K. FOREIGN ACTIVITIES OF DOMESTIC CHARITIES AND FOREIGN CHARITIES

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1. Introduction

International activities of charitable organizations have become a common topic at tax seminars. There are good reasons for this development. The most prominent cause, perhaps, has been the radical changes that have occurred in Eastern Europe. Governments there are now more receptive to private initiative and are more forthcoming about the assistance needed in their countries. Consequently, United States charities are attempting to respond to these needs through international grant-making.

In rendering international assistance, however, United States charities encounter considerable problems. Language difficulties can be formidable and accounting systems wildly disparate. Furthermore, concepts we take for granted, such as what constitutes a trust, are ill-developed, and in some cases unknown, in countries whose jurisprudence has developed apart from the Anglo-American system. Part of this topic, therefore, is devoted to the foreign activities of domestic charities and the difficulties these charities may encounter.

The other part of the topic concerns foreign charities, an area that has experienced a corresponding increase in interest. In the Soviet Union, for example, an international conference concerning the development of the law of charity in that country was held on October 4-7, 1990. A report of the conference notes that there are similar efforts being made in other nations, such as Japan, India, and Mexico. See "Efforts Underway in U.S.S.R. to Develop Charity Law," The Nonprofit Counsel, Nov. 1990, at 6. Here again, the former satellite nations of Eastern Europe are moving most rapidly but with an attendant degree of uncertainty. To cite one instance, prior to the changes in government in Czechoslovakia in November 1989, the nation's only "charity" was the Red Cross -- even churches were severely restricted in dispensing charity. After the change in government, Mrs. Havel, the wife of the President of Czechoslovakia, set up a foundation to aid the handicapped. The foundation, however, was registered under the Czechoslovak Commercial Code. As of mid-1991, Czechoslovakia did not even have a law of bankruptcy, let alone a law of charity.

How many of these foreign charities will apply for recognition of exemption under IRC 501(c)(3) is unknown. It seems reasonable to predict, however, that the Baltimore key district, which is the designated recipient of all applications for recognition of exemption by foreign entities, will experience an increase in applications. IRC 501(c)(3) status has distinct advantages for foreign organizations; it enables them to make investments and earn income in the United States with reduced tax liability or, in certain situations, with no tax liability. In addition, IRC 509(a)(1), (2), or (3) nonprivate foundation status for foreign organizations enables them to receive funds from domestic private foundations without the latter violating any of the provisions of Chapter 42 with respect to taxable expenditures, even where the foreign charity undertakes no prior or further investigations of the recipient with respect to taxable expenditures.

The body of this article begins by tracing the background and setting forth the general rules relating to IRC 501(c)(3) exemption of both domestic charities with foreign activities and foreign charities. The following section covers the background and general rules relating to the deductibility of contributions under IRC 170(c)(2). The next section proceeds from the theory of the two previous sections to the practice of processing applications; it applies the basic IRC 501(c)(3) and 170(c)(2) rules, discusses the restrictions of IRC 501(c)(3) in foreign contexts, sets forth special rules for IRC 501(c)(3) applicants, and deals with private foundation classification issues peculiar to domestic applicants with foreign activities and foreign applicants. The subject of the next section is private foundation issues that concern domestic private foundations with foreign activities (IRC 4942 and 4945) and foreign private foundations (IRC 4948). The final sections concern issues relating to unrelated business taxable income, withholding tax issues in the context of foreign organizations, and the filing of returns. An overview of tax treaties is appended to the article.

The matters that the article discusses, therefore, are quite extensive. Nevertheless, the article does not purport to be encyclopedic in its coverage of international tax issues, since many areas lie outside our jurisdiction. In this connection, it should be noted that the Associate Chief Counsel (International) has requested that any exempt organization ruling that involves a nonroutine international issue be coordinated with that office. Therefore, if a nonroutine international issue arises during the course of the determination or examination process, the issue should be referred to the National Office, so that coordination may be accomplished.

Essentially, the following matters must be coordinated:

(1) Any determination, ruling, or technical advice request involving an issue that is covered by any treaty or international agreement, and

(2) Any determination, ruling, or technical advice request involving unprecedented or novel issues related to the following IRC sections:

27	482	1059A
33	551 to 558	1212
58	638	1246 to 1248
78	668	1253
163	669	1291 to 1297
245	861 to 865	1351
267	871 to 999	1441 to 1465
269B	1016	1491 to 1494
367	1057	

2. Exemption Under IRC 501(c)(3) for Domestic Charities with Foreign Operations and for Foreign Charities

A. General Principles

1. Charitable Activity in a Foreign Country Is Compatible with IRC 501(c)(3) Status

An ancient ruling, A.R.R. 301, 3 C.B. 188 (1920), first broached the position that exempt status under what is now IRC 501(c)(3) extended to foreign charitable activities. A.R.R. 301 held that a nonprofit association formed to provide memorial buildings in European nations to serve as museums of World War I items and as forums for instructive lectures, etc., constituted an exclusively educational organization.

During the ensuing years, the Service reaffirmed this position in various documents. In G.C.M. 30710 (June 4, 1958), it was recognized that providing a water supply system for a desperate populace in a Lebanese city aided a needy group; therefore, the provider organization was entitled to IRC 501(c)(3) exempt status on that basis. The position was further clarified in Rev. Rul. 68-117, 1968-1 C.B. 251, which holds that an otherwise qualified organization that conducts a guided self-help program that furnishes expert advice in developing nations to subsistence-level farmers and their families with respect to modern and more efficient farming methods as well as child care, nutrition, and other aspects of

home economics may qualify for exempt status under IRC 501(c)(3). The organization also assists the farmers in obtaining easy credit loans and access to surplus United States agricultural products under a U.S. government foreign aid program. Rev. Rul. 68-117 notes that the organization is both charitable for raising the living standards of needy families, and educational for its instructional activities on modern farming and home economics.

A similar organization is held to be exempt in another 1968 ruling. Rev. Rul. 68-165, 1968-1 C.B. 253, discusses a domestic nonprofit organization, a cooperative undertaking of educational, civic, business, and other groups, that has joined with a counterpart group in a Latin American country. The efforts are directed towards promoting student and cultural exchanges as well as aiding self-help projects designed to raise the living conditions of needy families in Latin America. Here again, the organization is dually qualified as both educational for its work with the students and charitable for its assistance to the low income persons. The fact that the benefitted class resides in a foreign country does not bar recognition of exemption.

The compatibility between charitable status and foreign operations is set forth explicitly in Rev. Rul. 71-460, 1971-2 C.B. 231, which states that activities that qualify as charitable in a domestic setting are also charitable when carried out overseas. This revenue ruling simply ratifies what was implicit in the previously cited rulings: a domestic organization that carries on part, or even all, of its activities outside of the United States is not precluded from qualifying as an IRC 501(c)(3) organization on that count.

Several revenue rulings concern IRC 501(c)(3) organizations that sponsor educational and cultural exchange programs partially conducted in other lands. These situations are discussed, inter alia, in Rev. Ruls. 68-165, noted above in connection with the organization's foreign assistance programs, and 80-286, 1980-2 C.B. 179.

2. Foreign Organizations May Qualify for IRC 501(c)(3) Status

The general principle regarding tax exemption of foreign entities is enunciated in Rev. Rul. 66-177, 1966-1 C.B. 132, which states in its entirety: "The fact that an organization has been formed under foreign law will not preclude its qualification as an exempt organization under section 501(a) of the Internal Revenue Code of 1954 if it meets the tests for exemption under that section." Thus, creation on foreign soil is not a bar to exemption from taxation under IRC 501(a).

(Some subparagraphs of IRC 501(c) limit their description to domestic entities, e.g., IRC 501(c)(1), (19), (21), (22), and (23); however, most subparagraphs, including IRC 501(c)(3), do not.)

Consequently, the nature of the activity, and not its locus, determines whether it is "charitable" for purposes of IRC 501(c)(3). For example, consider a foreign amateur sports organization that is the sole competent authority for the national organization and promotion of a particular sport for adults and youths in its native country. It organizes local, regional, and national competitions for amateur clubs and schools and participates in international amateur competitions under the auspices of the international oversight entity and of the national Olympic committee of that country. It develops amateur coaches, referees, players, and administrators. Even though the organization is wholly foreign and the impetus for the enactment of IRC 501(j) was to exempt United States organizations, the language of the statute does not preclude exemption for foreign organizations otherwise described therein.

3. Foreign Governments and IRC 501(c)(3)

When we speak of foreign organizations, for purposes of IRC 501(a), we do not include foreign governments or international agencies. Foreign governments and international organizations are instead covered by IRC 892, which exempts those entities from taxation on certain United States source income. IRC 892 is under the jurisdiction of the Associate Chief Counsel (International).

A private organization's direct interaction with a foreign government, however, does not necessarily create a problem with respect to IRC 501(c)(3) status. See Rev. Rul. 68-117, supra, which notes that the IRC 501(c)(3) organization it discusses cooperates with foreign governments as well as with relevant American government agencies. The question, rather, is whether the foreign government serves as an agent through which the charity's exempt purpose is accomplished or whether the "charity" was formed to support the foreign government. In the latter case, the organization cannot qualify for exemption -- supporting a foreign government is not a recognized charitable purpose.

3. Deductibility of Contributions

A. The Basic Rule -- Foreign v. Domestic Organizations

1. The Statute

IRC 170(c)(2)(A) provides that, if a charitable contribution is to be deductible, it 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." (The rule that contributions to foreign organizations are not deductible can be modified by treaty and has been modified in a treaty with Canada, discussed in the Appendix to this article.)

The general thrust of IRC 170(c)(2) is to focus on the country of creation of the recipient organization, not upon the country of use. The last sentence of the statute, however, contains a "domestic use" rule peculiar to corporate charitable contributions -- it denies a deduction for a charitable contribution by a corporation to a **trust, chest, fund, or foundation** if it is used outside the United States or any of its possessions. The sentence, on the other hand, contains no limitation as to deductions by a corporation for charitable contributions to a domestic charitable **corporation**. The result is that a corporate contribution to a domestic charity that is not itself a corporation is uniquely subject to a "domestic use" rule. See Rev. Rul. 69-80, 1969-1 C.B. 65.

2. Background of the Statute

Previous to the passage of the Revenue Act of 1938, individuals might make deductible contributions to charitable organizations regardless of where the organizations were created. The rule for corporations was different -- section 102(c) of the Revenue Act of 1935, which first permitted a deduction for **corporate** charitable contributions, limited that deduction to contributions to "domestic" organizations that used such contributions within the United States. The rule as to individual contributions was changed with the passage of the Revenue Act of 1938. Section 23(o) of that Act provided that contributions by individuals were deductible only if the recipient was a "domestic" organization. The Ways and Means Committee Report on section 23(o) (H.R. Report No. 1860, 75th Cong., 3rd Sess. 19-20 (1938), reprinted in 1939-1 (Part 2) C.B. 728, at 742), essentially noted that the rationale for deductions from income tax was predicated on the loss of tax revenue being offset by the relief of a burden that would otherwise have to be met by appropriation from public funds. Gifts to foreign institutions were seen as not providing any such benefit. However, if the recipient was a domestic organization, the fact that a portion of its funds was used to further charitable purposes in other countries, such as schools or missionary work, would not adversely affect the deductibility of the contribution. Section 224 of the

Revenue Act of 1939 substituted for the requirement that a qualifying organization be "domestic," the requirement that it have been "created or organized in the United States or in any possession thereof," etc. In substantially the same form, this requirement was re-enacted as section 170(c)(2)(A) of the 1954 Code and carried over to the 1986 Code.

B. Implementation of the Basic Rule

1. Distinguishing Foreign from Domestic Organizations

Since 1939, therefore, the Service consistently has held that donations by individuals to or for the use of domestic charitable organizations are deductible even though entirely used abroad, subject to the "conduit" and "earmarking" restrictions discussed in the next section of this article. This long-standing rulings position is reflected in G.C.M. 30645 (Apr. 30, 1958). It was not until 1972, however, that the position was expressly incorporated into the regulations at Reg. 1.170A-8(a)(1), which provides:

> "A charitable contribution by an individual to or for the use of an organization described in section 170(c) may be deductible even though all, or some portion, of the funds of the organization may be used in foreign countries for charitable or educational purposes."

Conversely, gifts given directly to foreign charities are not deductible as charitable contributions because of the IRC 170(c)(2)(A) requirement that the recipient be a domestic organization, i.e., a corporation, trust or community chest, fund or foundation that is 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. (Organizations created at embassies, legations, consulates and the like are domestic and not foreign organizations. See G.C.M. 37444 (March 7, 1978).)

The fundamental classification of domestic versus foreign organizations, however, has itself raised interpretational difficulties. In Dora F. Welti, 1 T.C. 905 (1943), the Tax Court denied a deduction for a direct gift to a foreign church whose claim to United States provenance was grounded on the fact that it was an affiliate of a domestic church of the same denomination. The Swiss organization was held to be legally independent of the American church; therefore, it was not a tax deductible donee.

However, in another "foreign/domestic" situation, Bilingual Montessori School of Paris, Inc., 75 T.C. 480 (1980), the Tax Court decided in favor of the taxpayer. In that instance, a school had been created in France under the corporation laws of that country and had operated there for many years before filing incorporation papers in Delaware. The Service maintained that the United States corporation had no activities and was merely a shell set up to facilitate the collection of tax-deductible American contributions. The Tax Court found that not only was the organization technically "created" in the United States by virtue of the Delaware filing, but the fact that it did not merely fund, but actually operated, the Paris school was sufficient to characterize the entity as a domestic charity for IRC 170(c)(2) purposes, notwithstanding the school's foreign roots. The operational nexus with the United States organization, even though largely ceremonial, was sufficient to distinguish the domestic organization from the mere shell that Rev. Rul. 63-252 (see below) found unacceptable for IRC 170 purposes. It is difficult to reconcile this decision with the "earmarking" and "conduit" notions discussed below. Accordingly, one must exercise caution in relying upon the Bilingual Montessori School case.

2. The "Earmarking" and "Conduit" Restrictions

Thus far, this discussion of contribution deductibility has focused upon situations where the charity applies its contributed funds directly to its own foreign projects. We now turn to situations where contributions originally collected by a domestic entity are turned over to a foreign organization.

It is a basic principle that an inquiry as to the deductibility of a contribution does 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 charitable contribution. See S.E. Thomason v. Commissioner, 2 T.C. 441 (1943); Rev. Rul. 54-580, 1954-2 C.B. 97; and Rev. Rul. 63-252, 1963-2 C.B. 101.

Rev. Rul. 63-252, in applying this principle to transfers of United States-solicited contributions from domestic to foreign organizations, concludes:

> "'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 a foreign organization were held to be deductible solely because, in the course of transmittal to a 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 then sets forth five examples of this point, each expressing a variation on the theme:

(1) A mere conduit entity formed by the beneficiary foreign organization in order to tap into United States resources;

(2) An organization with a similar origin and function to the first example, the only difference being that it was formed by persons in the United States interested in helping the designated foreign entity;

(3) An exempt domestic charity that is prevailed upon by a specific foreign organization to canvass for donations in the United States and to direct contributions to that foreign organization;

(4) An exempt domestic charity that makes grants to foreign charities after reviewing the grant applications to ensure that the foreign activities will further its own charitable purposes; and

(5) An exempt domestic charity that forms a subsidiary organization in a foreign country for administrative efficiency in conducting its foreign charitable programs, and minutely manages its foreign subsidiary.

A common thread running through the first three cases is that the organizations are charities nominally created in the United States but organized or operated solely to solicit earmarked funds on behalf of a pre-existing foreign entity. The domestic entities are, in effect, agents or conduit organizations with respect to the foreign beneficiaries. As such, contributions to them are not deductible. (Note the distinction that the Tax Court made in Bilingual Montessori School of Paris, Inc., supra, between mere funding and actual involvement in operations.) Examples four and five discuss organizations that both solicit funds without any express understanding that they would be forwarded to a foreign entity and exercise "discretion and control" over the funds solicited from within the United States. These domestic entities, in other words, are independent actors with their own charitable programs, not mere intermediaries for foreign-based organizations; consequently, they are found to warrant deductible contributions.

The organizations described in examples four and five are commonly known as "friends (of) ..." organizations.

What constitutes adequate control of the donated funds was clarified in Rev. Rul. 66-79, 1966-1 C.B. 48. That revenue ruling discusses the situation of a domestic charity that solicits contributions in the United States for a specific project of a foreign counterpart organization. The board of directors has taken specific steps to carefully review the project in advance of any funding and to monitor its continued adherence to the domestic charity's goals. Notwithstanding that the donations are technically "earmarked," as in negative examples one through three of Rev. Rul. 63-252, the domestic organization has demonstrated that it has full control of the donated funds and discretion as to their use so as to insure that the funds will be used to carry out the domestic charity's function and purposes. These standards entail more than merely being able to decide whether or not to contribute and being able to require the foreign recipient to furnish a periodic accounting.

Another analysis of the control and accountability factor is set out in Rev. Rul. 75-65, 1975-1 C.B. 79. That revenue ruling discusses a domestic charity formed to deal with the problem of plant and wildlife ecology in a foreign country through programs that include grants to foreign private organizations. The domestic charity maintains control and responsibility over the use of any funds granted to a foreign organization by first making an investigation of the purpose to which the funds will be put, by then entering into a written agreement with the recipient organization, and lastly by making field investigations to see that the money is spent in accordance with the agreement. The charity exercises the power to require fund accountability over these programs. Contributions to the organization are deductible under IRC 170.

In yet another illustration of control and accountability, G.C.M. 35319 (Apr. 27, 1973), considers a domestic organization that transmitted funds to a foreign organization without knowing precisely how the money could be spent. Even though the foreign organization promised to use the funds for "humanitarian purposes" and even though both the foreign organization and its distributees were required to account for the use of the funds, there was too little discretion and control by the domestic organization to meet the standards set out in Rev. Ruls. 63-252 and 66-79. On the other hand, the required discretion and control could be present even if a domestic organization turns funds over to foreign entities that are not themselves organized and operated exclusively for charitable purposes provided that the foreign organization can be shown to be acting as agent of the

domestic charity. This follows the precept originally demonstrated in an entirely domestic context in Rev. Rul. 68-489, 1968-2 C.B. 210.

In reaching its conclusion, G.C.M. 35319 emphasizes that the domestic organization did not know, in advance of a distribution of funds, exactly how those funds would be used. However, the G.C.M. further states it may not be necessary for a domestic IRC 501(c)(3) organization to know in advance the precise nature of ultimate distributees to insure that its qualification under IRC 170(c)(2) is not jeopardized if it can establish that its methods of operation include the following kinds of procedures:

(1) At the outset, it apprises its agents of the terms of IRC 170(c) and makes clear to its agents that they are subject to the same limitations in distributing its funds;

(2) It reviews proposed projects in detail to ensure that the projects are reasonably calculated to accomplish one or more of its charitable objectives before turning over any funds to its agents for expenditure;

(3) It turns over its funds to agents only as needed for specific projects; and

(4) It (or an independent agent it selects) makes periodic financial audits and requires periodic financial statements to ensure that the funds are not being misspent.

Adoption of these guidelines, which were subsequently cited with approval in G.C.M. 37444, supra, can be of help in insuring IRC 170(c)(2) deductibility.

C. Estate and Gift Tax Parallels and Contrasts

The treatment of gifts and bequests under the estate and gift tax provisions does not limit the use of funds overseas. In fact, the estate tax deduction provided in IRC 2055(a)(2) and the gift tax deduction under IRC 2522(a)(2) 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. See IRC 2522(b)(2) and (3).

With respect to bequests, etc., to governments, IRC 2055 is similar to IRC 170(c), in that it allows deductions for gifts to United States governmental entities but not to foreign governmental entities. Unlike IRC 170(c), however, IRC 2055 also permits deductions for bequests to charitable trusts without requiring that the

trusts be domestic organizations. Thus, the question arose as to whether a bequest to a foreign governmental entity to be used exclusively for charitable purposes could be deductible as a bequest to a foreign charitable trust. A growing body of federal case law holds that a bequest to a foreign governmental entity can be instilled with a charitable purpose. In such case, it would be deductible under IRC 2055(a)(3). See Old Colony Trust Company v. United States, 438 F.2d 684 (1st Cir. 1971); Kaplun v. United States, 436 F.2d 799 (2d Cir. 1970); and National Savings and Trust Company v. United States, 436 F.2d 458 (Ct. Cl. 1971). After these adverse court decisions, the Service, in Rev. Rul. 74-523, 1974-2 C.B. 304, accepted the possibility of a foreign government acting as a fiduciary for purposes of the estate tax charitable deduction under IRC 2055.

The implications of this ruling for IRC 501(c)(3) and 170(c)(2) have not yet been clarified. Caution should be exercised in making analogies until such time as a revenue ruling is published specifically addressing IRC 170(c)(2) and/or 501(c)(3) on this point.

4. Processing Applications

A. Recognition of Exemption Under IRC 501(c)(3)

1. Wrapping It Up -- Correlation Between the Requirements of IRC 501(c)(3) and 170(c)(2) for Domestic Organizations

As discussed above, although the requirements of IRC 501(c)(3) and 170(c)(2) are parallel in many respects, they are not identical. In some situations, therefore, one will reach a different ruling result on the question of deductibility of contributions to an organization under IRC 170 from the result reached on the question of that organization's exempt status under IRC 501(c)(3). The most obvious illustration of this statement is the case of a foreign charitable organization. Contributions to or for the use of a foreign organization are not deductible for income tax purposes because it does not meet the domestic organization requirement of IRC 170(c)(2)(A); nevertheless, it may qualify for recognition of exemption under IRC 501(c)(3), because that subparagraph has no domestic organization requirement. A second situation exists in the case of a domestic organization that serves as a conduit for a foreign IRC 501(c)(3) organization. Contributions to the domestic organization are no more deductible under IRC 170(c)(2) than if they had been made directly to the foreign organization; nevertheless, the domestic organization may qualify for IRC

501(c)(3) status on the basis that its activities exclusively support an organization described in that subparagraph.

In other situations, the two provisions operate in parallel fashion. If a domestic organization transmits its funds to a foreign private organization but retains the requisite control and discretion over the funds in conformity with Example 4 or Example 5 of Rev. Rul 63-252, supra, or Rev. Rul. 66-79, supra, it qualifies for recognition of exemption under IRC 501(c)(3) and contributions to it will be deductible under IRC 170(c)(2). On the other hand, if a domestic organization, otherwise qualified under IRC 501(c)(3), transmits its funds to a private organization not described in IRC 501(c)(3) and fails to exercise, or has too little, discretion and control over the use of such funds to assure their use exclusively for charitable purposes, the domestic organization forfeits its qualification for exempt status because it cannot demonstrate that it is operated exclusively for charitable purposes, and contributions to it are not deductible. A domestic organization formed to support a foreign government is treated adversely under both IRC 501(c)(3) and 170 -- supporting a foreign government is not recognized as a charitable purpose.

2. The Restrictions of IRC 501(c)(3) in Foreign Contexts a. Inurement and Private Benefit

The strictures against inurement and private benefit apply just as fully to foreign activities as they do domestic operations. Furthermore, reliance on local law or custom as to what constitutes a charitable operation will not obviate an inquiry into whether private benefit or inurement is involved. Thus, for example, if local custom provides that the applicant will simply give money to a person who dispenses money as he/she sees fit with no separate account for moneys received from the United States for charitable purposes, exemption would be denied under IRC 501(c)(3) on the grounds of inurement, serving a private interest, and/or failing to serve any charitable purpose. Even if the recipient were to use the funds only for charitable purposes, he/she would still have to account for their use, and the organization applying for recognition of exemption under IRC 501(c)(3) would have to retain discretion and control over the use of the funds for exemption to be recognized. See Rev. Rul. 68-489, supra. Furthermore, records of the charity dispensed must be maintained. See Rev. Rul. 56-304, 1956-2 C.B. 306.

b. Lobbying and Electioneering

As with inurement and private benefit, the restriction against lobbying and the prohibition against political activity on behalf of or in opposition to a candidate for elective public office (electioneering) exist in a foreign context as well. For example, Rev. Rul. 73-440, 1973-2 C.B. 177, concludes that the term "legislation" includes foreign as well as domestic laws, for purposes of the IRC 501(c)(3) lobbying restriction. Great care should be taken in applying this principle, however. The regulations under IRC 501(c)(3) carefully limit the definition of legislation to actions by legislatures or by the public through referendum, initiative, constitutional amendment, etc. See Reg. 1.501(c)(3)-1(c)(3)(ii). The regulations under IRC 4911 develop this definition by providing that legislation does not include action by executive, judicial or administrative bodies. See Reg. 56.4911-2(d). It should be kept in mind, therefore, that it may be improper to characterize various types of resolutions, edicts, etc., of a wide assortment of state bureaucracies as "legislation." This is particularly so in dealing with an authoritarian or theocratic regime where the legislative process as it is known in the United States is unknown in that country.

c. Illegal Activities and Activities Contrary to Public Policy

It is settled that the conduct of illegal activities or activities that are contrary to public policy may jeopardize IRC 501(c)(3) exempt status regardless of the locus of the activity. What is not settled, however, is whether an activity conducted in a foreign country is illegal for IRC 501(c)(3) purposes because it is illegal under the laws of that country. If a case contains this issue, technical advice should be sought from the National Office.

Public policy considerations relating to activities conducted in a foreign country center around the problem of ascertaining whether foreign schools are racially discriminatory. The declared Federal public policy against racially discriminatory schools is so pervasive that foreign schools must furnish the information required by Rev. Proc. 75-50, 1975-2 C.B. 587. However, if a foreign school can demonstrate that the information is impossible to collect because collecting it would be illegal under foreign law or impractical under the circumstances, and can make a prima facie showing that the allegation is true, such as a copy of the law or regulation and an English-language translation thereof, the Service will waive so much of the information required by Rev. Proc. 75-50, as is based upon such statistics. See G.C.M. 37867 (Feb. 27, 1979).

3. Special Rules for Foreign IRC 501(c)(3) Applicants a. IRC 508 and Foreign Applicants

Due to the provisions of IRC 4948(b), a foreign private foundation that receives "substantially all of its support (other than gross investment income) from sources outside the United States" is excepted from the provisions of IRC 508, including the notification requirement of IRC 508(a) and the governing instrument requirement of IRC 508(e). "Substantially all," for purposes of IRC 4948(b), means that the organization, from the date of its creation, has received at least 85 percent of its support as defined in IRC 509(d), other than gross investment income, from sources outside the United States. Reg. 53.4948-1(b) provides that, in computing support for purposes of this test, gifts, grants, contributions or membership fees received directly or indirectly from a United States person (as defined in IRC 7701(a)(30)) are from sources within the United States. (Most foreign private foundations will be found to have "substantially all" of their income derived from sources outside the United States, particularly in view of the fact that the 85 percent support test does not include gross investment income in determining United States support.)

The provisions of IRC 508 apply, however, to all other foreign IRC 501(c)(3) applicants. Therefore, all foreign nonprivate foundation applicants (unless they fall within exceptions set forth in Reg. 1.508-1(a)(3)) and those rare foreign private foundation applicants that receive more than 15 percent of their support from United States sources must notify the Service that they are applying for recognition of exemption within 15 months from the end of the month on which they were organized. (Note: For IRC 501(c)(3) cases involving section 508(a) issues, Rev. Rul. 77-114, 1977-1 C.B. 152, provides that the date of the United States postmark controls. In the case of foreign organizations, this revenue ruling can be read to mean that the date of the foreign postmark controls, even if there is also a United States postmark on the envelope. If there is no postmark, then the date the application is stamped as received by the Service would control.)

Foreign private foundation applicants that receive more than 15 percent of their support from United States sources are also subject to the governing instrument provisions of IRC 508(e)(1), which require the foundation to comply with the income distribution requirements of IRC 4942 and to prohibit the private foundation from engaging in any act violative of the restrictions of IRC 4941, 4943, 4944, and 4945. See Reg. 1.508-3(b)(1) through (4). No foreign government, including Canada, appears to have enacted a provision for satisfying Chapter 42 as

to restrictions under IRC 508(e); consequently, the applicant's organizational document needs the IRC 508(e) provision.[1]

b. IRC 170 and Foreign Applicants

A foreign organization's application for recognition of exemption from federal income taxation under IRC 501(c)(3) (Form 1023) should contain a statement that the organization knows that contributions to it are not deductible. (In the case of a Canadian organization, the application should state that contributions to it are governed by the relevant treaty.) If the application contains no such statement, such a statement should be sought. If no such statement is forthcoming, whether or not exemption is recognized under IRC 501(c)(3), deductibility must be denied under IRC 170(c)(2) with protest, conference, and declaratory judgment rights under IRC 7428 included in the letter denying deductibility. In the event that the organization does acknowledge that contributions are not deductible, any favorable letter should acknowledge such statement or agreement; no protest, conference, and declaratory judgment paragraph should be included in such a case.

c. Documents in English and Currency in Dollars

All documents submitted in support of an application must be in English or accompanied by a good English translation, and all financial information must be submitted in United States dollars. (If the dollar amount is converted from foreign currency, the conversion rate also must be stated.) Both of these requirements were instituted so that the public can understand what it is reading in a successful application. Anything which the applicant submits for the file, even newspaper articles, etc., must be translated for this reason. Specialists may not accept as complete any application or supporting documents (including responses to development letters) not in conformity with the above requirement even if the specialist can understand the foreign language in which the document is written.

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[1] The Canadian treatment of the issue may be found in (paragraph) 149(1)(1)(g) of the Canadian Income Tax Act with respect to those entities registered after February 15, 1984. For a general discussion of Canadian tax exemption, including the then proposed rules applicable to Canadian private foundations, see various articles under the general heading of "Income Taxation of Charities," Report of Proceedings of the Thirty-Fifth Tax Conference, 1983, pp. 371-417, and "Tax Treatment of Non-Profit Organizations," Report of Proceedings of the Forty-First Tax Conference, 1989, Topics 35-37. Call number: KE5668.R4 1983 and 1989, respectively.

C. Private Foundation Classification Issues

1. IRC 509(a)(1) and 509(a)(2)

Broadly speaking, there are two types of organizations that are not classified as private foundations by reason of IRC 509(a)(1) and (2). The first type is composed of the "public institutions" -- those IRC 509(a)(1) organizations described in IRC 170(b)(1)(A)(i) through (v). The second type consists of "publicly supported organizations" -- those organizations described in IRC 170(b)(1)(A)(vi) and IRC 509(a)(2).

Foreign situs has no relevance in determining whether an organization is a "public institution" described in IRC 170(b)(1)(A)(i) through (iii). Therefore, foreign churches, private schools, and hospitals and medical research organizations are as fully described in IRC 170(b)(1)(A)(i) through (iii) as their domestic counterparts, and it is not unusual to encounter one of them. On the other hand, a foreign organization classifiable under IRC 170(b)(1)(A)(iv), which describes certain organizations providing support for United States public colleges and universities, would be a considerable phenomenon. IRC 170(b)(1)(A)(v), which describes United States governmental units, is, of course, a classification unavailable to foreign organizations.

The only peculiar issue under IRC 509(a)(1)/170(b)(1)(A)(vi) and IRC 509(a)(2) for domestic organizations with foreign activities and for foreign organizations relates to support from a foreign government. Rev. Rul. 75-435, 1975-2 C.B. 215, holds that support from a foreign government constitutes support from a government under IRC 170(c)(1), and therefore is not subject to the 2 percent limitation under IRC 509(a)(1) and 170(b)(1)(A)(vi). Although G.C.M. 38327 (March 31, 1980), recommends the revocation of Rev. Rul. 75-435, the revenue ruling remains in force and effect.

2. IRC 509(a)(3)

With respect to both domestic organizations with foreign activities and foreign organizations seeking to qualify as supporting organizations described in IRC 509(a)(3), Rev. Rul. 74-229, 1974-1 C.B. 142, holds that a domestic charitable organization, organized and operated in support of a foreign organization described in IRC 501(c)(3), qualifies as an IRC 509(a)(3) supporting organization.

There is, however, a conceptual difficulty in applying the supporting organization tests to domestic organizations that conduct foreign activities. The problem is that the IRC 170(c) "conduit" and "earmarking" prohibitions argue against a showing that the foreign, i.e., supported, organization maintains sufficient authority over the domestic funding organization to satisfy one of the three relationships required to establish IRC 509(a)(3) qualification.

Practically speaking, domestic organizations with foreign operations are going to preclude themselves from satisfying either the "operated, supervised, or controlled by" test set forth in Reg. 1.509(a)-4(g) or the "supervised or controlled in connection with" test of Reg. 1.509(a)-4(h). As noted above, one of the foremost considerations for a domestic IRC 501(c)(3) organization is that it not run afoul of the IRC 170(c) "conduit" and "earmarking" prohibitions. The root of the problem, therefore, is that the very factors employed to satisfy the "operated, supervised, or controlled by" test (the presence of a substantial degree of direction by the foreign charity over its policies, programs and activities) and the "supervised or controlled in connection with" test (the presence of common supervision or control to ensure that the domestic charity will be responsive to the needs and requirements of the foreign charity) would identify the domestic charity as a mere conduit. Domestic IRC 501(c)(3) organizations with foreign activities are not necessarily caught in the IRC 170(c)(2)/509(a)(3) dilemma when attempting to satisfy the remaining relationship test (the "operated in connection with" test of Reg. 1.509(a)-4(i)), but they are going to find difficulty in satisfying one of the test's component parts, the "responsiveness" test of Reg. 1.509(a)-4(i)(2). Reg. 1.509(a)-4(i)(2) provides that the responsiveness test may be satisfied in one of two ways and the first, which requires a showing that the two organizations have a convergent relationship, is precluded by the "conduit" problem. See Reg. 1.509(a)-4(i)(2)(ii). The second responsiveness test, which is set forth in Reg. 1.509(a)-4(i)(2)(iii), may be satisfied only if the domestic organization can show that the foreign organization it supports and names in its governing instrument both is a charitable trust under its country's laws, and, under the laws of that country, has the power to enforce the trust and compel an accounting. It is possible, therefore, that a domestic organization could show that the Reg. 1.509(a)-4(i)(2)(iii) responsiveness test was satisfied, but it would take considerable documentation.

The relationship tests are, however, not the only obstacle confronting a domestic IRC 501(c)(3) organization seeking IRC 509(a)(3) status on the basis that it supports a foreign organization -- there is the problem of satisfying the operational test set forth in Reg. 1.509(a)-4(e). Once again, the requirements of insuring IRC 170(c)(2) deductibility and satisfying the test are at cross purposes.

The essence of the problem is that the operational test requires the domestic organization to engage solely in activities that support or benefit the foreign organization it purports to support whereas IRC 170(c)(2) deductibility is predicated on showing that the domestic charity has "control and discretion" over the use of the contributions it receives.

Since foreign IRC 501(c)(3) organizations are not entitled to receive IRC 170(c)(2) contributions, they do not encounter the peculiar difficulties of domestic organizations with foreign activities, insofar as obtaining classification as an IRC 509(a)(3) organization is concerned. They must, of course, meet the usual requirements of the IRC 509(a)(3) regulations, which is often not an easy task.

5. Issues Under Chapter 42

A. Foreign Grant-making Activities of Domestic Private Foundations

1. Introduction

Domestic charities that are private foundations increasingly have become involved in international grant-making. As with their grants to domestic organizations, private foundations want their grants to foreign organizations to be treated as "qualifying distributions" for purposes of IRC 4942 and not to be treated as taxable expenditures for purposes of IRC 4945.

2. IRC 4945 Issues

IRC 4945(d)(4) provides that a grant to an organization other than an IRC 509(1), (2), or (3) public charity or an "exempt operating foundation" (as defined in IRC 4940(d)(2)) is a taxable expenditure unless the foundation exercises expenditure responsibility as defined in section 4945(h). (For purposes of IRC 4945, the term "grants" also includes loans for purposes described in IRC 170(c)(2)(B) and program related investments.[2] See Reg. 53.4945-4(a)(2).)

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[2] "Program-related investments" are defined in IRC 4944(e) as investments whose primary purpose is to accomplish one or more charitable purposes and that does not have, as a significant purpose, the production of income or the appreciation of property. Reg. 53.4945-4(a)(2) mentions, as examples of "program-related investments," investments in small businesses in central cities or in businesses that assist in neighborhood renovation. These types of investments can be made, of course, in a foreign as well as in a domestic context.

Making grants to a foreign grantee that does not have a ruling or determination letter classifying it as an IRC 509(a)(1), (2), (3) public charity, or as an "exempt operating foundation," creates considerable difficulties. The first problem is outlined in Reg. 53.4945-(6)(c)(1), which provides that, since a private foundation cannot make an expenditure for a purpose other than for one described in IRC 170(c)(2)(B), it may not make a grant to a non-IRC 501(c)(3) organization unless (1) the making of the grant itself constitutes a direct charitable act or the making of a program-related investment, or (2) the grantor is reasonably assured that the grant will be used exclusively for purposes described in IRC 170(c)(2)(B). Reg. 53.4945-6(c)(2)(ii) makes just a general statement as to how a grantor foundation can be "reasonably assured" that a foreign organization that has no IRC 501(c)(3) ruling or determination letter will be treated as an organization described in that subparagraph -- it requires that a foundation manager make a "reasonable judgment" that the foreign grantee organization is described in IRC 501(c)(3).[3]

In theory, a private foundation, intent on making a grant to a foreign organization, after reasonably assuring itself that the grantee is the equivalent of an IRC 501(c)(3) organization, would make the grant and exercise expenditure responsibility. However, as discussed more fully below, exercising expenditure responsibility is a complicated and arduous process. Consequently, a private foundation will seek to obviate the necessity of exercising expenditure responsibility.

Reg. 53.4945-5(a)(5) provides that a grantor may avoid the expenditure responsibility requirement if it makes a good faith determination that the grantee is an organization described in IRC 509(a)(1), (2), or (3). (The regulations do not mention "exempt operating foundations" because IRC 4940(d)(2) was enacted after the regulations were promulgated. However, a "good faith determination" that the grantee is described in IRC 4940(d)(2) would also avoid the expenditure responsibility requirement.) Reg. 53.4945-5(a)(5) further provides that a "good faith determination" may be based on an affidavit of the grantee or on an opinion

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[3] Reg. 53.4945-6(c)(2)(ii) does not prescribe any particular manner for the exercise of "reasonable judgment;" it merely states: "The term 'reasonable judgment' shall be given its generally accepted legal sense within the outlines developed by judicial decisions in the law of trusts."

of the grantor's or grantee's legal counsel that sets forth sufficient facts about the grantee's operations and support to enable the Service to determine that the grantee would likely qualify as an IRC 509(a)(1), (2), or (3) public charity.

Each grantor is now required to make its own "good faith determination" about a particular grantee; in other words, each grantor must prepare its own affidavit or opinion. Many foundations have found this process burdensome, especially when it is complicated by factors such as different legal systems, accounting procedures, etc. We are working to ease this burden by developing a simplified procedure allowing a grantor to rely on an affidavit or opinion prepared by another grantor. Under the simplified procedure, grantors could rely on an affidavit or opinion about a particular recipient prepared by another grantor as long as the information remained satisfactory and up to date. The procedure will also describe circumstances in which an affidavit may be updated rather than replaced.

Grants to foreign governments and international organizations may also be excepted from the expenditure responsibility rules. Reg. 53.4945-5(a)(4)(iii) provides that a foreign government, any instrumentality or agency thereof, or an international organization designated by Executive Order under 22 U.S.C. 288 will be considered an IRC 509(a)(1) organization provided that the grant is made for exclusively charitable purposes as described in IRC 170(c)(2)(B). Effectively, this means that grants to foreign governments, to their instrumentalities, or to international organizations are treated in the same manner as grants to their United States counterparts -- the grant must be for exclusively charitable purposes and not for governmental ones.

If the foreign grantee does not fall within any of the above exceptions, then the expenditure responsibility rules apply. As set forth in IRC 4945(h), these rules require the private foundation to exert all reasonable efforts and establish adequate procedures to (1) see that the grant is spent solely for the purpose for which it is made, (2) obtain full and complete reports from the grantee regarding how the funds were spent, and (3) make full and complete reports to the Service.[4]

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[4] The required information must be submitted on or with the Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as a Private Foundation. See Text (17)95 of IRM 7752, which sets forth the grantor reporting and record keeping requirements under IRC 4945(h)(3).

Reg. 53.4945-5 sets forth the rules for satisfying the expenditure responsibility requirement. Reg. 53.4945-(5)(b)(2)(i) requires a pre-grant inquiry that should be complete enough to give a reasonable person assurance that the grantee will use the grant for the proper purposes. Reg. 53.4945-5(d) provides that private foundations must report expenditure responsibility grants to the Service on Form 990-PF and specifies the information that is required. The pre-grant inquiry and reporting requirements are the same for grants to domestic and foreign organizations.

The rules relating to terms of grants, however, contain a special rule where foreign grantees are concerned. Under the general rule, set forth in Reg. 53.4945-5(b)(3), each grant must be made subject to a written commitment signed by an appropriate officer, director, or trustee of the grantee organization. The commitment must specify the purposes of the grant. It must also include provisions relating to repayment of funds not used for the grant's purposes; to submission of annual reports; and to maintenance of books and records, which are to be made available to the grantor at all reasonable times. Furthermore, pursuant to Reg. 53.4945-5(b)(3)(iv), the commitment must contain the grantee's agreement not to use any funds (1) to carry on propaganda, or otherwise to attempt, to influence legislation (within the meaning of IRC 4945(d)(1)); (2) to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive (within the meaning of IRC 4945(d)(2)); (3) to make any grant to an individual or organization; and (4) to undertake any activity for any noncharitable purpose, to the extent that use of the funds would be taxable to the grantor foundation. The special rule concerns the grantee's agreement: Reg. 53.4945-5(b)(5) provides that in the case of a grant to a foreign organization the requirement is satisfied if the agreement contains "substantially equivalent" restrictions. These restrictions may be phrased in appropriate terms under foreign law or custom and the requirement will be met if the grantor's or grantee's counsel renders an opinion or affidavit stating that the restrictions are "substantially equivalent." (Note: Reg. 53.4945-(5)(b)(4)(iv) contains an equivalent agreement requirement for program-related investments, and the special rule of Reg. 53.4945-(5)(b)(5) applies to that agreement requirement also.)

Where a grant is made by a private foundation to a foreign organization that is not a public charity, the foundation, in addition to exercising expenditure responsibility, must also maintain the grant funds in a separate account dedicated to one or more exempt purposes described in IRC 170(c)(2)(B). See Reg. 53.4945-6(c)(2)(i).

3. Qualifying Distributions

Essentially, IRC 4942 compels private foundations to make "qualifying distributions" in furtherance of their charitable purposes. In general, "qualifying distributions" consist of amounts (including certain administrative expenses) paid to accomplish IRC 170(c)(2)(B) or 170(c)(1) purposes, amounts paid to acquire assets used directly in carrying out IRC 170(c)(2)(B) purposes, and certain set-asides. For a detailed discussion, see "IRC 4942(g) - Qualifying Distributions," 1988 CPE text, 39.

The concept of "good faith determination" is as critical to determining whether a distribution to a foreign organization is a qualifying distribution, as it is to determining, for purposes of IRC 4945, whether expenditure responsibility need be exercised. Under Reg. 53.4942(a)-3(a)(6), distributions for IRC 170(c)(2)(B) purposes to a foreign organization that has not received a ruling or determination letter classifying it as an organization described in IRC 509(a)(1), (2), or (3), or 4942(j)(3) will be treated as a distribution to an organization so described if the private foundation has made a "good faith determination" that the foreign grantee is described in one of the appropriate Code provisions. The components of the determination are the same for IRC 4942 and IRC 4945.

If the "good faith determination" cannot be made, the domestic private foundation's distribution must meet the requirements of the "twelve-month pass-through" exception of IRC 4943(g)(3) in order to be considered a qualifying distribution. Reg. 53.4942(a)-3(c) sets forth the considerably complex components of the "twelve-month pass-through" rule. The basic elements of the rule are found in Reg. 53.4942(a)-3(c)(1), which provides, insofar as is pertinent here, that a contribution to a private nonoperating foundation is treated as a qualifying distribution if:

(1) The donee organization, in turn, makes a distribution equal to the full amount of such contribution not later than the close of the first taxable year in which it received the contribution;

(2) The donee organization's distribution of the contribution is a qualifying distribution that is treated under IRC 4942(h) as a distribution out of corpus (or would be so treated if the donee were a private nonoperating foundation); and

(3) The private foundation making the contribution obtains adequate records or other sufficient evidence from the donee organization showing that the qualifying

distribution has been made, describing the names and addresses of the recipients and showing that the "out of corpus" requirement of IRC 4942(h) has been met.

Reg. 53.4942(a)-3(c) contains additional specific rules with respect to the "twelve-month pass-through" exception. These rules relate to such matters as administrative expenses, distribution requirements, the treatment of a "failed pass-through," valuation of contributions, prior distributions out of corpus, and rules relating to situations where the donee uses the distribution to make payments to another organization (the secondary donee). Because of the number and complexity of these rules and the difficulties foreign grantees have in grasping their import, we have been requested to draft a revenue procedure to state that, as long as a grantee has spent the amount of a grant paid in year one by the end of year two, that expenditure will be treated as a distribution out of corpus, and the grant will be treated as a qualifying distribution. After studying the request, we concluded that the language of IRC 4942(g)(3) precludes the issuance of such a revenue procedure -- only legislation can simplify the process.[5]

B. IRC 4948 and Foreign Private Foundations

1. Introduction

For purposes of IRC 4948, a "foreign organization" means any organization that was not created or organized in the United States or any possession thereof, or under the laws of the United States, any State, the District of Columbia, or any possession of the United States.

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[5] The Joint Committee on Internal Revenue Taxation's General Explanation of the Tax Reform Act of 1969 ("Blue Book") 59 (Dec. 3, 1970), emphasizes that adherence to IRC 4942(g)(3) is required in this situation:

> "Under the Act, if an organization formed outside the United States meets the definition of a private foundation, it is to be treated as such despite the place of its organization. Accordingly, **a gift by a domestic private foundation to a foreign nonoperating private foundation is a qualifying distribution only if the '1-year passthrough' requirement is met**, but a gift to a foreign operating foundation qualifies under the same circumstances that a gift to a domestic operating foundation would qualify." **[Emphasis supplied]**

Essentially, IRC 4948 contains two sets of rules: first, an excise tax is levied on the investment income of all foreign private foundations; second, comprehensive private foundation rules applicable to those foreign private foundations that receive substantially all their support from sources outside the United States are set forth.

2. Tax on Investment Income of Foreign Private Foundations under IRC 4948(a)

In lieu of the tax imposed under IRC 4940, IRC 4948(a) imposes on all foreign private foundations exempt under IRC 501(a) a tax equal to 4 percent of their gross investment income derived from sources within the United States. Gross investment income and United States source income are defined, respectively, in IRC 4940(c)(2) and IRC 861 and the regulations thereunder. The tax on gross investment income applies for each taxable year, beginning after December 31, 1969, during which the organization was exempt from taxation under IRC 501(a).

However, wherever there exists a tax treaty between the United States and a foreign country, and a foreign private foundation subject to IRC 4948(a) is a resident of that country or is otherwise entitled to the benefits of the treaty, if the treaty provides that any item or items of gross investment income shall be exempt from income tax, the item or items need not be taken into account by the foreign private foundation in computing the IRC 4948(a) tax. The Service has issued two revenue rulings relating to whether treaty provisions affect the taxability of investments of foreign private foundations under IRC 4948(a). In the first, Rev. Rul. 74-183, 1974-1 C.B. 328, concludes that Canadian private foundations, exempt from both Canadian and United States income taxation (the latter under IRC 501(a)), are also exempt from the tax imposed on gross investment income by IRC 4948(a) by virtue of Article XXI of the current United States-Canada Income Tax Convention, as amended. (For a further discussion of the United States-Canada Income Tax Convention, see the Appendix to this article.) By contrast, Rev. Rul. 76-330, 1976-2 C.B. 488, concludes that a Belgian private foundation, whose only business activities in the United States are investments from which it derives interest income, is not exempt from IRC 4948(a) tax because neither the United States-Belgium Income Tax Convention nor the Belgian F.E.N Treaty requires that interest income of a Belgian private foundation be exempt from tax.

3. Foreign Private Foundations That Receive Substantially All Their Income from Sources Outside the United States

a. The General Statutory Scheme

Under the provisions of IRC 4948(b), a foreign private foundation that receives "substantially all of its support (other than gross investment income) from sources outside the United States" is excepted from the termination of private foundation status rules of IRC 507, from the governing instruments and other special rules of IRC 508, and from the general private foundation rules of Chapter 42 (other than IRC 4948). However, pursuant to IRC 4948(c)(2), such an organization is disqualified from tax exemption under IRC 501(a) if it engages in a "prohibited transaction" after December 31, 1969.

b. Denial of Exemption for Prohibited Transactions

In S. Rep. No. 552, 91st Cong., 1st Sess. 59 (1969), reprinted in 1969-3 C.B. 423, 462, the Senate Finance Committee set forth the rationale and schema of the IRC 4948 sanctions as follows:

> "The committee provided a series of modifications of the private foundation rules to take account of the fact that some of the rules could not easily be applied in practice to foreign organizations.... The requirements regarding change of status, governing instruments, self-dealing, minimum distributions, excess business holdings, jeopardy investments, and limitations on activities do not apply to foreign private foundations if no significant part of their support (other than investment income) is derived from United States sources. However, in general, such a foreign private foundation will lose its exemption under the Internal Revenue Code if it engages in any of the acts that would have justified a doubling of the taxes imposed upon the organization (that is, repeated or willful or flagrant violations) had it been a domestic organization engaging in those same acts. Also, no income, gift, or estate tax deductions are allowed to a foreign organization that has lost its exempt status under these circumstances. In effect, such an organization would be treated as a taxable nonresident alien."

For IRC 4948(b) foundations, therefore, the sanction for failure to observe the Chapter 42 requirements is a potential denial of exemption under IRC 501(a) instead of a tax imposed on the activity. However, one should not equate imposition of the Chapter 42 sanctions with the denial of exemption provisions of IRC 4948(c) -- there are two distinct differences.

The first difference is that not all activities that constitute Chapter 42 violations for other private foundations are "prohibited transactions" for purposes of IRC 4948(c). There is a statutory exception, set forth in IRC 4948(c)(2), which,

in effect, provides that foreign organizations described in IRC 4948(b) are not subject to the minimum investment return provisions of IRC 4942(e) and that failure to meet minimum distribution requirements will not result in a "prohibited transaction." See G.C.M. 39842 (Apr. 1, 1991). In addition to this statutory exception, Reg. 53.4948-1(c)(2)(ii) eases some grant-making rules by providing that for purposes of determining whether a prohibited transaction has occurred:

(1) Approval by an appropriate foreign government of grants by a foreign private foundation to individuals is sufficient to satisfy the requirements of IRC 4945(g); and

(2) In the case of a grant to an organization by a foreign private foundation, the grantor's determination as to the status of the qualifying distribution rules of IRC 4942(g)(1)(A)(ii) and the expenditure responsibility rules of IRC 4945(d)(4) and (h) will be accepted if made in good faith after a reasonable effort to identify the status of the grantee.

The second difference between Chapter 42 and IRC 4948(c)(2) lies in the difference of their treatment of an act or failure to act. For purposes of Chapter 42, an act or failure to act triggers tax liability although the tax subsequently may be abated. For purposes of IRC 4948(c)(2), however, an act or failure to act will only be treated as a "prohibited transaction" if there has been a prior act or failure to act (not necessarily related) that:

(1) Would have resulted in tax liability for tax under Chapter 42 if the foreign private foundation had been a domestic private foundation; and

(2) Has been the subject of a warning that a second act or failure to act would result in a prohibited transaction.

IRC 4948(c)(2) operates in a manner similar to liability for a penalty under IRC6684(1) and to the termination tax of IRC 507(b)(2). The sequence leading up to denial of exemption for a "prohibited transaction" is as follows:

(1) Foundation's act or failure to act;

(2) Warning by the Service of consequences of a second act or failure to act;

(3) Second act or failure to act;

(4) Warning that the second act or failure to act may be treated as a "prohibited transaction;"

(5) 90 day period from the date of the warning for the foundation to make correction (within the meaning of Chapter 42 and the regulations thereunder);

(6) If no correction, denial of exemption under IRC 4948(c)(3).

Under the provisions of IRC 4948(c)(3), denial of exemption for engagement in a "prohibited transaction" will be effective for all tax years beginning with the taxable year during which it was notified by the Service that it has engaged in the transaction. Notice of the denial of exemption is to be published in the Federal Register on the day the foundation is notified. Text (19)50(1) of IRM 7751 provides that the National Office will coordinate issuance and publication of the notice.

The foundation may reapply for exemption by filing a Form 1023, Application for Recognition of Exemption, with respect to the second or any subsequent tax year following the taxable year in which the notice of denial was issued. In addition to the information generally required in connection with filing an application for recognition of exemption, the application must also contain a written declaration, made under penalty of perjury by a principal officer of the foundation, that the foundation will not knowingly engage in a prohibited transaction again.

Reg. 53.4948-1(c)(3)(ii)(b) provides that, if the foundation satisfactorily establishes that it will not knowingly again engage in a prohibited transaction and that it otherwise satisfies the requirements for exemption, it will be so notified in writing. In such a case, the organization will not be denied exemption by reason of any prohibited transaction engaged in before notice of loss of exemption was issued. However, in no case may an organization denied exemption under IRC 4948(c) be again exempt under IRC 501(a) sooner than the conclusion of one full taxable year following the year in which notice of loss of exemption is given.

Under IRC 4948(c)(4), no deduction is allowed under IRC 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 if made to a foundation after the Service publishes the "prohibited transaction" notice in the Federal Register and in a tax year of the organization for which it is not exempt due to having engaged in the prohibited transaction. (Note: Reg. 53.4948-1(d)(2) provides that, for these purposes, a bequest, legacy, devise, or transfer under IRC 2055 or 2106(a)(2) is treated as made on the date of death of the decedent; it also furnishes an illustration of how the provision operates.)

6. Unrelated Trade or Business Income

A. Domestic Organizations with Foreign Subsidiaries

A current problem that is as yet unresolved concerns the treatment of UBTI/IRC 951 - 964 income received from controlled foreign corporations. The issue, insofar as we are concerned, is whether, for purposes of the exclusion from unrelated business income tax treatment under IRC 512(b)(1), IRC 951 - 964 income received by a domestic parent from a foreign subsidiary should be treated as a dividend. (There are, of course, other issues under IRC 951 - 964 with respect to such income, but these issues are beyond our jurisdiction.)

We are working with the Associate Chief Counsel (International) to resolve the UBTI issue. Until it is resolved, however, cases in which this issue appears should be referred to the National Office.

B. Foreign Organizations

IRC 512(a)(2) provides that the unrelated business taxable income of a foreign organization exempt from taxation under IRC 501(a) includes both its unrelated business taxable income from United States sources not connected with a trade or business and its United States source unrelated business taxable income. Reg. 1.512(a)-1(g) states that IRC 861 - 865 determine whether income realized by a foreign organization is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States. (As noted in the introduction to this article, those statutory provisions are under the jurisdiction of Associate Chief Counsel (International).)

Under IRC 515 of the Code, for which there are currently neither final nor proposed regulations, taxes imposed by foreign governments and United States possessions may be used to offset any unrelated trade or business taxable income due, limited by the rules of IRC 901. (IRC 901, which is also under the jurisdiction of Associate Chief Counsel (International) deals with taxes of foreign countries and possessions of the United States.)

7. Withholding Tax Issues and Foreign Organizations

Generally, foreign organizations recognized as exempt under IRC 501(c)(3) are not liable for the 30 percent withholding tax imposed on certain types of gross income received by such organizations under IRC 881 and 1442. IRC 1443, which

is under the jurisdiction of the Associate Chief Counsel (International), contains the exceptions to this general rule.

IRC 1443(a) provides that unrelated trade or business taxable income of a foreign IRC 501(c) organization is subject to withholding. This means that any unrelated business income tax liability under IRC 511 through 514 is either subject to the 30 percent withholding tax under IRC 881, 1442, and 1443 or, if that income is effectively connected with a United States trade or business, it is subject to net basis taxation at the domestic corporation rate under IRC 864 and 882(a). (For the procedure to establish that an organization is not subject to withholding on unrelated trade or business "effectively connected" with the conduct of a trade or business carried on within the United States, see Reg. 1.1441-4.)

IRC 1443(b) provides for withholding in the case of investment income of a foreign private foundation subject to the tax imposed by IRC 4948(a).

As noted above, Canadian private foundations, by treaty, are not subject to the IRC 4948(a) tax. The procedures that these private foundations use to obtain exemption from withholding on their United States source investment income are contained in Reg. 1.1441-6. (For a further discussion of withholding and the Canadian treaty, see the Appendix to this article.)

8. Forms 990 and 990-T Filing Requirements of Foreign Organizations and Failure to File Required Returns

The filing requirements for foreign tax exempt organizations are identical to those of domestic exempt organizations. The Service does not exempt organizations from filing on an individual basis, and foreign organizations as a group have not been excused from filing.

As is the case with applications for recognition of exemption, all financial information entered on Forms 990 and 990-T must be stated in United States dollars and the conversion rate used must be stated.

One problem which has arisen with foreign organizations exempt from federal income taxation under the Code is the failure to file required returns. The following discussion is based upon "Voluntary Relinquishing of Tax Exempt Status," 1985 CPE text, 125, especially 128-131.

If an organization is required, but refuses, to file an annual information return, follow the procedure in IRM 7(10)91.53, which is based upon IRC 6652(c)(1). The usual situation with respect to foreign tax exempt organizations is that the organization has secured such status to avoid taxation of its United States investment income. It disposes of this income, and, finding exempt status not currently advantageous, stops filing information returns, although still required to do so. In such a case, any person under a duty to file a particular exempt organization's return may be liable for the IRC 6652(c)(1) penalty. This sanction may prove effective since one or more of the persons under a duty to file (such as a person listed on a power of attorney, by reason of also being an officer of the organization) might have assets in the United States.

Should the foreign organization fail to pay any IRC 6652(c)(1) penalty and, should the key district determine the foreign organization's entitlement to exempt status is substantially in doubt, a proposed revocation letter should be issued. Should the organization subsequently have United States investments, it would have to reapply for exempt status, and the penalty assessed would be collectible. (While IRC 6501(a) provides time limitations for the assessment and collection of tax, in the case of failure to file a return, the tax may be assessed, or a proceeding in court may begin without assessment, at any time. See IRC 6501(c)(3).)

APPENDIX

TREATIES

1. Canada

With respect to treaties dealing with issues of taxation, both Commerce Clearing House and Prentice-Hall maintain tax treaty series giving the latest rules to be applied under current tax treaties. Foreign governments negotiate income and estate and gift tax treaties to protect their nationals, to resolve issues of double taxation, and to assist in the administration of taxes. Despite the fact that the United States has about 50 income tax treaties currently in force, very few deal with exempt organizations. IRC 894(a) is the legal authority under which tax treaties are implemented.

With respect to specific countries, the Service has issued Rev. Proc. 59-31, 1959-2 C.B. 949, explaining procedures used to establish the tax exempt status of organizations created under Canadian or Honduran law and the deductibility of contributions to such organizations. However, the Honduran treaty lapsed on December 31, 1966, and is not currently in force. The former Japanese treaty provision concerning exempt organizations terminated on July 9, 1972. Therefore, only the Canadian treaty is worth review here. The revenue procedure provides additional details, but the Canadian treaty, generally effective January 1, 1985, provides in Article XXI, in relevant part:

Article XXI - Exempt Organizations

1. Subject to the provisions of paragraph 3, income derived by a religious, scientific, literary, educational, or other charitable organization shall be exempt from tax in a Contracting State if it is a resident in the other Contracting State but only to the extent that such income is exempt from tax in that other State.

* * *

3. The provisions of paragraph 1 ... shall not apply with respect to the income of a trust, company or other organization ... carrying on a trade or business or [to] a related person other than a person referred to in paragraph 1 ...

4. A religious, scientific, literary, educational, or charitable organization which is resident in Canada and which has received substantially all of its support

from persons other than citizens or residents of the United States shall be exempt in the United States from the United States excise taxes imposed with respect to private foundations.

5. For the purposes of United States taxation, contributions by a citizen or resident of the United States to an organization which is resident in Canada, which is generally exempt from Canadian tax and which could qualify in the United States to receive deductible contributions if it were resident in the United States shall be treated as charitable contributions; however, such contributions (other than such contributions to a college or university at which the citizen or resident or a member of his family is or was enrolled) shall not be deductible in any taxable year to the extent that they exceed an amount determined by applying the percentage limitations of the laws of the United States in respect to the deductibility of charitable contributions to the income of such citizen or resident arising in Canada. The preceding sentence shall not be interpreted to allow in any taxable year deductions for charitable contributions in excess of the amount allowed under the percentage limitations of the laws of the United States in respect to the deductibility of charitable contributions.

For deductibility to be applicable under the treaty, the income sought to be deducted must be derived in the country granting the exemption, and the organization must be exempt from income taxation under the laws of both countries, or it would be exempt if it did apply for recognition of exemption in both countries. Subject to the two exceptions in IRC 508 for churches and for organizations with gross receipts under $5,000, since applications are generally required under IRC 501(c)(3), a Canadian IRC 501(c)(3) organization must generally have applied to the Service to be recognized exempt in order to fall under the treaty provision. Under the IRC 1443 withholding provisions, without a determination of exemption by the Service, the issuance of a certificate waiving the usual percentage of foreign withholding is unlikely. Discussions are under way between the United States and Canada to determine how these provisions are going to be implemented.

Under Article XXI, paragraph 5, deductions for contributions, other than to a college or university at which the U. S. citizen or resident or a family member of such person is enrolled, are limited to the income of the United States citizen or resident arising in Canada, as determined under the treaty. In addition, the percentage limitations under IRC 170 also apply after the limitations established by the treaty, but carryover provisions apply to amounts in excess of those permitted for any one taxable year. A note exchanged when the treaty was submitted makes clear that the term "family" includes brothers and sisters, whether of the whole or

half blood or adopted, spouse, ancestors, lineal descendants, and adopted descendants. The note also provides for the establishment of competent authorities of Canada and the United States to review procedures and requirements for establishment of exemption and for eligibility to receive charitable contributions or gifts.

Article XXI, paragraph 4, deals with private foundations resident in Canada. Such entities are exempt from U.S. excise taxes under IRC 4948 only if they are religious, scientific, literary, educational, or charitable organizations and only if the organization has received substantially all of its support from persons other than citizens or residents of the United States. For a Canadian discussion of the treaty, see Bradley, J. Michael, "The Canada--United States Income Tax Treaty--II", Report of Proceedings of the Thirty-Second Tax Conference, 1980, pp. 374-405, esp. 400-403. Call number KE5668.R4 1980.

2. Other Countries

A. Union of Soviet Socialist Republics

The current treaty with the Soviet Union provides in Article IX for treatment which may affect exempt organizations. The entire treaty must be consulted for relevant provisions. The most pertinent article reads:

Article IX - [Exemption of Transaction Giving Rise to Exempt Income]

> If the income of a resident of one of the Contracting States is exempt from tax in the Contracting State, in accordance with this Convention, such resident shall also be exempt from any tax which is at present imposed or which may be imposed subsequently in that Contracting State on the transaction giving rise to such income.

The "Technical Explanation of the Convention between the United States of America and the Union of Soviet Socialist Republics on Matters of Taxation, with Related Letters, Signed at Washington on June 20, 1973," issued by the Department of the Treasury on December 3, 1975, indicates that the foregoing treaty provision was intended to apply to the 4% excise tax imposed on the investment income of foreign private foundations by IRC 4948. The parties to the treaty exchanged letters indicating that customs duties are not covered by the provision. Since all other items are "under this convention," National Office consideration might be appropriate in any case involving Soviet organizations. There is discussion of revising the convention with the Soviet Union.

B. Federal Republic of Germany

The current treaty with the Federal Republic of Germany, applicable to what was formerly the German Democratic Republic as of October 3, 1990, (the date the Constitution of the Federal Republic of Germany became effective in what was formerly East Germany), provides, in relevant part, as a result of a protocol effective for tax years beginning on or after January 1, 1965:

Article XV A

(4) A German company or organization operated exclusively for religious, charitable, scientific, educational or public purposes shall be exempt from tax by the United States, if and to the extent that -

(a) such company or organization is exempt from tax in the Federal Republic, and

(b) such company or organization would be exempt from tax in the United States if it were organized, and carried on its activities, in the United States.

Note that a German entity must still apply for recognition of exemption from federal income taxation under IRC 501(c)(3) unless it falls within one of the IRC 508(c) exceptions since the treaty stipulates "if and to the extent that...". The treaty provides for an equivalent recognition of exemption of United States entities in the Federal Republic of Germany.

C. United Kingdom, Australia, and South Africa

The current treaty with the United Kingdom does not discuss exempt organizations. The current income tax treaty with Australia also contains no such provision although the prior treaty did. The treaty with South Africa, which did contain such a provision, terminated on July 1, 1987. Even these former treaty provisions did not provide for deductibility of contributions.

D. Israel

With respect to the State of Israel, a treaty has been negotiated, but it is not currently in effect because the instruments of ratification have not been exchanged

between the two countries. As a point of information, the protocol, signed on May 30, 1980, provides:

Article 15-A - Charitable Contributions

(1) In the computation of taxable income of a citizen or a resident of the United States for any year under the revenue laws of the United States, there shall be treated as a charitable contribution under such revenue laws contributions to any organization created or organized under the laws of Israel (and constituting a charitable organization for the purpose of the income tax laws of Israel) if and to the extent such contributions would have been treated as charitable contributions had such organization been created or organized under the laws of the United States; provided, however, that this paragraph shall not apply to contributions in any taxable year in excess of 25 percent of taxable income for such year (in the case of a corporation) or of adjusted gross income for such year (in the case of an individual) from sources in Israel.

(2) In the computation of tax liability of a resident of Israel for any taxation year under the income tax laws of Israel, there shall be treated as charitable contributions eligible for credit or deduction, as the case may be, under such income tax laws, gifts to any organization constituting a charitable organization for the purpose of the revenue laws of the United States, if and to the extent such contributions would have been treated as charitable contributions had such organization been a charitable organization for the purpose of the income tax laws of the State of Israel; provided, however, that this paragraph shall not apply to contributions in any taxation year in excess of 25 percent of taxable income for such year from sources in the United States.

3. Conclusion

Other treaty provisions come into force from time to time as protocols or new treaties are adopted. The above list is, therefore, not exhaustive. The Treasury's Model Convention and the OECD Model Convention do not have specific provisions for exempt organizations.