

# FINAL REGULATIONS ON FOREIGN PUBLIC CHARITY EQUIVALENCY DETERMINATIONS

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On 9/25/15, the Treasury issued final regulations on foreign public charity equivalency determinations,<sup>1</sup> revising regulations initially introduced over 40 years ago. The final regulations adopt most of the draft revisions proposed in 2012,<sup>2</sup> and also provide guidance in several areas not addressed by the proposed regulations. The discussion below reviews the history of the equivalency regulations leading up to the 2012 proposed regulations, explains the terms and implications of the new regulations, examines questions that remain open, and proposes ways for the IRS to provide further guidance to exempt organizations and practitioners.

## Background

A Section 501(c)(3) organization may be classified as either a public charity or a private foundation. "Private foundation" is the default classification: a 501(c)(3) organization is presumed to be a private foundation unless it can demonstrate that it fits into at least one of nine categories set forth in Section 509(a)(1).<sup>3</sup> The nine categories include churches; schools; hospitals; certain government entities; and supporting organizations that exist in coordination with, and solely to support, other public charities; as well as two broad categories of organizations that receive a substantial portion of

their funds from the public at large or the government (this final category being the most common). Practitioners and the IRS refer to organizations that fit within one or more of these nine categories as "public charities," although the Code does not use that term.

Private foundations,<sup>4</sup> by contrast, typically receive funds from a single individual, family, or business. Lawmakers viewed these organizations as less accountable to the public. Therefore, private foundations are subject to a more restrictive set of operating rules. Moreover, donations to private foundations generally receive less favorable tax deduction treatment.

The restrictive operating rules specific to private foundations are found in Chapter 42 of the Code and the accompanying regulations, and are enforced by the IRS through a series of two-tier excise taxes imposed on foundations, their management, and/or their "disqualified persons."<sup>5</sup> Excessive violations of these rules may also cause a private foundation to lose its exemption. The discussion below focuses on two specific sections of Chapter 42: Section 4942 and Section 4945.

Section 4942 requires that private foundations make qualifying distributions (QDs) for charitable purposes each year, generally equal to 5% of a foundation's investment assets. Private foundations are free to make QDs that exceed the minimum amount.<sup>6</sup> QDs include

**The final regulations provide welcome clarity for private foundations engaged in international philanthropy and their advisors.**

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**Allowing foundations to determine that a foreign organization is the equivalent of a U.S. public charity gave private foundations flexibility.**

grants, charitable distributions, reasonable and necessary administrative expenses, payments for assets used in exempt purposes, and professional fees for advice on program activity. QDs do not include investments, payments to investment advisors, grants for non-charitable purposes and, with certain exceptions, grants to most other private foundations.<sup>7</sup> Thus, private foundations must ensure each year that sufficient amounts of their grants and expenses qualify as QDs to avoid penalizing taxes. The Section 4942 regulations generally permit private foundations to count as qualifying distributions grants to domestic Section 501(c)(3) public charities as well as their foreign equivalents.<sup>8</sup>

Section 4945 prohibits private foundations from engaging in certain activities permissible for public charities. The Code refers to prohibited private foundation payments under Section 4945 as "taxable expenditures."<sup>9</sup> These include the funding of legislative lobbying and most voter registration drives, as well as most private foundation grants to individuals without advance approval from the IRS, and grants to any entity that is not a public charity (or its foreign equivalent) unless the private foundation exercises heightened inquiry and control by engaging in the somewhat technical process known as "expenditure responsibility." Expenditure responsibility requires that the private foundation conduct a pre-grant inquiry, execute a written grant agreement containing specific terms and conditions, receive reports containing certain information from the grantee, and report cer-

tain information regarding the grant to the IRS on its annual Form 990-PF.<sup>10</sup> The Section 4945 regulations permit private foundations to make grants to foreign organizations for charitable purposes without treating such grants as taxable expenditures, but only if the private foundation either exercises expenditure responsibility, or determines that the foreign organization is the equivalent of a public charity.<sup>11</sup>

The process of determining whether a foreign organization is the equivalent of a U.S. public charity, under both Sections 4942 and 4945, is referred to by practitioners as "foreign public charity equivalency," "FPCE," and sometimes as "equivalency determination" or "ED." The final regulations issued in 2015 specifically update the rules regarding FPCE determinations.

### History of the FPCE regulations

Congress enacted Sections 4942 and Section 4945 as part of the Tax Reform Act of 1969. Among other significant amendments to the Code (including introduction of the alternative minimum tax), the Tax Reform Act introduced a series of restrictions, prohibitions, and penalizing taxes on private foundations in an effort to check perceived abuses, including the failure to have "adequate controls to ensure that the funds be used exclusively for exempt purposes."<sup>12</sup> Under the 1969 law, the IRS would penalize a private foundation by imposing excise taxes if the foundation failed to make reasonable, minimum distributions for charitable purposes, or if it made grants to any en-

<sup>1</sup> TD 9740, 2015-42 IRB 573, 80 Fed. Reg. 57,709 (2015), effective 9/25/15.

<sup>2</sup> Former Prop. Reg. 53.4945-5(a)(5), REG-134974-12, 2012-47 IRB 553, 77 Fed. Reg. 58,796 (2012).

<sup>3</sup> Section 509(a)(1) makes further reference to Sections 170(b)(1)(A)(i) through (vi) and Sections 509(a)(2) through (4).

<sup>4</sup> Section 509(a).

<sup>5</sup> See Section 4946(a)(1). Disqualified persons of private foundations include substantial contributors (and entities that are at least 20% owned by substantial contributors), foundation managers (officers, directors, trustees, or individuals having similar powers or responsibilities), and certain family members of the aforementioned (spouses, ancestors, lineal descendants through great-grandchildren, and spouses of these lineal descendants), as well as an entity of which any of the above persons owns more than 35% of the combined voting power (if a corporation), or the profits interest (if a partnership), or of the beneficial interest (if a trust or estate). For purposes of Section 4941 (self-dealing) only, certain government officials are also disqualified persons.

<sup>6</sup> Section 4942(d) defines the required "distributable amount" that private foundations must spend in qualifying distributions. Failure to spend such amount by the end of the succeeding tax year results in an excise tax equal to 30% of the undistributed amount. Section 4942(a). The distributable amount is calculated by adding the foundation's "minimum investment return" to repayments of prior qualifying distributions and

amounts set aside for specific projects but no longer needed for such projects, reduced by net investment income taxes paid for the same tax year. Section 4942(e) defines "minimum investment return" as 5% of the excess of the aggregate fair market value of all foundation assets that are used (or held for use) to accomplish any purpose other than directly carrying out the foundation's exempt purpose, over the acquisition indebtedness with respect to such assets. Practically speaking, the only assets used or held for use by a private foundation for purposes that do not directly further the foundation's charitable purposes are investment assets. Moreover, most foundations do not acquire such assets by incurring debt. Therefore, for most foundations, the distributable amount equals roughly 5% of their investment assets.

<sup>7</sup> Exceptions include grants to private operating foundations and grants to other private non-operating foundations if the grantor and grantee follow the "out of corpus" rules.

<sup>8</sup> As discussed elsewhere in this article, private foundations may also make grants to entities not recognized under Section 501(c)(3) via "expenditure responsibility." Under a 2001 general information letter requested by the Council on Foundations, the IRS clarified that a private foundation making a grant to a non-U.S. organization using expenditure responsibility could generally count such a grant as a qualifying distribution. IRS General Information Letter, dated 4/18/01, addressed to John A. Edie, Council on Foundations.

<sup>9</sup> Section 4945(d).

<sup>10</sup> Section 4945(h); Reg. 53.4945-5(b)-(d).

tity not recognized by the IRS as a public charity without exercising expenditure responsibility.<sup>13</sup>

The Treasury first issued regulations to Section 4942 in 1973.<sup>14</sup> The regulations provided a mechanism for private foundations to make qualifying distributions to the foreign equivalent of public charities. The distribution had to have been for charitable purposes described in Section 170(c)(2)(B), and the distributing foundation must have made "a good faith determination" that the donee organization was "an organization described in section 509(a)(1), (a)(2), or (a)(3) or in section 4942(j)(3)." A determination was considered to be "a good faith determination if the determination is based on current written advice received from a qualified tax practitioner ... and if the foundation reasonably relied in good faith on [such] written advice...."<sup>15</sup>

These regulations were consistent with the Treasury's issuance of regulations under Section 4945 in 1972.<sup>16</sup> The earlier regulations allowed private foundations to make grants to foreign organizations that were the equivalent of public charities without incurring a taxable expenditure if, "in the reasonable judgment of a foundation manager," the grantee organization was described in Section 501(c)(3) (other than Section 509(a)(4)).<sup>17</sup>

For a private foundation to avoid exercising expenditure responsibility, the new Section 4945 regulations provided that (as subsequently restated in the 4942 regulations) a private foundation grant to a foreign organization that was not recognized by the IRS as a public charity could be treated as such "if the grantor private foundation has made a good faith determination that the grantee organization is an organization described in section 509(a)(1), (2), or (3)." A "good faith determination" would ordinarily be considered made where the determination was based on an affidavit of the

grantee or an opinion of counsel (of either the grantor or the grantee) that the grantee was public charity. The regulations required that an affidavit or opinion set forth "sufficient facts concerning the operations and support of the grantee for the Internal Revenue Service to determine that the grantee would be likely to qualify as an organization described in section 509(a) (1), (2), or (3)."<sup>18</sup>

In other words, the regulations required that a private foundation seeking to have a grant to a foreign organization treated as a grant to a public charity complete two steps. First, it had to make a "reasonable judgment" that the grantee satisfied the requirements of Section 501(c)(3). Second, it had to make a good-faith determination, based on an affidavit of the grantee or an opinion of counsel, that the grantee was the equivalent of a public charity.

Providing a procedure for foundations to determine that a foreign organization is the equivalent of a U.S. public charity gave private foundations the flexibility to use foreign public charity equivalency or expenditure responsibility as the circumstances merited,<sup>19</sup> and was consistent with IRS precedent. In a 1966 revenue ruling, the IRS stated that "[t]he 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."<sup>20</sup> As restated in the 1992 Exempt Organizations CPE Text, "the nature of the activity, and not its locus, determines whether it is 'charitable' for purposes of IRC 501(c)(3)."<sup>21</sup> The same CPE article announced that the IRS was working to provide clarification on good-faith determinations in an effort to alleviate a "burdensome" existing process.

The existence of an equivalency process—legal opinion or affidavit—was helpful. Still, many grantors preferred to avoid the expense of

<sup>11</sup> Reg. 53.4945-5(a)(5). A small number of non-U.S. entities themselves have obtained recognition as Section 501(c)(3) public charities, and neither expenditure responsibility nor foreign public charity equivalency determinations are required for grants to such organizations.

<sup>12</sup> IRM 7.27.19.1.1 (2-22-1999), available at [www.irs.gov/irm/part7/irm\\_07-027-019.html](http://www.irs.gov/irm/part7/irm_07-027-019.html).

<sup>13</sup> See "IRC 4942(g): Qualifying Distributions," *Exempt Organizations Continuing Professional Educational Technical Instruction Program for FY 1988* (1987); see also Staff of the Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1969 (H.R. 13270, 91st Congress, Public Law 91-172 (1970)), available at [https://archive.org/stream/generalexplanati00jcs1670/generalexplanati00jcs1670\\_djvu.txt](https://archive.org/stream/generalexplanati00jcs1670/generalexplanati00jcs1670_djvu.txt).

<sup>14</sup> TD 7256, 1973-1 CB 496.

<sup>15</sup> *Id.*; Reg. 53.4942(a)-3(a)(6).

<sup>16</sup> TD 7215, 1972-2 CB 604.

<sup>17</sup> TD 7215, 1972-2 CB 604; Reg. 53.4945-6(c)(2)(ii).

<sup>18</sup> TD 7215, 1972-2 CB 604; Reg. 53.4945-5(a)(5)(i).

<sup>19</sup> For example, expenditure responsibility was often expedient for one-time, smaller grants, or grants for which equivalency determination was not possible because the grantee could not qualify. Equivalency determination was often a better fit for multi-year grants, grants for general support, or grants where re-grants were contemplated.

<sup>20</sup> Rev. Rul. 66-177, 1966-1 CB 132 (quoted here in its entirety).

<sup>21</sup> Bloom, Luft, and Reilly, "Foreign Activity of Domestic Charities and Foreign Charities," *Exempt Organizations Continuing Professional Educational Technical Instruction Program for FY 1992* (1991), available at <https://www.irs.gov/pub/irs-tege/eotopic92.pdf>.

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a formal legal opinion, particularly if the grant under consideration was small, but the sector lacked clarity about what information the affidavit described in the regulations should request.

**Rev. Proc. 92-94.** In response to requests for guidance, the IRS issued Rev. Proc. 92-94<sup>22</sup> 20 years after adoption of the FPCE regulations. It offered much-needed clarity on the content of grantee affidavits for a private foundation making a good-faith determination whether a foreign organization was the foreign equivalent of a U.S. public charity.

### Completing affidavits repeatedly for different grantors (as not all affidavits were exactly the same) took away significant time from program work.

Rev. Proc. 92-94 declared that a private foundation would satisfy the regulations if it based its "reasonable judgment" and "good faith determination" on a "currently qualified" affidavit prepared by the grantee for the grantor, or another grantor, that contained the information set out in the revenue procedure.<sup>23</sup> In effect, Rev. Proc. 92-94 provided a safe harbor; while not *requiring* private foundations to use affidavits that fit its specifications, private foundations that did and that received completed information from their grantees that appeared facially reasonable would be protected from Section 4942 and Section 4945 taxes in relying on such affidavits.

To fit within Rev. Proc. 92-94, grantee affidavits must: (1) be in English; (2) contain a signed declaration from a principal officer that the grantee's activities are—and that the laws

and customs of the grantee's country require that they be—consistent with several Section 501(c)(3) restrictions and prohibitions; (3) provide a public support schedule spanning the grantee's four latest tax years *if* the grantee is seeking equivalency as a publicly supported charity under Section 509(a)(1) or (a)(2); (4) provide a schedule demonstrating that the grantee meets the operating foundation tests *if* it is seeking equivalency as an operating foundation under Section 4942(j)(3); (6) attest to the grantee's compliance with Section 170(b)(1)(A)(ii) *if* the grantee is seeking equivalency as a school. The Section 501(c)(3) restrictions and prohibitions to be addressed in the affidavit include prohibiting private benefit, private inurement, and political campaign intervention, and restricting any lobbying or non-charitable activities to an insubstantial part of the organization's overall activities.

For an affidavit to be "currently qualified," the facts in the grantee's most recent affidavit must remain unchanged, and must either reflect the grantee's latest complete accounting year, or be updated to reflect the grantee's current data.

**Opinion of counsel of grantor or grantee.** While Rev. Proc. 92-94 offered a "simplified procedure" for grantors to rely on grantee affidavits, grantors retained the option to rely on "an opinion of counsel (of the grantor or the grantee) that the grantee is an organization described in section 509(a)(1), (2), or (3)."<sup>24</sup> The opinion "must set forth sufficient facts concerning the operations and support of the grantee for the Internal Revenue Service to determine that the grantee would be likely to qualify as an organization described in section 509(a)(1), (2), or (3)."<sup>25</sup> The then-existing regulations did not further specify what an opinion of counsel must include, nor what qualifications counsel must have. In practice, an opinion of counsel needed to include an examination of the grantee's governance, activities, and financial data similar to the information described in Rev. Proc. 92-94.

**Practical effects.** While Rev. Proc. 92-94 provided private foundation grantors some clarity, other issues persisted. For example, the burden to a non-U.S. charity in completing a detailed affidavit describing the technical nuances of U.S. tax law for a single grant could be large, particularly if English is not spoken in the country involved. Completing such affidavits repeatedly for different grantors (as not all affidavits were exactly the same) took away significant time from program work. Private foundation grantors to a common

<sup>22</sup> 1992-2 CB 507.

<sup>23</sup> Rev. Proc. 92-94 also stated that the grant could not be "a transfer of assets pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization described in section 507(b)(2) of the Code."

<sup>24</sup> Reg. 53.4945-5(a)(5), prior to TD 9740, *supra* note 1.

<sup>25</sup> *Id.*

<sup>26</sup> "Request for Proposals to Establish and Maintain a Centralized Repository of Information on Non-US Based NGOs," Press Release issued by Council on Foundations on 3/31/08, available at [http://foundationcenter.org/media/news/pr\\_0803a.html](http://foundationcenter.org/media/news/pr_0803a.html).

<sup>27</sup> Note 2, *supra*.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> Preamble to TD 9740, *supra* note 1.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

grantee noted that it was inefficient for each of them to produce and review affidavits and governing documents of the same grantee; alternatively, it was extremely expensive for each of them to procure legal opinions for grants to the same grantee. Often, grantees had difficulty properly completing the affidavit, requiring significant assistance from the private foundation grantor's staff, which sometimes required overcoming language barriers, time zones, and explaining the nuances of U.S. tax law.

As a result, in approximately 2008, a group of private foundations led by the Council on Foundations began the process of working toward a "repository"—conceptually, an entity that would work with foreign grantees to gather information for a completed affidavit, review the information and keep the affidavits on file, and provide a legal opinion to U.S. grantmakers on which they could rely.<sup>26</sup> In this way, a grantee could simply complete one affidavit—the repository's—rather than each individual grantor's. The repository, rather than the grantors, would work with the grantee to help compile a complete and accurate affidavit and take over the burden of overcoming language, time difference, legalese, and other barriers. For their part, grantors would not have to extensively examine the affidavit, work with the grantee on it, or each hire their own counsel to produce an opinion. The repository could provide opinions to any grantors interested in making a grant to the grantor. In this way, the group believed that major economies of scale could be achieved, with resulting benefits to international philanthropy.

It was not immediately evident, however, that such a repository fit within the regulations' definition of "counsel."

## 2012 Proposed Regulations

In November 2012, the Treasury released proposed regulations (the "Proposed Regulations") updating the Section 4942 and Section 4945 regulations for making a good-faith determination that a foreign grantee is a qualifying charitable organization.<sup>27</sup> The Proposed Regulations (1) addressed standards relating to written advice and grantor reliance, (2) identified a broader class of tax practitioners upon whose written advice a private foundation could base a "good faith determination," (3) excluded foreign counsel from the class from which grantors could obtain written advice unless such counsel qualified as a "qualified tax practitioner," and (4) made certain conforming changes consistent with

statutory amendments already made to Sections 4942 and Section 4945.<sup>28</sup>

**Standards for reliance.** The Proposed Regulations defined what it meant for a grantor to rely "in good faith" on an opinion of counsel, by referring to existing reliance standards stated elsewhere in the Code:

In the case of a determination based on written advice, the determination will be considered as made in good faith if the foundation reasonably relied in good faith on the written advice in accordance with the requirements of [Reg.] 1.6664-4(c)(1).<sup>29</sup>

Reg. 1.6664-4(c)(1) provides that all facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on written advice. The inquiry is subjective. "[T]he taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith."<sup>30</sup> The Preamble to the Proposed Regulations explained that:

A taxpayer will not be considered to have reasonably relied in good faith on written advice unless the requirements of [Reg.] 1.6664-4(c)(1) are satisfied. For example, a private foundation's reliance on written advice is not reasonable and in good faith if the private foundation knows, or reasonably should have known, that a professional tax advisor lacks knowledge of the relevant aspects of Federal tax law or that the professional tax advisor is otherwise not qualified or competent to render the written advice. Moreover, a private foundation may not rely on written advice if it knows, or has reason to know, that relevant facts were not disclosed to the professional tax advisor or the written advice is based on a representation or assumption that the private foundation knows, or has reason to know, is unlikely to be true.<sup>31</sup>

**Expanded class of tax practitioners.** The original regulations provided that a good-faith determination would ordinarily be considered made "where the determination is based on an affidavit of the grantee organization or an opinion of counsel (of the grantor or the grantee)." The Proposed Regulations changed "an opinion of counsel (of the grantor or the grantee)" to "written advice given by a 'qualified tax practitioner.'"

This change accomplished several goals set forth by the Treasury. By expanding the class of tax practitioners from lawyers to include certified public accountants and enrolled agents, the Treasury aimed to decrease the cost of seeking professional advice regarding determinations, enabling foundations to engage in international philanthropy in a more cost-effective manner. At the same time, expressly allowing reliance on a broader spectrum of professional tax advisors was intended to encourage more private foundations to obtain written tax ad-

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**The Final Regulations retain the expansion of the class of advisors on whose opinions a private foundation may ordinarily rely.**

vice, promoting the quality of the determinations being made.<sup>32</sup>

Moreover, by expanding the class of practitioners and by removing the phrase “of the grantor or the grantee,” the Treasury was clearing the way for repositories, so that a private foundation grantor could rely on the kind of organization envisioned by the Council on Foundations and described above, without the repository having to be the private foundation’s attorney or tax advisor. On the same day of the release of the Proposed Regulations, then-Secretary of State Hillary Clinton gave a speech launching the State Department’s Global Philanthropy Working Group, in which she both endorsed the Proposed Regulations and the concept of an FPCE repository:

Now, in making equivalency determinations, foundations can rely on advice from a broader range of tax professionals, not just attorneys, which will make the process easier and far less expensive. And although it’s not specifically addressed in the new rules, this change will clear the way for foundations to set up organizations that can serve as repositories of this determination, meaning this would only need to be done one time. And Treasury and State will work together with you to try to create such a clearinghouse of information that would then be accepted as reliable.<sup>33</sup>

In March 2013, TechSoup and the Council on Foundations, two public charities that collaborated to build such a repository, publicly released the FPCE repository, “NGOsource.”<sup>34</sup> In addition to NGOsource, other charities have begun to compile repositories for private foundation grantors in an effort to further facilitate international grantmaking.

**Narrowed class of foreign counsel.** Although the Proposed Regulations generally expanded the class of practitioners on whose written advice a private foundation may ordinarily base a good-faith determination, the expanded class now included only those foreign counsel who are qualified tax practitioners: “A ‘good faith determination’ ordinarily will be considered as made if the determination is based on an affidavit of the grantee organization or written advice from a qualified tax practitioner...”<sup>35</sup> A “qualified tax practitioner” is one who is subject to IRS Circular 230, which governs practice before the IRS, and requires licensure in a state, territory, or possession of the United States, including as an “enrolled agent.” The definition of qualified tax practitioner thus necessarily would limit the class of foreign counsel on whose written advice a grantor can rely.

**Conforming regulations to current law.** In addition, the Proposed Regulations made conforming changes consistent with the Pension Protection Act of 2006 (PPA) regarding grants from private foundations to certain disqualified supporting organizations.<sup>36</sup> The PPA had required a private foundation to exercise expenditure responsibility over these grants, and disallowed their treatment as qualifying distributions. The Proposed Regulations updated the existing regulations under Sections 4942 and Section 4945 to conform to the 2006 changes.

**Request for comments.** The Proposed Regulations sought public comment on four principal issues: (1) whether to limit the time frame during which a private foundation may rely on a qualified tax practitioner’s written advice, (2) whether the standards in Revenue Procedure 92-94 should be modified to take into account changes to the public support test for public charity status under Sections 170 and 509; (3) whether additional guidelines regarding appropriate time frames for gathering information on which written advice is based should be provided; and (4) whether to further amend the regulations to remove the ability of a private foundation to base a good-faith determination on an affidavit of a foreign grantee. On the last issue, the Proposed Regulations elaborated: “For example, future guidance could prohibit the use of affidavits for grants above a certain dollar threshold, or could require supporting factual information that might serve to corroborate the content of affidavits.”<sup>37</sup>

## Final regulations

Three years after issuing the Proposed Regulations, Treasury issued final regulations on 9/25/15

<sup>33</sup> Hillary Rodham Clinton, Remarks at the Launch of the Department of State’s Global Philanthropy Working Group, New York City, 9/24/12, available at <http://www.state.gov/secretary/20092013clinton/rm/2012/09/198098.htm>.

<sup>34</sup> [www.ngosource.org](http://www.ngosource.org).

<sup>35</sup> The term “qualified tax practitioner” is defined as “an attorney, a certified public accountant, or an enrolled agent, within the meaning of 31 CFR 10.2 and 10.3, who is subject to the requirements in 31 CFR part 10”; in other words, a practitioner who generally provides advice to clients with respect to taking positions on tax returns, and who is subject to the requirements in Circular 230.

<sup>36</sup> As amended by the PPA, Section 4942(g)(4)(A)(i) provides, in principal part, that “the term ‘qualifying distribution’ shall not include any amount paid by a private foundation which is not an operating foundation to...any type III supporting organization ... which is not a functionally integrated type III supporting organization...and [any supporting organization if] a disqualified person of the private foundation directly or indirectly controls such organization or a supported organization ... of such organization.”

<sup>37</sup> Note 2, *supra*.

<sup>38</sup> Preamble to TD 9740, *supra* note 1.

<sup>39</sup> Reg. 53.4945-5(a)(5). *Accord* Reg. 53.4942(a)-3(a)(6), which uses “donee” rather than “grantee.”

<sup>40</sup> Preamble to TD 9740, *supra* note 1.

(the "Final Regulations"). In the Preamble, Treasury explained that the Final Regulations balance two important considerations in applying the "special rule" by which private foundations may both avoid a taxable expenditure and count a grant to a foreign organization as a qualifying distribution:

(1) Removing barriers to international grantmaking by foundations (as well as by entities treated like foundations for these purposes) and (2) ensuring that foundations' good faith determinations are informed by a sufficient understanding of the applicable law, are based on all relevant factual information, and are likely to be correct.<sup>38</sup>

**Expanded class of advisors from Proposed Regulations retained.** The Final Regulations retain the expansion in the Proposed Regulations of the class of advisors on whose opinions a private foundation may ordinarily rely under the special rule. These include CPAs and enrolled agents, along with attorneys, all of whom are subject to Circular 230. Such "qualified tax practitioners," the Preamble clarifies, may include in-house counsel.

As described above, qualified tax practitioners must be authorized to practice in a state, territory or possession of the United States, effectively excluding most foreign advisors. The Preamble clarifies, however, that a qualified tax practitioner may still use foreign counsel—to assist in gathering information for the qualified tax practitioner, for example, or in advising on questions of foreign law or on other matters within the foreign counsel's expertise. The Final Regulations provide that a foundation's reliance will be considered made "in good faith" if it meets the facts and circumstances requirements of Reg 1.6664-4(c)(1) (summarized above). Treasury further explains in the Preamble that reliance is not reasonable and in good faith if the grantor knows (or reasonably should have known) that the qualified tax practitioner lacked knowledge of the relevant aspects of the U.S. tax law of charities, or knew (or had reason to know) that the relevant facts were not disclosed to the qualified tax practitioner, or that the written advice was based on a representation or assumption that the private foundation knows (or had reason to know) is unlikely to be true.

**Reliance on affidavit.** The Proposed Regulations made explicit (as did the prior regulations) that a private foundation grantmaker could rely either on an opinion of counsel or on an affidavit from the grantee. However, Treasury and the IRS expressed concern at the time that, "grantee affidavits, standing alone, are not always as reliable a basis for making good faith determinations as

written advice from qualified tax practitioners." Treasury received several comments in response to this concern, most of which stated that private foundations should not be required to obtain professional tax advice and should continue to be able to rely on an affidavit directly. Nevertheless, in sharp contrast to both the prior, longstanding regulations and the Proposed Regulations, the Final Regulations omit a grantor's directly relying on an affidavit without an opinion of counsel. "A determination ordinarily will be considered a good faith determination if the determination is based on current written advice received from a qualified tax practitioner concluding that the grantee is [an appropriate public charity or exempt operating foundation]."<sup>39</sup> The Preamble to the Final Regulations explains, however, that direct reliance on an affidavit has not been foreclosed entirely:

### **Final Regulations omit a grantor's directly relying on an affidavit without an opinion of counsel.**

Nor does elimination of the affidavit for purposes of the special rule mean that the foundation must obtain written advice from a qualified tax practitioner in order to make a good faith determination. For example, a foundation manager with understanding of U.S. charity tax law may under the general rule make a good faith determination that a foreign grantee is a qualifying public charity based on the information in an affidavit supplied by grantee.<sup>40</sup>

What does this mean in practice? In the authors' opinion, the IRS has set forth a clear path for private foundation grantmakers to follow, which is to rely on the written advice of a qualified tax practitioner. Grantors can still choose to rely directly on an affidavit without a qualified tax practitioner, but if the IRS challenges a grant made this way, the foundation will have the burden of proving that its reliance was in good faith and reasonable, a task that may be difficult unless the grantor's staff has a thorough understanding of the underlying tax law and good documentation, including a correctly-completed affidavit. Practically, after the Final Regulations, it may make more sense for many or most grantmakers to simply obtain such an opinion.

**Reliance period.** The Final Regulations clarify when the opinion of a qualified tax advisor is "current." Generally, the opinion is current if, as of the date of the grant payment, the relevant law on which the advice is based has not changed since the date of the written advice, the facts on which the advice is based is from the grantee's current or prior tax year, and the private foundation grantor has no reason to know that such information is no

longer accurate. In other words, the Final Regulations imply that generally, a grantor wishing to continue making distributions to a particular grantee over several years must obtain a new opinion (if only a short opinion to update a prior opinion) at least every other year (because the facts on which the advice is based must be "from the grantee's current or prior taxable year"). Written advice that a grantee met the public support test under either Section 170(b)(1)(A)(vi) or Section 509(a)(2) is considered current for the two tax years of the grantee immediately following the end of the five-year test period.<sup>41</sup>

### The Final Regulations clarify that donor-advised funds can use equivalency determinations.

The Preamble to the Final Regulations explains that these rules apply only for the special rule of the Final Regulations and that "it is possible that written advice that is not current for purposes of the special rule may, under some facts and circumstances, reasonably serve as the basis for a good faith determination under the general rule."<sup>42</sup> Again, the Final Regulations provide a path for a private foundation grantmaker to follow; a private foundation taking another route may have the burden of demonstrating, if questioned, why the opinion on which it relied was "current."

**Shared advice with other foundations.** The Final Regulations are silent about the sharing by one private foundation of its opinion from a qualified tax practitioner with another. The Preamble, however, states that, for purposes of the special rule, a foundation must receive the opinion from the qualified tax practitioner rather than another foundation. The Preamble further concedes that there may be circumstances under which one grantor may reasonably rely on written advice re-

ceived by another grantor, such as "if the foundation with whom the written advice is shared knows the qualified tax practitioner well and is familiar with the due diligence practices of the foundation that provided the facts to the qualified tax practitioner and received the written advice."<sup>43</sup> Here again, IRS has provided a path for grantmakers to follow. Grantmakers choosing a different path will bear the burden of demonstrating why their alternate path was reasonable.

**Donor-advised funds can use equivalency.** The Final Regulations also clarify that donor-advised funds can use equivalency determinations. A decade ago, the PPA enacted Section 4966, which both defined "donor-advised fund" and set forth what kind of payments from donor-advised funds would be "taxable distributions." Distributions that are not taxable include distributions "to any organization described in section 170(b)(1)(A) (other than a disqualified supporting organization)...."<sup>44</sup> Since passage of the PPA, exempt organization practitioners have hypothesized and advised clients that the sponsoring organization of donor-advised funds (the entity that holds, owns, and controls the donor-advised fund) could use foreign public charity equivalency to make grants to non-U.S. organizations. The Final Regulations confirm this approach.

**PPA conforming changes.** Like the Proposed Regulations, the Final Regulations updated portions of the Section 4942 and Section 4945 regulations to conform to the PPA.

**Effective date.** The Final Regulations became effective on the date of their release—9/25/15—and apply to grant payments made after that date, with two available exceptions:

1. Any grant made within 90 days of 9/25/15—that is, through 12/24/15—is deemed in compliance if it was made in accordance with the prior regulations.

<sup>41</sup> Conceivably, therefore, a single opinion for a publicly-supported charity may have a public support portion that is valid for a different amount of time than the balance of the opinion.

<sup>42</sup> Preamble to TD 9740, *supra* note 1.

<sup>43</sup> *Id.*

<sup>44</sup> Section 4966(c)(2)(A).

<sup>45</sup> Regs. 53.4942(a)(3)(f), 53.49455(f)(3).

<sup>46</sup> Rev. Proc. 92-94 currently requires that grantee affidavits certify that the grantee has "adopted and operates pursuant to a racially nondiscriminatory policy as to students, as ... implemented in Rev. Proc. 75-50," and to "explain any basis for the grantee school's failure to comply with one or more of the provisions of Rev. Proc. 75-50." However, Rev. Proc. 75-50 is uniquely tailored to U.S. history and policy, and is often either (or both) incompatible or irrelevant in the context of a school in another country. In addition, it is unclear currently

what bases, if any, for failing to comply with Rev. Proc. 75-50 would be acceptable for equivalency purposes.

<sup>47</sup> See "Charitable Giving in U.S. Continues to Rise," Wall St. J., 6/16/15, available at [www.wsj.com/articles/charitable-giving-in-u-s-continues-to-rise-1434427261](http://www.wsj.com/articles/charitable-giving-in-u-s-continues-to-rise-1434427261) ("Organizations devoted to the arts, health, animals and the environment saw the greatest gains in donations last year, with only giving to international-affairs causes dropping. Experts attributed that decline to the lack of a large international disaster, like a typhoon or earthquake, which typically draws American givers."). See also "Annual Philanthropy Numbers on the Rise," *Forbes*, 6/17/14, available at <http://www.forbes.com/sites/tomwatson/2014/06/17/annual-philanthropy-numbers-on-the-rise-u-s-giving-nears-pre-recession-levels/#53b5a5874394> ("Giving to international affairs also has become more volatile in recent years and showed a decline of 6.7%").

2. Grants made pursuant to written commitments *on or before* 9/25/15 may continue to be paid for up to five years—that is, through 9/25/20.<sup>45</sup>

### Implications

The biggest change presented by the Final Regulations is the removal of the direct reliance on an affidavit by a private foundation for purposes of the “special rule.” Technically, private foundations may still choose not to avail themselves of the special rule and rely directly on an affidavit. Practically, in the authors’ opinion, this will become far less common than in the past. While the Preamble states that Treasury expects small foundations to continue this type of direct reliance, in the authors’ experience, it is paradoxically the smaller grantmakers whose staffs are more likely to lack experience with the equivalency process—and in some cases, the knowledge of tax law—to demonstrate that direct reliance on the affidavit was reasonable. In the past, even grantors with experienced staff sophisticated in the relevant tax law would often obtain opinions for larger grants. The authors would expect the Final Regulations to increase this trend, and to encourage grantmakers who are able to obtain opinions from a qualified tax practitioner to do so wherever possible.

Other helpful guidance included confirmation of the ability of the sponsoring organizations of donor-advised funds to use equivalency determinations, and the Preamble commentary regarding reliance on an opinion procured by another grantmaker.

Looking forward, the authors hope the update to Rev. Proc. 92-94 alluded to in the Preamble to the Final Regulations will provide a great deal of clarity. Aside from implementing aspects of the Final Regulations and the 2011 public support test changes, the authors hope Treasury will consider guidance on several other topics, including:

- Confirmation that supporting organizations can use the equivalency process for grants to foreign organizations.
- Confirmation that the Affordable Care Act changes of Section 501(r) to the requirements for

being a hospital (including, for example, the every-three-year community health needs assessment) do not apply for purposes of determining whether a foreign organization is the equivalent of a Section 170(b)(1)(A)(iii) hospital.

- Clarification on whether and how a foreign organization must meet the no-racial-discrimination requirements of Section 170(b)(1)(A)(ii), including its publication requirements, given the United States’ particular history of racial discrimination.<sup>46</sup>
- Confirmation that a grantor wishing to continue making distributions to a particular grantee over several years must obtain a new opinion at least every other year (particularly where a grantee qualifying as a public charity is a non-publicly supported entity such as a church, school, or hospital), and clarification as to whether there is an abbreviated option by which grantors might obtain updated opinions or affidavits.
- Further clarity regarding the extent to which one private foundation may share an equivalency opinion that it obtained from a qualified tax practitioner with another foundation.
- Confirmation that the equivalency process is available where the grantee organization is within its first five years of existence and the grantor wishes to classify the grantee as publicly-supported.

### Conclusion

The issuance of Final Regulations on foreign public charity equivalency provided welcome clarity for private foundations engaged in international philanthropy and their advisors. The authors hope that the IRS will not wait long to issue an updated revenue procedure to accompany the new regulations. While charitable giving in the U.S. in recent years has been on the rise, charitable giving for international causes has, according to several sources, declined.<sup>47</sup> Providing a clear path for U.S. foundations to understand and implement grantmaking abroad could play a key role in augmenting international philanthropy, while increasing the likelihood of private foundations’ compliance with the tax law. ■

**The biggest change presented by the Final Regulations is the removal of the direct reliance on an affidavit by a private foundation.**