However, following the formation of the foreign subsidiary, the domestic organization will transmit funds it receives for its foreign charitable activities directly to that organization.

Rev. Rul. 63-252 held that contributions to organizations described in the first, second, and third examples were not deductible but that contributions to the organizations described in examples four and five were. In examples four and five the contributions were not earmarked for use in a foreign country and the contributions were subject to control by the domestic organization.

Rev. Rul. 66-79, clarified an ambiguity contained in examples three and four of Rev. Rul. 63-252. Rev. Rul. 66-79 provided that contributions to a domestic charity solicited for a specific project of a foreign charity are deductible under IRC 170 where the domestic organization has approved the project as being in furtherance of its own exempt purposes and has control and discretion as to the use of the contributions. In this case the bylaws of the domestic organization provided among other things that the Board of Directors would require that grantees furnish a periodic accounting to show that the funds were expended for purposes for which they were approved and the Board might, in its absolute discretion, refuse to make grants for which any funds were requested. The revenue ruling concluded that "the test in each case is whether the organization has full control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out [the domestic organization's] function and purposes."

Rev. Rul. 75-65, 1975-1 C.B. 79, provided another example of contributions to a domestic organization that made grants to foreign organizations. The domestic organization was formed to deal with the problem of plants and wildlife ecology in a foreign country. Among other things, it made grants to foreign organizations for this purpose. The domestic organization maintained control over the use of funds by making a field investigation of the purpose to which the funds would be put, by entering into a written agreement with the recipient organization, and by making continuous field investigations to see that the money was expended in accordance with the agreement. The revenue ruling concluded that in this case contributions by individual donors were deductible.

The principle enunciated in Rev. Rul. 63-252 -- that deductibility of contributions would be judged by the substance rather than form of the transaction -- was tested in Bilingual Montessori School of Paris v. Commissioner, 75 T.C. 480 (1980), acq. 1981-1 C.B. 1. The organization was incorporated in Delaware in 1978 for purposes which included the operation of a Montessori school in Paris, France. Its registered office was in Wilmington, Delaware where its registered agent was located. The organization had no employees in the United States and conducted no activities in this country other than some fund-raising. The Service recognized the organization's exemption under IRC 501(c)(3) but determined that contributions were not deductible under IRC 170. Relying on Rev. Rul. 63-252 the Service argued that the domestic organization was a corporate shell without assets or employees in the United States and was used solely to funnel contributions overseas. The school argued and the Tax Court held that the legislative history of the restriction in IRC 170(c)(2)(A) indicated that the restriction was merely a restriction on foreign incorporation. Thus, Rev. Rul. 63-252 does not require an organization to have domestic operations in the U. S.

IRC 170(c)(2) defines charitable contributions to include a contribution to "A corporation, trust, or community chest, fund or foundation..." (Emphasis added.) IRC 170(c) limits contributions by a corporation as follows: "A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States...." The Service has ruled that since the language in IRC 170(c) does not specifically prohibit gifts to corporations, a contribution by a taxable corporation to a domestic charitable corporation to be used abroad is deductible. (Rev. Rul. 69-80, 1969-1 C.B. 65).

The treatment of gifts and bequests under the estate and gift tax provisions does not limit the use of funds overseas. In fact, IRC 2055(a)(2) (the estate tax deduction), and IRC 2522(a)(2) (the gift tax deduction), permit bequests and gifts to foreign organizations for charitable purposes. In the case of a non-resident who is not a citizen, gifts will be subject to the gift tax if they are not made to a domestic charitable corporation. If the gift is made to any charitable trust, community chest, fund or foundation, the gift must be used exclusively within the United States. (IRC 2522(b)(2) and (3)).

4. Foundation Grants to Foreign Charities

Generally, domestic private foundations may make grants to foreign charities for the same purposes that they make grants to domestic charities. There are, however, limitations on grants to foreign governments. These limitations are the same as those discussed earlier in this paper. The primary issue under Chapter 42 has to do with how grantees are chosen and how the grants are administered.

IRC 4945(d)(4) provides that a grant to an organization other than a public charity is a taxable expenditure unless the foundation exercises expenditure responsibility with respect to the grant. Expenditure responsibility is defined in IRC 4945(h). The regulations under IRC 4945(d)(4) provide that where a foreign organization does not have a ruling or determination letter that it is a public charity, a grant will not be treated as a taxable expenditure under IRC 4945(d)(4) if the grantor foundation has made a "good faith determination" that the grantee organization is an organization described in IRC 509. The "good faith determination" can be made on the basis of an affidavit of the grantee organization or an opinion of counsel that the grantee is a publicly supported organization. The affidavit or opinion must contain sufficient facts to permit the Service to determine that the grantee would be likely to qualify as a public charity. (Reg. 53.4945-5(a)(5).) Similarly, if foreign law imposes restrictions on the use of the grant substantially equivalent to the restrictions imposed on domestic foundation with respect to the handling and use of funds under IRC 4945, a domestic organization need not exercise expenditure responsibility with respect to that grant. An affidavit or an opinion of counsel to this effect is also sufficient to satisfy this requirement.

IRC 4945(d)(5) provides that grants for purposes other than those specified in IRC 170(c)(2)(B) will result in taxable expenditures. Thus, an unrestricted grant to an organization that is not described in IRC 501(c)(3) will normally be a taxable expenditure. Reg. 4945-6(c) provides that a grantor must be "reasonably assured" that the grant will be used for IRC 170(c)(2)(B) purposes to avoid imposition of the tax. If, in the "reasonable judgment" of a foundation manager of the grantor organization, the grantee organization is described in IRC 501(c)(3); this requirement will be satisfied.