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ARTICLES
International Charitable Giving and Planning Under U...

International Charitable Giving and Planning Under U.S. Tax Law

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INTRODUCTION

Charitable giving has long been a humanitarian and philanthropic arm of estate planning for persons of substantial means. As economic and cultural globalization proceeds apace, charitable giving also increasingly takes on an international complexion because more and more families are establishing personal and financial ties with countries and even continents beyond the borders of their ancestry and original heritage. The events of September 11, 2001, however, as in so many other areas of life, have cast a new perspective on the phenomenon of transnational charitable giving, as investigations of the financial support for terrorist activities have discovered that funds provided by some charitable foundations and entities in the Middle East and even some in the United States may have been used for these activities. These discoveries have already precipitated a legislative response, under the USA PATRIOT Act, that brings potential adverse U.S. immigration consequences for U.S. non-citizen residents who make unwise international charitable donations. Whether legislative attention will also be brought to bear on the U.S. tax benefits of gifts to charitable non-profit and charitable organizations and projects abroad and at home remains to be seen. For now, as described in more detail in this article, the U.S. Treasury Department and the Internal Revenue Service have made the grant-making procedures of charitable organizations that support foreign charitable activities their primary focus.

The rules regarding the tax deduction available for contributions to foreign charitable entities and programs are already complicated, and careful attention must also be paid to the tax rules affecting the foreign charitable activities of U.S. charities, particularly private foundations. The enactment in 1996 of legislation defining and regulating foreign trusts added an additional layer of complexity to the applicable rules regarding foreign charitable trusts. This article begins with a detailed analysis of the "players" in the field of international charitable giving and then proceeds to discuss the issue of U.S. tax deductibility for charitable giving under the income tax and transfer tax systems, the special rules applicable to foreign charitable trusts, the U.S. tax treatment of foreign public charities and foreign private foundations, and the special rules governing foreign charitable activities of U.S. private foundations. A brief discussion of the current focus on the grant-making procedures of U.S. charitable organizations that make contributions to charitable activities and entities abroad brings the article to a conclusion.

THE ACTORS IN THE FIELD OF INTERNATIONAL CHARITABLE GIVING

Mention of international charitable giving in a U.S.-centered discussion probably brings first to mind individual donors who wish to benefit worthy causes and projects being conducted outside the United States. Of substantial if not equal importance, however, are charitable entities such as non-profit corporations and trusts, which are not only recipients of charitable donations but often the source of substantial flows of funds to charitable projects and undertakings abroad.

Individuals

The rules regarding individual charitable donors differ depending on whether the donor is a U.S. citizen, U.S. permanent resident, U.S. "days" resident (as defined below), U.S. domiciliary, or a person of foreign citizenship who does not qualify as a U.S. resident or U.S. domiciliary in any sense ("nonresident alien").

Citizens

U.S. citizens are subject to both the worldwide U.S. income tax and the worldwide U.S. transfer taxes (gift, estate, generation-skipping transfer). The tax deductions for charitable giving are significant because they offer potential relief from U.S. income tax on as much as 50% of an individual's adjusted gross income in any given calendar year and potentially complete relief from U.S. transfer taxes. (Details about the technical rules for determining the amount of annual taxable income that can be protected from income tax by virtue of the charitable deduction are set forth in the footnote below).[1] As discussed below, the income tax charitable deduction is generally not available for gifts by U.S. citizens to foreign charitable organizations although deductions for certain indirect gifts may be available. The transfer tax deductions for international charitable donations by U.S. citizens, however, are generally available for foreign as well as domestic contributions.

Persons Who Qualify as U.S. Permanent Residents and Domiciliaries

Pursuant to §7701(b)(1)(A)(i), non-U.S. citizens who are lawfully admitted to the United States for permanent residence are U.S. tax residents for purposes of the Federal income tax and are therefore subject to the worldwide U.S. tax. It should be noted that the mere possession of a green card does not automatically make one subject to worldwide U.S. transfer taxes, because, under §2001(a) and the regulations thereunder, the obligation to pay U.S. transfer taxes on a worldwide basis is a function of domicile rather than immigration-based or tax-based residence. However, the premise of legal permanent residence under The Immigration and Nationality Act, as the term implies, is that one intends to reside permanently in the United States. While this intention does not preclude an intent to leave the United States at some later date, it may create a rebuttable presumption of domicile. Thus, the rules regarding the income tax charitable deduction that apply to U.S. citizens (income tax deduction limited to gifts to U.S. charities) apply also to U.S. permanent residents and, in many cases, the rules regarding the transfer tax charitable deductions that apply to U.S. citizens (transfer tax deductions available for gifts and bequests to U.S. and foreign charities) will also apply to U.S. permanent residents.

Persons Who Are U.S. Permanent Residents but Foreign Domiciliaries

U.S. permanent residents who are not U.S. domiciliaries have a more limited exposure to U.S. transfer taxes. Only U.S. situs property is subject to estate tax and only gifts of U.S. real and tangible property are subject to gift tax. The transfer tax charitable deduction for a direct contribution to a foreign charitable organization of property that is otherwise subject to U.S. gift or estate tax will generally not be available to protect the transfer from tax. However, the methods that may be used to obtain an income tax charitable deduction for certain gifts with a foreign focus (discussed below) may also be used by U.S. permanent residents who are not U.S. domiciliaries to obtain transfer tax deductions.

Persons Who Are U.S. Tax Residents and Foreign Domiciliaries

Under the rules contained in §7701(b)(3), a foreign person who does not have a green card may still be considered a U.S. resident for income tax purposes and therefore be subject to the worldwide U.S. income tax if he or she spends in any given year more than 183 days in the United States or spends, over a period of three or more years, an average of 121 days in any given year.[2] In many cases, a person who has become a U.S. days resident but who is not a U.S. permanent resident will not qualify as a U.S. domiciliary and therefore will be subject to U.S. transfer taxes on their U.S. situs property. Therefore, like those U.S. permanent residents who have not established a U.S. domicile, most U.S. days residents will be subject to charitable deduction restrictions on gifts and bequests of U.S. situs property to foreign charities both for income and transfer tax purposes.

Persons Who Are U.S. Tax Residents and U.S. Domiciliaries

Certain U.S. days residents, such as persons who have spent many years in the United States under the aegis of non-immigrant visas for "treaty traders" and "treaty investors," may qualify as U.S. domiciliaries and therefore become subject to worldwide U.S. transfer taxes. This could also be true of persons who are U.S. days residents by virtue of overstaying the time they were permitted to remain in the United States under whatever category of nonimmigrant visas were issued to them. These days residents who establish themselves as U.S. domiciliaries will be eligible to claim transfer tax deductions for direct as well as indirect gifts to foreign charities.

Persons Who Are U.S. Domiciliaries But Not U.S. Permanent Residents or Tax Residents

It would appear fairly unusual for a non-U.S. citizen not to hold a green card and not qualify as a U.S. days resident but still have a U.S. domicile. In any such case, the person would be treated for income tax purposes as a nonresident alien (subject to the rules described in (vii) immediately following) but be treated as a U.S. citizen or domiciliary for transfer tax purposes (subject to the rules discussed in (i) and (ii) immediately above).

"Nonresident Aliens"

Under §871, persons who are neither U.S. citizens, permanent residents nor days residents may be subject to U.S. income tax on their U.S. source income and their income that is effectively connected with a U.S. trade or business. They will also be subject to U.S. gift tax on transfers of U.S. real and tangible property, pursuant to §2501(a)(1) and (2), and their estates will be subject to U.S. estate tax on a wider variety of assets located in the United States, pursuant to §2101(a). Such persons cannot claim an income tax deduction for any direct gifts of U.S. source income to foreign charities. Nor may any such person claim an income tax deduction for any direct gifts of U.S. source income unless such person is engaged in a U.S. trade or business. As non-domiciliary persons, they may generally transfer any U.S. intangible asset of their choice during life to anyone they like, whether charitable or non-charitable and whether domestic or foreign, without U.S. gift tax consequences. They may not, however, claim a transfer tax deduction for gifts of U.S. real property and tangible property to foreign charities, nor may their estates claim an estate tax deduction for bequests of U.S. situs property (real or intangible) to foreign charities.

Entities

Non-Charitable Domestic Corporations

Under §170(b)(2), corporations are generally permitted to claim deductions for charitable contributions, although a corporation may not claim charitable deductions in any taxable year in excess of 10% of its taxable income subject to certain adjustments. Under §170(c)(2), corporations may claim charitable deductions for contributions to domestic charitable corporations in cases where the contributions will be used abroad, as long as the use of the contributions is subject to the discretion and control of a domestic charity. However, in the case of a corporate gift to a charitable "trust, fund, chest or foundation," the contribution is only deductible if it is used within the United States or any of its possessions.

Non-Charitable Domestic Trusts Generally

Non-charitable trusts that are not permitted or required by their governing instruments to make contributions to charity will generally be precluded from making charitable contributions under general concepts of trust law. However, under §642(c), a charitable deduction is allowed to a trust that is permitted or required to make contributions for charitable purposes. The deduction available to such a trust is limited to the extent of the amount of gross income actually paid for the charitable purpose, but contributions to foreign charitable organizations and even foreign governments (if for a charitable purpose) will qualify for the charitable income tax deduction.

Public Charities

Pursuant to the provisions of §509, the world of charitable entities (including both corporations and trusts) is divided into "public charities" and "private foundations." Entities that qualify as public charities meet one of several sets of criteria based on receiving support from a broad base of contributors or from payments for their services related to charitable goals. They are not only permitted to make distributions to foreign as well as domestic charitable entities, but also to disburse funds to individuals and even non-charitable entities abroad as well as at home for programs consistent with their charitable goals.

Private Foundations

Private foundations are organizations fully dedicated to charitable purposes but which generally do not receive broad support from the public. Private foundations are generally subject to detailed statutory restrictions on their activities including limitations on holdings in any one business entity, prohibitions against investments that might "jeopardize" the capital of the foundation, and prohibitions against transactions between the foundation and its major contributors, directors and managers. *See* §4941 and §§4943-4945. Most private foundations are required to pay out certain minimum amounts each year to qualifying donees, which may include: (1) U.S. governmental units for charitable purposes, (2) domestic public charities, (3) exempt operating foundations, (4) foreign governments, grants to which are used exclusively for charitable purposes, (5) international organizations, grants to which are used exclusively for charitable purposes, and (6) foreign public charities. Failure to make such minimum distributions subjects a private foundation to penalty taxes.[3]

THE CHARITABLE INCOME TAX DEDUCTION AND FOREIGN DONEES

Individuals in General

As already discussed, the United States does not permit individuals to claim an income tax deduction for direct contributions to foreign charities. Section 170(c)(2)(A) expressly limits the charitable income tax deduction to corporations, trusts or community chests, funds or foundations "created or organized in the United States or any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States." Thus, in the leading case of *Welti v. Comr.,*[4] the Tax Court held that a contribution to the First Church of Christian Science in Berne, Switzerland, which was separately incorporated in Switzerland, was not eligible for the charitable income tax deduction, even though the parent church was located in Boston. On the other hand, in the subsequent leading case of *Bilingual Montessori School of Paris v. Comr.,*[5] the Tax Court sustained the charitable deduction for a contribution to a school that was incorporated in the United States but located in France.

In Rev. Rul. 63-252, the IRS discussed the following five scenarios:

> (i) A foreign charity causes a domestic charity to be formed to solicit funds. The domestic charity is required, by its charter, to pay funds to the foreign charity. Contributions to this type of domestic charity, said the IRS, are not deductible.
>
> (ii) U.S. persons organize a domestic charity to promote the work of a foreign charity. The domestic charity is required, by its charter, to make periodic payments to the foreign charity. Contributions to this type of domestic charity, said the IRS, are not deductible.
>
> (iii) A foreign charity enters into an agreement with a domestic charity, which the United States has already recognized as exempt, for the domestic charity to conduct a fund-raising campaign for the express benefit of the foreign charity. The IRS said that funds contributed in response to this specific fund-raising campaign would not be deductible. Other contributions to the domestic charity would be deductible.
>
> (iv) A domestic charity conducts various domestic programs. From time to time this domestic charity also makes grants to foreign charities for purposes the domestic charity reviews and approves. Grants are paid from general funds of the domestic charity and no special funds are raised by solicitation from the public for purposes of the foreign charity. Contributions to this type of domestic charity, the IRS said, are deductible.
>
> (v) A domestic charity, which conducts charitable activities in a foreign country, forms a subsidiary to facilitate its operations there. The foreign charitable subsidiary is completely controlled by the domestic charity. This domestic charity solicits funds to support its activities abroad. Following the formation of the foreign subsidiary, the domestic charity will transmit funds it raises for its foreign activities directly to the subsidiary. Contributions to this domestic charity for its foreign activities, the IRS said, are deductible.

The logic behind the IRS's conclusions in Rev. Rul. 63-252 is the following: Under the leading case of *S.E. Thomason v. Comr.,*[6] amounts paid to a charity are not deductible if they are "earmarked" for a particular individual in a way that would, in effect, turn contributions of these amounts into gifts that would not have been deductible if made directly to that individual. By the same reasoning, channeling a gift to a foreign charity through a domestic charity that would not have been deductible if made directly to the foreign charity taints the contribution. On the other hand, contributions that are not earmarked for a specific foreign charity but could, in the discretion of a domestic charity, be passed on to a foreign charity in furtherance of the domestic charity's purposes are deductible because domestic charities are permitted to conduct charitable activities abroad. This is particularly true where the funds are passing to a foreign charity that is completely controlled by the domestic charity.

With this framework in place, the IRS developed, in Rev. Rul. 66-79, a new position that represented a certain retreat from the disallowance of the charitable deduction in scenarios (i), (ii) and (iii) of Rev. Rul. 63-252. In the 1966 Ruling, the IRS indicated that contributions to a domestic charity that "at times solicits contributions which are used to provide grants to [a] foreign organization... for specific purposes approved by [the domestic charity's] board of directors in accordance with its bylaws" would be eligible for the charitable deduction. This Revenue Ruling now forms the basis for the deductibility of contributions to a well-known class of domestic charities that style themselves as "friends" or "supporters" of foreign charities. The bylaws of the domestic charity that was the subject of Rev. Rul. 66-79 provided, among other matters, that the board of directors would review all requests for funds, would require information about the purposes for which such funds would be used, would require a grantee to furnish a periodic accounting to show that the funds were expended for the purposes approved by the board, and could, "in its absolute discretion," refuse to make any grants or otherwise provide funds for any or all purposes for which funds are requested. Under these circumstances, the IRS ruled that the contributions would be treated as deductible contributions to the domestic charity, rather than as nondeductible contributions to a foreign charity.

It should be noted that, under §509(a)(3)(C), a charitable organization may be recognized as a public charity when it is operated exclusively for the benefit of, or to carry out the purposes of, another public charity and is controlled by another public charity or "operated, supervised, or controlled by or in connection with" one or more public charities. Such organizations are often referred to as "support organizations." In Rev. Rul. 74-229, the IRS stated that a charitable organization can qualify as a "support" organization for a foreign public charity described in §509(a)(1). This raises the possibility, suggested by several commentators, that a U.S. charity with some overlap in leadership with a foreign public charity but not controlled by the foreign charity could qualify as a U.S. public charity, and that donations to it could be eligible for the income tax charitable deduction as long as it exercised its own discretion and independent judgment in making distributions to the foreign charity.[7]

Domestic Business Corporations

Domestic business corporations may, like individuals, only claim the income tax charitable deduction for contributions to U.S. charitable entities. However, under the flush language of §170(c)(2), "[a] contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible... only if it is used within the United States or one of its possessions." This means that a domestic business corporation can not claim a charitable deduction for a contribution to a U.S. charity that may be a "friend" or "supporter" of a foreign charity, pursuant to Rev. Rul. 66-79, unless the U.S. entity is a corporation. Since the reference to "foundations" in the flush language of §170(c)(2) predates the 1969 enactment of the private foundation rules, it would appear that a contribution by a domestic business corporation to a U.S. charitable corporation that qualifies as a private foundation would be eligible for the charitable deduction under these circumstances.

Non-Charitable Domestic Trusts

Here we deal with trusts that do not qualify as exempt charitable entities under §501(c)(3) and do not qualify as exempt charitable remainder trusts under §664. These might include trusts that are expressly permitted or required to make charitable distributions. An example would be a charitable lead trust, under which a certain percentage of the trust must be distributed to qualifying charities each year during the trust term, provided the lead trust is treated as an entity separate from the trust's grantor (i.e., not treated as a grantor trust). While an individual may fund deductible contributions from any source, whether income or capital, the deduction for non-charitable trusts under §642(c) is only available to the extent of "gross income" that is actually paid from the trust. However, the deduction is available to *any* contribution made for a purpose under §170(c) *without* the limitations of §170(c)(2)(A), which latter provision makes the deduction available only for donations to U.S. charities. The purposes listed in §170(c) include "religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of [the donee's] activities involve the provisions of athletic facilities or equipment), or for the prevention of cruelty to children or animals." "Gross income," under §61(a)(3), includes realized capital gains. Contributions to a foreign charity by a trust that does not qualify as a tax-exempt entity under §501(c)(3), for purposes listed in §170(c), are therefore deductible and, in addition, there are no percentage limitations on the amount of distributed income for which a deduction may be claimed.

Treaty Exceptions for U.S. Citizens and Residents

The following exceptions to the prohibition on deductibility of contributions to foreign charities are provided under the relevant income tax treaties.

Contributions to Canadian and U.S. Charities

Under Article XXI(5) of the U.S.-Canada Income Tax treaty, for U.S. tax purposes, contributions by a U.S. citizen or resident to a Canadian charity (treated as an exempt organization by Canada and eligible to be treated as a U.S. charity if it were located in the United States) are generally eligible for the charitable deduction in an amount not to exceed that percentage of the U.S. citizen's or resident's Canadian income that could be deducted if the percentage limitations under §170 were applied to the Canadian income alone. However, in the case of contributions to a Canadian college or university at which the U.S. citizen or resident or a member of his family is or was enrolled, the amount that can be deducted is not limited to the U.S. citizen's or resident's Canadian income but rather to the general limitations applied for contributions to domestic charities. Article XXI(6) provides similar rules with respect to Canadian taxes for Canadian residents who make contributions to U.S. charities.

Contributions to Mexican and U.S. Charities

Under Article 22(2) of the U.S.-Mexico Income Tax Treaty, for U.S. tax purposes, contributions by a U.S. citizen or resident to a Mexican public charity eligible to receive deductible contributions under Mexican law (as long as the standards for determining Mexican public charity status are essentially equivalent to U.S. standards) are eligible for the U.S. charitable income tax deduction in an amount not to exceed that percentage of the U.S. citizen's or resident's Mexican income that could be deducted if the percentage limitations under §170 were applied to that person's Mexican income alone. Unfortunately, there is no exception to the Mexican income limitation for contributions by a U.S. citizen or resident to a Mexican college or university. Article 22(3) provides similar rules with respect to income tax deductions under Mexican law for Mexican residents who make contributions to U.S. public charities.

Contributions to Israel and U.S. Charities

Under Article 15A(1) of the U.S.-Israel Income Tax Treaty, for U.S. tax purposes, contributions by a U.S. citizen or resident to an Israel charity that is recognized as a charity under Israel's income tax laws and would be eligible to be treated as a U.S. charity if it were located in the United States, are eligible for the U.S. charitable income tax deduction in an amount not to exceed 25% of the U.S. citizen's or resident's Israel income. As with Mexico, there is no exception to the Israeli source income limitation for contributions by a U.S. citizen or resident to an Israeli college or university. Article 15A(2) provides similar rules with respect to Israel taxes for Israel residents who make contributions to U.S. charities.

Taxpayers Who Are Neither U.S. Citizens Nor Residents

Under the strict terms of §873(a), non-U.S. citizens who are neither U.S. permanent residents nor days residents ("nonresident aliens") are permitted to claim income tax charitable deductions only if the nonresident alien is conducting a trade or business in the United States within the meaning of §871(b). The same rule applies to foreign corporations and foreign trusts. Section 873(b)(2) does allow a nonresident alien taxpayer to claim the charitable deduction for contributions to U.S. governmental units and U.S. charities (in accordance with §170) even though the income is not effectively connected with a U.S. trade or business, but does not remove the requirement that the nonresident alien taxpayer be engaged in a U.S. trade or business. Thus, if a nonresident alien individual taxpayer is conducting a business in the United States and also has U.S. source income that is effectively connected with a U.S. trade or business, the taxpayer may claim the charitable deduction for contributions to U.S. government units and U.S. charities, subject to the percentage limitations described in footnote 1 above, with respect to both the taxpayer's U.S. source income that is effectively connected with a U.S. trade or business and the U.S. source income that is not so connected. In no event, however, may a nonresident alien taxpayer claim a charitable deduction for contributions to foreign governmental units or foreign charities.[8]

CHARITABLE TRANSFER TAX DEDUCTIONS AND FOREIGN DONEES

Generally, the restrictions on tax deductions for contributions to foreign charities do not apply in the case of the deductions under the estate taxes payable by the estates of U.S. citizens and U.S. non-citizen domiciliaries and also do not apply in the case of the gift taxes payable by U.S. citizens and U.S. non-citizen domiciliaries. The estate tax deduction is available for transfers to "any corporation" organized exclusively for charitable purposes (§2055(a)(2)), with no national or geographic limitation, and the gift tax deduction is available to transfers to "a corporation" organized exclusively for charitable purposes (§2522(a)(2)), again with no national or geographic restriction. The same holds true of trusts, community trust funds, chests and the like (§§2055(a)(3) and 2522(a)(2)), but without the restriction that any such trust, community fund and the like be exclusively organized for charitable purposes. *See also* Regs. §§20.2055-1(a) and 25.2522(a)-1(a).

Transfers to Foreign Governments

The estate and gift tax deductions, in the case of U.S. citizen and domiciliary estates or donors, is also available for transfers "to or for the use of the United States, any State, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes." Transfers to a foreign government for an exclusively public purpose, as far as the literal meaning of the statute is concerned, are therefore not deductible. However, some transfers to foreign governmental units have qualified for transfer tax deductions on the theory that: (i) the recipient of a deductible bequest or gift under §2055(a)(3) and §2522(a)(2) need not be devoted exclusively to charitable purposes and (ii) the bequests or gifts were made for charitable purposes that would generally be considered appropriate for non-governmental as well as governmental entities. In Rev. Rul. 74-523, the IRS agreed to accept the decisions of the U.S. Courts of Appeals for the First and Second Circuits respectively in *Old Colony Trust Company v. U.S.*,[9] allowing an estate tax deduction for a transfer to a hospital corporation owned by a Canadian municipality, and *Kaplun v. U.S.*,[10] allowing an estate tax deduction for a bequest of a coin collection to the State of Israel for permanent display in a museum. The IRS declared, however, that it would "continue to disallow a deduction under section 2055... with respect to a bequest of property to a foreign government or political subdivision thereof where the use of such property is not limited to exclusively charitable purposes within the meaning of sections 2055(a)(2) and 2055(a)(3)." The IRS has generally interpreted the restriction to charitable purposes very strictly. For example, in TAM 8748001, the IRS disallowed the deduction for a contribution to a foreign country even though the foreign country agreed that the bequest would be used for an agricultural high school. In TAM 8929001, the IRS disallowed the deduction for a bequest to a foreign country under whose law general bequests must be used for charitable purposes. It is clear that the bequest, by its terms, must be limited to charitable purposes and reliance on internal procedures of a foreign government or agreement between the foreign government and the estate will not likely remedy the deficiency. The IRS approach was recently upheld by the U.S. Tax Court in *Engelman est. v. Comr.,*[11] In that case, the remainder interest in a trust includible in Mrs. Engelman's taxable estate was to pass to the State of Israel upon her death. The estate argued that the estate tax charitable deduction should be allowed because, under a directive promulgated by the government of Israel in 1995, four years before the decedent's death but long after the establishment of the trust, Israel was bound to use all testamentary legacies to it for charitable purposes. The court held that, in order to sustain the charitable deduction, the donor not the donee must clearly require that the funds be used for charitable purposes. Because the donor did not make such an express stipulation in the trust instrument and because the trust had been established long before the government of Israel's directive, the court concluded that the requisite proof of the donor's intent donor was absent and that the deduction therefore could not be allowed. The case suggests that the result might have been different if the trust had been established after the action of the government of Israel, but, in the absence of an express direction in the trust instrument itself, the estate would have still had a very high burden of persuading the court that the bequest had been made with the directive in mind.

Transfers to Foreign Private Foundations Generally

There are additional requirements under §2055(e)(1) and §2522(c)(1) for obtaining the charitable deduction for transfers to private foundations and trusts not exclusively devoted to charitable purposes, which may be particularly difficult to satisfy in the case of transfers to foreign foundations.

Requirement of Filing for U.S. Tax Exemption

Generally, a private foundation must have applied to the IRS for exempt status or it must have given notice of its intent to file for such exemption (§508(d)(2)(B)).

Compliance with Private Foundation Rules for U.S. Domestic

Foundations

Generally, under §508(e)(1), an eligible private foundation must be required by its charter documents to make the required minimum distributions stipulated in §4942 and to abide by the restrictions on private foundation activities stipulated in §4941 and §4943-4945. These restrictions, as mentioned above, include prohibitions on jeopardizing investments, excess investments in any one company and "self-dealing" transactions between the foundation, on the one hand, and significant contributors and the entity's directors, officers or trustees, on the other.[12]

Exception for "85%" Foreign Private Foundations

Under §4948(b), the rules described above, which essentially require a foreign foundation to qualify as a U.S. tax-exempt entity and follow all the U.S. restrictions on the activities of domestic private foundations, "shall not apply to any foreign organization which has received substantially all of its support (other than gross investment income) from sources outside the United States." Under Regs. §53.4948-1(b), "any foreign organization which from the date of its creation has received at least 85 percent of its support (as defined in §509(d) [gifts, grants, contributions, membership fees, gross receipts from admissions, fees, and related payments, net income from unrelated business activities, and certain tax revenues and governmental services or facilities provided to the organization] other than §509(d)(4)) [gross investment income] from sources outside the United States" is a beneficiary of this exception. The regulation goes on to clarify, however, that "gifts, grants, contributions, or membership fees directly or indirectly from a United States person (as defined in §7701(a)(30)) [see the discussion, above] are from sources within the United States." This article refers to a foreign foundation that receives at least 85% of its support from abroad as an "85% foreign foundation."

Transfers to "85%" Foreign Foundations

The "bad news" about contributions to 85% foreign foundations is that there are some special restrictions on the availability of the charitable deduction under §4948. The good news is that the IRS has, by regulation, substantially ameliorated these restrictions. Under §4948(c)(4), no charitable deduction under any provision of the Code is available to an 85% foreign foundation (1) to which the Secretary of the Treasury has issued a Notice published in the Federal Register to the effect that the foreign organization has engaged in a transaction that is a "prohibited transaction" in violation of the private foundation rules, or (2) it has in fact engaged in a "prohibited transaction" after December 31, 1969. The first circumstance would be easy enough to establish but the second circumstance would impose an almost impossible requirement of due diligence on every potential contributor concerned about securing a U.S. gift or estate tax deduction for a contribution to a foreign foundation because a "prohibited transaction," under §4948(c)(2), is not only a mere violation of the private foundation rules but one which would attract a tax under §507 or a penalty under §6684, both of which assume willful and repeated behavior. However, in apparent acknowledgment of the unreasonable demand imposed by the second condition under §4948(c)(4), the IRS has created, under Regs. §53.4948-1(c)(2)(iii), a safe harbor with regard to the second condition. Under this safe harbor, the second condition applies only if the IRS Commissioner has issued a warning to the foreign donee regarding a prohibited transaction in which the foreign foundation has allegedly engaged.

Transfer Tax Deductions for Transfers by Persons Who Are Not U.S. Citizens or Domiciliaries

The provisions of §§2055 and 2522(a) that allow transfer tax deductions for bequests and gifts to foreign charities do not apply to transfers to foreign charities by persons who are neither U.S. citizens nor U.S. non-citizen domiciliaries. Section 2106(a)(2) permits the charitable deduction for bequests by decedents who were neither U.S. citizens nor U.S. non-citizen domiciliaries to the United States, the States of the United States, and their political subdivisions for exclusively public purposes. Unlike the provisions of §2055 which make the U.S. estate tax charitable deduction available to estates of U.S. decedent citizens and domiciliaries, §2106(a)(2) permits the deduction for transfers to corporations dedicated exclusively to charitable purposes only if the charitable corporations are domestic. Unlike §2055, it also limits the deduction to trustees only if "such contributions of gifts are to be used within the United States." The same restrictions apply, under §2522(b), to the charitable deduction for gifts made by "a nonresident not a citizen of the United States." [13]

Exceptions and Special Cases under Tax Treaties

Contributions to Canadian and U.S. Charities

Under Article XXIX(B) of the U.S.-Canada Income Tax Treaty, for U.S. tax purposes, transfers at death from a U.S. decedent or Canadian decedent to a Canadian charity are to have the same tax consequences that would apply if the Canadian charity were a U.S. charity. The same rule applies for Canadian tax purposes to U.S. and Canadian decedents leaving property to U.S. charities. Since Canada has no inheritance tax, the Canadian deduction is applied against the Canadian capital gains tax on deemed realization at death. It must be kept in mind that Article IV(1) permits the application of Treaty benefits to a person who is not a Canadian resident but who is a U.S. citizen or permanent resident only if the person has domicile-like connections with the United States because this Treaty is an income tax treaty rather than an estate tax treaty.

Contributions to Danish and U.S. Charities

For U.S. tax purposes, under Article 9(1) of the U.S.-Denmark Estate and Gift Tax Treaty, contributions to a Danish corporation or organization that is devoted completely to charitable purposes and receives tax relief in Denmark are to be treated by the United States as if the Danish charity were a U.S. charity. Similarly, contributions to the Danish government "for exclusively public purposes" are to be treated as if they were made to U.S. governmental units "for exclusively public purposes." The same rules apply for Danish tax purposes for contributions to U.S. charities and governmental units.

Contributions to French and U.S. Charities

Under Article 10 of the U.S.-France Estate and Gift Tax Treaty, for U.S. tax purposes, contributions to a French charity completely devoted to charitable purposes are to be treated as if the French charity were a U.S. charity if contributions to a French charity would be fully tax-exempt in France, subject to the following conditions: the French charity must be organized exclusively for charitable purposes and the French charity must receive a substantial portion of its support from the public. The same rule applies for French tax purposes to contributions to U.S. charities. This means that the Treaty does not make the French charitable deduction available for contributions to U.S. private foundations.

Contributions to German and U.S. Charities

Under Article 10(2) of the U.S.-Germany Estate and Gift Tax Treaty, for U.S. tax purposes, contributions to a German charity completely devoted to charitable purposes or to a German "public body" for charitable purposes are to be treated as if the German charity or "public body" were a U.S. charity or "public body" as long as transfers to the German charity or "public body" would be fully tax-exempt in Germany and would be tax-exempt in the United States if the German charity were a U.S. charity or "public body." It is not necessary that the German charity meet a public support test under U.S. law unless such test is also imposed by German law. The same rule applies for German tax purposes to contributions to U.S. charities and "public bodies," which means that the German charitable deduction is available for contributions to U.S. private foundations as well as U.S. public charities if consistent with German law.

Contributions to Greek and U.S. Charities

The U.S.-Greece Estate Tax Treaty does not contain specific provisions regarding transfers to charities. However, the Treaty may provide some charitable deduction relief to Greek citizens who are not domiciled in the United States and U.S. citizens who are not domiciled in Greece. Under Article V, in the case of a decedent who did not die domiciled in the United States but was a citizen or domiciliary of Greece, the United States is required to afford the same exemptions and deductions it would afford to the decedent's estate if the decedent had been domiciled in the United States to the extent of the proportion that the decedent's property determined to have a situs in the United States under the Treaty bears to the value of the property that would have been subject to U.S. estate tax if the Greek decedent had died a U.S. domiciliary. The same rule applies for Greek tax purposes to the taxation of a decedent not domiciled in Greece who was a U.S. citizen or domiciliary.

Contributions to Swedish and U.S. Charities

Under Article 8(7) of the U.S.-Sweden Estate and Gift Tax Treaty, for U.S. tax purposes, contributions to a Swedish charity completely devoted to charitable purposes are treated as if the Swedish charity were a U.S. charity if: (i) transfers to the Swedish charity would be fully tax-exempt in Sweden and (ii) the transfers would be tax-exempt in the United States if the Swedish charity were a U.S. charity. As with the German Treaty and unlike the French Treaty, it is not necessary that the Swedish charity meet a public support test unless such a test is imposed by Swedish law. The same rule applies for Swedish tax purposes to contributions to U.S. charities, which means that the Swedish charitable deduction is available for contributions by Swedish and U.S. "domiciliaries" to U.S. private foundations as well as U.S. public charities if consistent with Swedish law. The Swedish Treaty does not have a provision dealing with contributions to governmental units.

SPECIAL CONSIDERATIONS REGARDING TRANSFERS TO FOREIGN CHARITABLE TRUSTS

In 1996, Congress revised many tax rules regarding the use by U.S. persons of foreign trusts. Of particular note for this discussion are new versions of: (i) §679, which makes a U.S. person who transfers assets to a foreign trust with U.S. beneficiaries the owner, for income tax purposes, of the trust, and (ii) §684, which imposes a capital gains tax on the unrealized appreciation of assets transferred by U.S. persons to a foreign trust. The 1996 legislation also established rules for determining whether a trust is foreign or domestic for U.S. income tax purposes, under which it is relatively easy for a trust to be treated as a foreign trust even if, from a property and choice-of-law perspective, the trust would be considered domestic. Essentially, all that is necessary for a trust that is subject to the jurisdiction of a U.S. court to be considered a foreign trust is for a person who is neither a U.S. citizen, a U.S. permanent resident nor a U.S. days resident to have the ability to make just *one* substantial decision affecting the trust, which could include any power about the recipient or the timing of a distribution but also could include the mere power to appoint a successor trustee (unless the trust's governing instrument expressly requires that the trustee be a U.S. person or entity).[14]

Possible Grantor Trust Status for Transfers to Foreign Charitable Trusts Established by U.S. Persons

Under §679 and the related regulations promulgated in 2001, a test must be made each year in respect of any foreign trust to which a U.S. person has contributed property (other than for fair and adequate consideration) to determine whether any U.S. person has a current or future interest in the trust. If any U.S. person has any such interest in the trust in that year, the U.S. contributor is treated, for U.S. income tax purposes, as the owner in that year of the trust property attributable to the U.S. person's contributions regardless of when those contributions were made. Only the interest of a U.S. beneficiary that the regulations treat as a "negligible contingent interest" may be disregarded.

Education Trust Described as "679" Trust

Example 10 of Regs. §1.679-2(a)(2)(iii) describes a trust that would seem to qualify as a charitable trust. The trust is described as being established to promote the academic study of ancient Greek and to give grants to persons dedicated to the study of the language. Because the trustee could select a U.S. person to receive funds from the trust, the trust is deemed a grantor trust for purposes of §679 and the trust is treated, for U.S. income tax purposes, as wholly owned by the grantor.

Exception for Certain Charitable Trusts

However, Regs. §1.679-4(a)(3) provides that any transfer to a foreign trust devoted exclusively to charitable purposes as described in §501(c)(3) will be exempt from the provisions of §679, even if the trust has not filed with the IRS for recognition as tax-exempt entity or otherwise met the requirements of §508(a) by giving notification of its intent to apply for such recognition.

Possible Tax on Transfers to Foreign Charitable Trusts Established by U.S. Persons

Under §684 and the regulations promulgated thereunder in 2001, a U.S. person who makes a transfer of appreciated property to a foreign trust (other than for fair and adequate consideration) is subject to capital gains tax on the unrealized appreciation in the contributed property. A contribution to a foreign trust does not trigger the §684 tax if the grantor is treated as the owner of the trust under §679 until such time as the grantor ceases to be treated as the §679 owner. Under Regs. §1.684-3(c), if the grantor ceases to be treated as the §679 owner because of the grantor's death but the trust is includible in the grantor's taxable estate, making it eligible for a step-up in basis, no §684 tax is triggered. Furthermore, under Regs. §1.684-3(b), the §684 tax is not triggered if property is transferred to a foreign trust devoted exclusively to charitable purposes as described in §501(c)(3), even if the trust has not applied for recognition of its exempt status or given notice of its intent to do so.

Charitable Remainder Trusts

Charitable remainder trusts are a mainstay of income and estate tax planning for U.S. persons with a desire to benefit charity. We now address the issues of whether a charitable remainder trust may have a foreign charitable beneficiary, and whether a charitable remainder trust may be organized as a foreign trust.

Foreign Charities Not Eligible Beneficiaries of a CRT

Under §664(d)(1)(C), in order for a trust to qualify as a charitable remainder trust, the remainder interest in the trust must, upon the termination of the noncharitable interests, "be transferred to, or for the use of, an organization described in section 170(c) or... be retained by the trust for such a use." Section 170(c)(2)(A), of course, requires that any corporation or trust thereunder be created or organized in the United States. One might think that a foreign charitable organization established for the use of a domestic charitable organization or controlled by it could be an eligible remainder beneficiary of a testamentary CRT, but any argument that the provisions of §664(d) permit a more flexible application appear to be belied by the estate and gift tax provisions of Regs. §20.2055-2(e)(2)(v) and §25.2522(c)-3(c)(2)(v). Although these regulations regarding the estate and gift tax charitable deductions generally permit charitable deductions for transfers to foreign charities, the cited provisions, which are found in the sections of the regulations dealing with transfers not exclusively dedicated to charitable purposes, require that transfers to charitable remainder trusts comply with the requirements of §664(d). Some doubt on the IRS's position is caused by TAM 7938001, under which the IRS declined to allow an estate tax charitable deduction for a bequest to a CRT with the State of Israel as the remainder beneficiary -- not because the State of Israel was the beneficiary but because the remainder interest was not required to be used exclusively for charitable purposes. In PLR 7837067, the IRS approved the grant of the estate tax charitable deduction in the case of a foreign charitable remainder trust established under the will of a U.S. citizen domiciled abroad but the ruling does not discuss the named charitable beneficiary and the will contained a charitable deduction savings clause. In PLR 9311029, the IRS, noting that Regs. §20.2055(c)(2)(v) provides that the charitable organization to which a remainder interest passes must meet both the requirements of §2055(a) *and* §664(d)(1)(C) or §664(d)(2)(C), concluded that "the charitable organization to which the charitable interest in [an] annuity trust passes may not be a foreign corporation."

A Lifetime CRT Must Be a Domestic Trust

Since the charitable beneficiaries of a CRT must be domestic charities, a foreign CRT established by a U.S. grantor with a U.S. charitable remainder beneficiary would, during the grantor's lifetime, be subject to the provisions of §679 because the domestic charity is a U.S. person with an interest in the trust. The exception to the application of §679 for foreign charitable trusts only applies to trusts that are exclusively devoted to charitable purposes under §501(c)(3), not to CRTs that gain their U.S. tax exemption under §664(c). Under Regs. §1.664-1(a)(4), for purposes of determining when a trust qualifies as a CRT, the trust is deemed to be created "at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust" under §§671-679. Regs. §1.664-1(a)(4) does provide that neither the grantor nor the grantor's spouse will be treated as the owner of a trust that would otherwise qualify as a CRT merely because either is named as a beneficiary of the trust. While this provision would have presumably prevented the mere interest of the U.S. grantor or grantor's spouse from causing a foreign trust to fail to qualify as a CRT, the requirement that the charitable beneficiary be domestic would cause any otherwise eligible CRT to fail to qualify if the CRT were set up as a foreign trust because §679 would still apply. This conclusion is confirmed by Rev. Rul. 77-285, under which the test of whether a trust qualifies as a charitable remainder trust is whether none of the provisions of §673 to §679 apply.

A Testamentary CRT May Be a Foreign Trust

The provisions of §679 cease to apply upon a grantor's death. There does not appear to be any requirement under §664 that a testamentary CRT be a domestic trust, even though the charitable remainder beneficiaries clearly must be domestic. If the trust is funded with appreciated assets that were not includible in the deceased grantor's taxable estate, the capital gains tax under §684 would apply because the exception for transfers to charitable organizations only applies to organizations that are exclusively devoted to charitable purposes. As mentioned above, in PLR 7837067 the IRS approved the grant of the estate tax charitable deduction to a charitable remainder trust established abroad provided that the trust would be valid under local law.

Nonresident Alien Withholding Tax for Foreign CRT

Since a domestic CRT is exempt from tax except to the extent of unrelated business taxable income ("UBTI"), one might conclude that a foreign CRT with no UBTI should not be subject to the nonresident alien withholding tax on fixed, periodic and determinable income from U.S. sources. However, a CRT does not qualify as an exempt entity under Regs. §1.1441-1(b)(4)(xvii) because it is not exempt from tax under §501(c) but rather under §664(c). Under Regs. §1.1441-1(c)(6)(ii)(D), a CRT would be effectively treated as the beneficial owner of the U.S. source income paid to it, and therefore the payments to it would be subject to withholding tax, because a foreign trust that is neither a foreign simple trust nor a foreign grantor trust is considered to be the beneficial owner of the trust's income. Of course, if the trust's income consists solely of foreign income and income eligible for exemptions from U.S. taxation under the relevant provisions of §871(a) (e.g., short-term original issue discount, bank account income, certain portfolio debt, as well as capital gains on the sale of U.S. assets), there should be no nonresident alien withholding on the CRT's U.S. source income. Since the foreign CRT would be treated as the beneficial owner of the U.S. source income paid to it, the CRT should have no obligation to withhold U.S. income tax on payments made to a foreign annuitant.

Charitable Lead Trusts

A less popular, but in certain circumstances significant, tax-planning entity for U.S. persons with charitable intent is the charitable lead trust. The article addresses below the issue of whether a charitable lead trust may have a foreign charitable beneficiary, and the consequences of establishing a charitable lead trust as a foreign trust.

Foreign Charities Appear to Be Eligible Beneficiaries of CLTs

Unlike CRTs, CLTs do not enjoy any automatic tax exemption. However, income permitted or required to be paid to a charitable beneficiary is eligible for the income tax charitable deduction under §642(c). As noted above, in the case of the income tax charitable deduction for non-charitable trusts, the restriction to U.S. charitable entities imposed on individual donors does not apply. It should be noted, however, that if an individual donor is seeking an income tax deduction for a contribution to a charitable lead trust, the charitable beneficiary must be a U.S. charity. There is no such limitation on the estate and gift tax charitable deductions and there does not appear to be any regulatory equivalent to Regs. §20.2055-2(e)(2)(v) and §25.2522(c)-3(c)(2)(v), which, as discussed above, appear to preclude the availability of the deduction in the case of testamentary CRTs with foreign charitable remainder beneficiaries.

A CLT May Be a Foreign Trust

Since there is no *per se* limitation on the domestic or foreign status of a charitable beneficiary of a CLT, it appears a CLT could be a foreign trust. If the charitable or noncharitable beneficiary is a U.S. person, however, the trust will be a grantor trust under §679 and the grantor will taxable on all of the trust's income and gains. Of course, a grantor can claim a charitable income tax deduction on transfers to a charitable lead trust if the trust is a grantor trust and the charitable beneficiary is domestic. But the cost of assuming any CLT's tax liability appears to be worth the benefit of the income tax charitable deduction, at least under current law, only under certain limited circumstances, generally when the grantor is expecting to have significantly less income after the year in which the CLT is funded and the trust period is relatively short. If a foreign CLT has no U.S. beneficiaries for purposes of §679 and the trust is not otherwise a grantor trust, then it should be treated as a separate taxable entity. Of course, if a foreign CLT is funded with appreciated assets, the grantor will be liable for the capital gains tax on the unrealized appreciation of the assets pursuant to §684. But if the foreign CLT is a testamentary trust, funded with assets includible in the taxable estate, the appreciated assets will be eligible for a step-up in basis and no §684 tax will be due on the pre-death appreciation of the contributed assets, at least through the end of 2009, before estate tax repeal becomes effective during 2010, and possibly in 2011 and thereafter, if repeal is not made permanent.

Nonresident Alien Withholding Tax for Foreign CLT

Since a foreign CLT is not exempt from withholding tax under Regs. §1.1441-1(b)(4)(xvii) and is not a simple trust (where all income must be paid to one or more beneficiaries annually), payments of U.S. source income to the CLT appear to be subject to nonresident alien withholding tax. Moreover, unless the foreign CLT is considered to be actively engaged in a U.S. trade or business, the CLT, as a nonresident alien taxpayer, would appear not to be able to claim a charitable deduction for contributions to U.S. charities for the reasons discussed above. As with a foreign CRT, the withholding tax would generally not be applicable if the trust's income consisted solely of foreign income and income eligible for exemption from U.S. taxation under the provisions of §871(a) and, therefore, the lack of a charitable deduction would not be harmful.

FOREIGN CHARITABLE ORGANIZATIONS AND U.S. EXEMPT STATUS

The income tax exemption for charitable trusts under §501(c)(3) is not limited, by its terms, to domestic charities. Foreign charitable organizations may apply to the IRS to be recognized as exempt organizations and, under §508(a), it would appear that any charitable organization organized after October 9, 1969 must apply or give notice of its intent to apply in order to be treated as a 501(c)(3) organization.

Exemption from Nonresident Alien Withholding Tax for Foreign Charities

To the extent that a foreign charity has U.S. determinable fixed and periodic income that would not be exempt from tax under the provisions of §871, U.S. tax-exempt status is particularly important. As just mentioned, absent a statutory or regulatory exception, one would expect that exemption from nonresident alien withholding tax would not be available to a foreign charity under §508(a) unless it applied for recognition of its exempt status. In many cases, a foreign charity may be reluctant to subject itself to scrutiny by the IRS and to IRS reporting requirements.

Certain Foreign Private Foundations

As mentioned above, §4948(b) exempts an "85%" foreign (private) foundation from the requirements of §508 as long as it does not engage in "prohibited transactions." The same safe harbor discussed above also applies.

Foreign Public Charities and Foreign Foundations That Are Not 85% Foreign Foundations

Section 1443 ("foreign exempt organizations"), by its terms, does not expressly require foreign public charities to obtain formal IRS recognition of their tax-exempt status in order to be exempt from U.S. withholding tax. Instead, it states, rather laconically, that withholding applies only to the UBTI of a foreign exempt organization referred in §512 (income derived from U.S. sources whether or not qualifying as effectively connected income) to the extent the Secretary of the Treasury provides in regulations, and, in the case of foreign private foundations, only at the rate set forth in §4948. Regs. §1.1441-9(a) exempts from nonresident alien withholding tax amounts paid to a foreign organization described in §501(c), to the extent that such amounts are not includible under §512 in computing the organization's UTBI. To establish eligibility for the exemption, presentation of a withholding certificate is required. Under Regs. §1-1441-9(b)(2), the withholding certificate is made on Form W-8 and must contain a taxpayer identification number and either a letter from the IRS determining that the organization is exempt or an opinion from U.S. counsel concluding that the organization is described in §501(c).

Excise Tax on Foreign Private Foundations

Domestic private foundations are subject to a 2% annual excise tax on investment income (except in the case of private operating foundations, for whom the tax is reduced to 1%). Section 4948(a) increases the rate of tax on U.S. investment income of foreign private foundations to 4%. The tax may be reduced or eliminated by treaty.

Treaty Provisions

Canada

Under Article XXI(1) of the U.S.-Canada Income Tax Treaty, U.S. income of a Canadian "religious, scientific, literary, educational or charitable organization" will be exempt from U.S. income tax to the extent the income would be exempt from tax in Canada. Under Article XXI(4), if such a Canadian organization receives substantially all of its support from outside the United States, the organization will be exempt from the 4% U.S. excise tax on foreign private foundations. These benefits are subject to the "limitation of benefits" for non-profit organizations under Article XXIXA(2)(g) of the Treaty, under which one-half of the beneficiaries, members or participants in the Canadian entity must be Canadian residents or U.S. citizens or residents, governmental entities and certain companies. There are reciprocal provisions relating to Canadian income tax on U.S. charitable organizations.

Germany

Under Article 27 of the U.S.-Germany Income Tax Treaty, a German organization exclusively devoted to charitable purposes will be exempt from U.S. income tax if it is recognized as tax-exempt in Germany and the items of income would be exempted from U.S. tax if the charity were a U.S. charity. This benefit is *not* subject to the "limitation of benefits" for non-profit organizations under Article 28(1)(f) of the Treaty. The U.S. excise tax on private foreign foundations does not appear to be covered by the Treaty. There are reciprocal provisions relating to German income tax on U.S. charitable organizations.

Mexico

Under Article 22(1) of the U.S.-Mexico Income Tax Treaty, a Mexican organization exclusively devoted to charitable purposes will be exempt from U.S. income tax if it is recognized as tax-exempt in Mexico and the items of income would be exempt from U.S. tax if the charity were a U.S. charity. Under Article 22(4), if such a Mexican organization receives substantially all of its support from outside the United States, the organization will be exempt from the 4% excise tax on foreign private foundations. These benefits are subject to the "limitation of benefits" for non-profit organizations under Article 17(1)(e) of the Treaty, under which more than one-half of the beneficiaries, members or participants in the Mexican entity must be Mexican or U.S. residents. There are reciprocal provisions relating to Mexican income tax on U.S. charitable organizations.

The Netherlands

Under Article 36 of the U.S.-Netherlands Income Tax Treaty, a Netherlands organization exclusively devoted to charitable purposes will be exempt from U.S. income tax if it is recognized as tax-exempt in The Netherlands and the items of income would be exempt from U.S. tax if the charity were a U.S. charity. These benefits are subject to the "limitation of benefits" for non-profit organizations under Article 26(1)(e) of the Treaty, under which more than one-half of the beneficiaries, members or participants in The Netherlands entity must be Netherlands residents and U.S. citizens and residents. There are reciprocal provisions relating to Netherlands income tax on U.S. charitable organizations.

U.S. PRIVATE FOUNDATIONS AND FOREIGN ACTIVITIES

As mentioned above, domestic private foundations, in addition to making contributions to domestic public charities and certain other authorized domestic recipients, may also make grants for exclusively charitable purposes to foreign governments, international organizations and foreign public charities.

Qualification of Foreign Charity to Receive Distributions of U.S. Private Foundations

A U.S. private foundation may generally not make a distribution to a domestic charity unless the charity has applied to the IRS for recognition of its exempt status. Regs. §53.4945-5(a)(3). The IRS, however, has ameliorated the requirement of formal IRS recognition with respect to foreign public charities. Under Regs. §53.4945-5(a)(5), a U.S. private foundation that has made a "good faith" determination that a foreign charity would qualify as a public charity under §509(a) may make qualifying contributions to the foreign charity. A "good faith" determination is deemed to have been made if the private foundation has obtained an affidavit of the foreign charity or counsel for the private foundation or the foreign charity, setting forth sufficient facts for the IRS to be able to determine that the foreign charity would likely qualify as a public charity. Rev. Proc. 92-94 sets forth the specific requirements for the affidavit and for its updating in subsequent years.

Foreign Program Related Investment

The IRS has recently issued several PLRs regarding "program-related" investments of U.S. private foundations abroad. For example, in PLR 200031053, a private foundation proposed to make a grant to the government of a foreign country to finance the construction and rehabilitation of a highway running through much of the country. The IRS ruled that the grant was for an exclusively "charitable, program-related activity" because it would be "used exclusively in the impoverished country of M to create essential public works for the general public of M." The IRS found that the grant did not violate any of the private foundation rules, that it did not constitute a "taxable expenditure" under §4945 or otherwise require the exercise of "expenditure responsibility," and that it would be eligible to satisfy the minimum distribution requirements of §4942. Similar rulings have dealt with grants to establish a foreign orphanage (PLR 200121078), to assist organizations in a foreign country to establish news media (PLR 200034037), and an environmentally oriented for-profit financial intermediary under World Bank guidelines (PLR 200136026).

GRANT-MAKING PROCEDURES FOR CONTRIBUTIONS TO SUPPORT FOREIGN CHARITABLE ACTIVITIES AND ENTITIES

In the wake of the September 11, 2001 attacks, the U.S. Treasury Department made a determination that three U.S.-based charitable organizations were linked to foreign terrorist organizations, including Al-Qaeda and Hamas. These determinations led to a wider focus on the grant-making activities and procedures of U.S. charitable organizations that distribute funds abroad, whether in the form of overseas programs or donations to foreign charitable entities. In November, 2002, the Treasury Department issued "Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities" and in the spring of 2003, the Internal Revenue Service issued Announcement 2003-29, "International Grant-making and International Activities by Domestic 501(c)(3) Organizations: Request for Comments Regarding Possible Changes."

Voluntary Best Practices

The Treasury Guidelines cover a broad range of considerations that go beyond strict concern about the destination of foreign charitable donations, covering governance, disclosure about governance and finances, financial practice and accountability, as well as "Anti-terrorist Financing Procedures."

Governance

The governance guidelines, which seem to overlook the fact that domestic charities can be organized as trusts as well as corporations, urge that each charitable organization should have basic governing instruments, a board of directors with at least three members, and policies on conflicts of interest. The governance guidelines state that a charity whose directly or indirectly compensated board members constitute more than one-fifth of the total voting membership of the board or executive committee "will not be considered to have an independent governing body."

Disclosure/Transparency

The Guidelines urge that a charity make public a list of its board members and the salaries they are paid for their services, a list of its five highest paid employees and the salaries and benefits they receive, and any subsidiaries or affiliates that receive funds from it. The Guidelines also urge that the charity provide upon request an annual report and annual financial statements. In jurisdictions like New York that provide for governmental oversight of private charities, most charities are required to produce a form of annual report and annual financial statements.

Financial Practice and Accountability

The Guidelines, among other matters, provide that if a charity's total annual gross income exceeds $250,000, the charity's board should select an independent certified public accounting firm to serve as an auditor and issue a yearly audited financial statement.

Anti-Terrorist Financing Procedures

The guidelines urge that a domestic charity should collect what the Guidelines call "basic" information about a foreign recipient organization, including the foreign recipient's name in English and the addresses of its places of business abroad, the jurisdictions in which it is present, the jurisdiction in which it is organized and incorporated, and "a detailed report of the recipient's projects and goals." Furthermore, the Guidelines provide that the domestic charity should gather information about the organizations to which the foreign entity makes contributions or provides support, the foreign organization's principal subcontracting organizations, copies of any public filings or releases made by the foreign charity, and the foreign charity's sources of income. The Guidelines go even further and stipulate that a domestic charity "should be able to demonstrate that it conducted a reasonable search of public information, including information via the internet, to determine whether the foreign recipient organization is or has been implicated in any questionable activity." The domestic charity should also be able to demonstrate that it verified "that the foreign recipient organization does not appear on any list of the U.S. Government, the United Nations or the European Union identifying it as having links to terrorism or money laundering." Moreover, the Guidelines not only recommend that a domestic charity gather much of the same information about a foreign recipient organization that the Guidelines recommend be make public about the domestic charity but urge that the domestic charity should also require foreign recipient organizations "to certify" that they do not employ or deal with any entities or individuals on the U.S., U.N. or E.U. lists of suspect organizations or with any entities known to the foreign organization to support terrorism. In one of the most controversial directions of the recommendations, the Guidelines urge that a domestic charity should "identify the financial institutions with which the foreign organization maintains accounts" and "seek bank references and determine whether the financial institution has any characteristics that would be a grounds for concern" and also that the charity should "perform routine, on-sight audits of foreign recipient organizations whenever possible, consistent with the size of the disbursement and the cost of the audit."

Request for Comments on International Grant Making

The 2003 Announcement indicated that the IRS is considering issuing additional guidance to clarify "standards and requirements" for international grant making and international activities and, to that end, making revisions to the standard application for tax-exempt status on Form 1023 and the annual filings by charitable organizations on Form 990 (public charities) and 990-PF (private foundations). The IRS invited comments on current practices for monitoring overseas charitable activities, recommendations for procedures to better protect against grants being "diverted to support terrorism or other non-charitable activities," suggestions for possible changes to the above-mentioned IRS Forms, and responses to the November 2002 Voluntary Best Practices. The response to the IRS's invitation has been varied. In a comprehensive response, the organization Grantmakers Without Borders urged that the problems encountered with certain Islamic organizations were unique and should not be used as a pretext for substantial increases in the regulation of international charitable giving. The organization urged that the Treasury keep a list of prohibited foreign grantees that could be consulted by domestic charities contemplating overseas charitable grants and that any requirements of additional due diligence be calibrated to the size of the donation.

CONCLUSION

Navigating the complex U.S. tax rules regarding international charitable contributions and activities requires precise attention to the identity of the donor, the donee, and related charitable actors. The restrictions on the U.S. charitable deduction for U.S. income tax purposes can be alleviated in many cases by establishing approximate U.S. charitable entities for the support of overseas activities. The transfer tax charitable deductions are much more generous, although great care must be paid to contributions to foreign governments. In certain cases foreign trusts may operate as charitable remainder and charitable lead trusts. Foreign private foundations primarily established with foreign capital may generally avoid complex filings and reporting to the IRS in order to be exempt from most U.S. income taxes. U.S. private foundations, with reasonable due diligence and attention, may be able to become international actors in the field of charitable activity and funding. It is unclear at this time whether extensive additional reporting and due diligence will be required of U.S. charitable organizations and trusts that are engaged in overseas charitable activities and grant making.

Footnotes

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[1] An individual may deduct in any tax year contributions to public charities not exceeding 50% of the contributor's "contribution base" (adjusted gross income computed without regard to any net operating loss carryback to the taxable year). §170(b)(1)(A). The limit for contributions to public charities of capital gain property is 30% of the contribution base. §170(b)(1)(c)(i). Five-year "carryovers" for contributions in excess of the ceilings are allowed. §170(d)(1)(A) and §170(b)(1)(C)(ii). For purposes of valuing the deductible amount of contributions of long-term capital gain property to public charities, gifts of stock of closely-held companies as well as publicly-traded companies may generally be valued at market value rather than limited to the contributor's cost basis.

An individual may deduct in any tax year contributions to private foundations not exceeding the lower of: (i) 30% of the contributor's "contribution base" (adjusted gross income computed without regard to any net operating loss carryback to the taxable year) or (ii) the difference between 50% and the amount of deductible contributions allowable under the 50% ceiling (to public charities, U.S. governmental units for charitable purposes, educational institutions, etc.). §170(b)(1)(B). The limit for contributions of capital gain property to public foundations is the lower of 20% of the contribution base or the difference between 30% and the amount of authorized deductible capital gains contributions allowable under the 30% ceiling (to public charities, etc.). §170(b)(1)(D)(i). Five-year "carryovers" for contributions in excess of the ceilings are allowed. §170(d)(1)(A) and §170(b)(1)(D)(ii). For purposes of valuing the deductible amount of contributions of long-term capital gain property to private foundations, gifts of stock of closely-held companies may generally not include appreciation in excess of the contributor's cost basis. *See* §170(e)(1).

[2] The term "days resident" is used in this article to refer solely to those persons who are considered "residents" under the Internal Revenue Code for income tax purposes even though they are neither U.S. citizens nor U.S. permanent residents. Of course, all U.S. citizens and permanent residents qualify as "residents" for income tax purposes under the Internal Revenue Code.

[3] *See* Regs. §§53.4942(a)-3(a) and 53.4945-5(a).

[4] 1 T.C. 905 (1945).

[5] 75 T.C. 480 (1980).

[6] 2 T.C. 441 (1943).

[7] *See* H. Christensen, *International Estate Planning*, §13.03[7] (2001), B. Hopkins, *The Law of Tax-Exempt Organizations* §303 (1998).

[8] *Accord* W. Newton, I *International Income Tax and Estate Planning* ¶4.36 n. 353 (2001). In two cases, the strict construction of the limitation on the availability of the charitable deduction to nonresident aliens seems to have been overlooked. In *Barba v. U.S.,* 83-1 USTC ¶9404 (Ct. Cl. 1983), the Federal Court of Claims stated in dicta that the deductions permitted under §873(b), including the charitable deduction, are available even though there is no U.S. trade or business. In *Caba v. U.S.,* 2001-1 USTC ¶50,406 (Ct. Cl.

2001), the same Court overlooked the requirement of §871(a) that the income be effectively connected with a U.S. trade or business in order for a deduction (personal exemption) under §873(b) to be available. *But see P.A. deKrause*, 33 TCM 1362, T.C. Memo 1974-29 (Mexican trust beneficiary not eligible to claim deductions on trust distribution of U.S. dividend income because trust was not engaged in a U.S. trade or business). The opening sentence of Regs. §1.873-1 may be somewhat responsible for the confusion: "In computing the taxable income of a nonresident alien individual the deductions otherwise allowable shall be allowed only if, and to the extent that, they are connected with income from sources within the United States." However, the regulation has not been revised since 1957 despite numerous significant changes since then in the law regarding the U.S. taxation of nonresident aliens. In the case of a nonresident alien taxpayer that does conduct business in the United States, the taxpayer must allocate charitable contributions between foreign source and U.S. source income. *See* §861(b), Regs. §§1.861-8(e)(9) and 1.861-8(g)(iv).

[9] 438 F.2d 684 (1st Cir. 1971).

[10] 436 F.2d 799 (2nd Cir. 1970).

[11] 121 T.C. No. 4 (2003).

[12] Charitable lead trusts must also abide by the restrictions on private foundation activities stipulated in §4941 and §§4943-4945, and charitable remainder trusts must abide by some or all of these restrictions depending on whether the remainder beneficiaries are public charities or private foundations. §4947(a)(2).

[13] It is critical to keep in mind that "nonresident" for estate and gift tax purposes does not mean a person who does not qualify as a resident (permanent resident or days resident) for U.S. income tax purposes. Rather, under Regs. §20.0-1(b)(2), "[a] `nonresident' decedent is a decedent who, at the time of his death, had his domicile outside the United States." Similarly, under Regs. §25.2501-1(b), "a resident is an individual who has his domicile in the United States at the time of making the gift," and a nonresident, by implication, is a person who does not have a U.S. domicile at the time of making the gift.

[14] §7701(a)(30)(E) and (31). *See* Galligan, "Foreign Trusts and U.S. Estate Planning; A Client-Centered Analysis," *Journal of Asset Protection* 24 (July-Aug. 1999).