

Preliminary Thoughts on Modifying Expenditure Responsibility Requirements for Private Foundations and Importing an Expenditure Responsibility-Type Regime for International Grantmaking Activities of Public Charities: IRS Announcement 2003-29, the Treasury Department Anti-Terrorist Voluntary Guidelines and a Risk-Based Analysis

The Treasury Guidelines

In November 2002, the Treasury Department issued its now [in] famous *Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S. Based Charities* (the "Guidelines"). The intent of the Guidelines and its litany of best practices is

"to reduce the likelihood that charitable funds will be diverted for violent ends. If a U.S.-based charity follows these guidelines, and commits resources to implement them effectively, there will be a corresponding reduction in the likelihood of a blocking order against any such charity or donors who contribute to such charity in good faith, absent knowledge or intent to provide financing or support to terrorist organizations."

(Treasury Department Press Release, November 7, 2002).

Compliance, however, does not offer U.S. charities a safe harbor from blocking actions under any presently existing executive order or regulation;¹ nor does compliance preclude the Treasury Department or the Justice Department from imposing criminal or civil sanctions against persons who aid terrorists.

In summary, the Guidelines provide detailed recommendations as to "best practices" regarding (1) governance (*e.g.*, conflicts of interest policies as tools for fighting terrorism); (2) disclosure/transparency in governance and finances (*e.g.*, using GAAP to fight terrorism); (3) Financial Practice/Accountability (*e.g.*, the use of annual

¹ This includes Executive Order 13224, issued by President Bush on September 24, 2001; The International Emergency Economic Powers Act of 1977 ("IEEPA"); Executive Order 12947, issued by President Clinton in 1995; the USA PATRIOT Act of 2001; and the Suppression of the Financing of Terrorism Convention Implementation Act of 2002.

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budgeting as a tool against terrorism); and (4) anti-terrorist financing procedures (*e.g.*, undertaking a detailed vetting process to determine the *bona fides* of all individuals involved with a grantee directly or indirectly, investigating banking relationships of grantees, and asking grantees to certify that they do not work with or employ terrorists).

While I believe the Guidelines are misguided, I certainly do not want charitable assets to be used to support terrorism, knowingly or unknowingly. To be “charitable”, I would say that the Guidelines may have had the salutary effect of raising the consciousness of donors and charities to terrorism concerns within grantmaking and may even have raised the overall level of due diligence in overseas grantmaking.

Janne Gallagher, General Counsel of the Council on Foundations, coordinated the work of a task force of Council members and their attorneys, and the Council submitted its comments on the Guidelines in June 2003 (the "COF Comments"). The COF comments are well crafted and thoughtful (despite the participation of yours truly and other members of the Nonprofit Forum). The COF Comments request the withdrawal of the Guidelines and recommend the subsequent re-issuance of guidelines that adopt a risk-based approach to help grantmakers identify those grants that may present a greater risk of diversion and describe additional steps that may be undertaken to minimize the risk of diversion. Further, the COF Comments correctly note that there is no single set of "best practices" and thus recommend the replacement of the so-called best practices set out in the Guidelines (many of which were inconsistent with existing federal and state laws) with a list of general principles of “governance and financial accountability that would be considered relevant in an investigation by the Treasury Department of the alleged use of funds to support terrorism.” Finally, the COF recommended that the title and preamble

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be revised to reflect the serious legal context for the document, i.e., implementation of the USA PATRIOT Act of 2001 and Executive Order 13224. In summary, the COF Comments intend that its suggested revisions will, in fact, accomplish—or help accomplish—the Guidelines' stated objective: that good-faith compliance ought to help reduce the likelihood of a blocking order against an organization in the event of an investigation.

IRS Announcement 2003-29

Spurred by the release of the Treasury Guidelines (on which the IRS was not consulted), the IRS released Announcement 2003-29 in May, asking for public comments on “how new guidance might reduce the possibility of diversion of assets for non-charitable purposes while preserving the important role of charitable organizations worldwide.” The scope of Ann. 2003-29, however, is broader than the “diversion of funds to terrorists” issue; it is basically a call to consider the question of standards and requirements for all international grantmaking and international activities, for public charities and private foundations alike.

Betsy Adler and Victoria Bjorklund led a task force of the Committee on Exempt Organizations of the ABA Tax Section that submitted comments on July 14 (the “EO Committee comments”). These comments are a superb compendium and analysis of current practices and procedures of public charities, private foundations and religious organizations. Compatible with the COF Comments on the Guidelines, the EO Committee comments on Ann. 2003-29 explain the inherent weakness in a “one size fits all” approach to regulating international grantmaking and propose a risk-based, “know

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your grantee" approach to any new guidance that may be issued by the Service. This risk-based approach would provide new safe harbors for public charities, as well as revised safe harbors, presumably under Code Section 4945 and the underlying Treasury regulations, for private foundations. The EO Committee comments include a chart that outlines the continuum of risk factors, from less risk to some risk to more risk, and a table that compares the specifics of the Guidelines to actual common practices of grantmakers.

The Council on Foundations' submitted comments on Ann. 2003-29 on August 5, 2003, in which the COF strongly endorsed the EO Committee recommendation for a safe harbor from liability for "those charities that document that they have assessed the risk that assets might be diverted and then implemented reasonable risk reduction procedures." The COF further recommends a second safe harbor for charities that make grants through intermediary organizations "when the initial grantor has satisfied itself using reasonable efforts and adequate procedures that the re-granting intermediary has sufficient safeguards in place to reduce the risk of diversion of charitable assets."

The Follow-Up Questions

The purpose of this nugget is not to explore the general analysis of the two sets of COF's comments on the Guidelines and on Ann. 2003-29, or the EO Committee comments on Ann. 2003-29. I generally agree with a risk-based approach in connection with helping organizations reduce the likelihood of having their assets blocked.² Rather, I think the EO community ought to begin thinking about whether the Internal Revenue

² I believe it is essential to cleanly separate the issue of minimizing the possible blocking of assets by the Treasury Department from the question of how international grantmaking should be conducted under the Federal tax laws. Nonetheless, it would seem logical that a reasonable and productive risk-based approach to minimizing the need for the Treasury Department to block a charity's assets in the course of investigating a possible diversion of funds for terrorist purposes ought to be subsumed within any modified requirements that may be considered for private foundations and public charities under the Federal tax laws.

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Code should be amended or guidance issued to (1) expand the current parameters of the Section 4945 regulations regarding expenditure responsibility using a risk-based approach to all international grantmaking, and (2) provide an expenditure responsibility regime for public charity grantmaking that parallels the existing (or revised) Code Section 4945 regime for private foundations. These questions, I believe, are implicit in both the EO Committee request that the Service issue precedential guidance that would be structured in the form of one or more "safe harbors"³ and the COF comments on Ann. 2003-29. As you will see, my conclusions are tentative, and my interest lies more with the possibility of developing an expenditure responsibility regime for public charities.

A safe harbor provides protection to an organization against the imposition of a tax or other penalty for an untoward outcome where an organization otherwise complies with required steps. Safe harbors are commonly employed throughout the Code, Treasury Regulations, and IRS guidance in the EO area. (For example, see Section 4945 rules on expenditure responsibility; Rev. Proc. 96-32 regarding low-income housing organizations' compliance with requirements to relieve the poor and distressed; portions of regulations under Code Section 4958 regarding intermediate sanctions; the revenue procedures detailing safe harbors for receipt of token items, low-cost articles and low fair market value of benefits received from requirements of the Section 170(f) disclosure and substantiation rules; and Rev. Proc. 92-94, regarding equivalency determinations.) Safe harbors are a sensible approach where (1) mistakes can be made despite the taxpayer's

³ I am resisting the temptation to think about whether the entire Sections 170, 501(c)(3) and Chapter 42 regimes ought to be revamped; *i.e.*, why should we assume that risk-based due diligence is unnecessary because the grantee has an exemption letter from the IRS? My fear, however, is that any, even modest, changes that might be contemplated would, in our current political climate, lead inexorably to over-regulation and worse, to trampled Constitutional rights. So, yes, I do worry about the "slippery slope" and the other side of the coin that says, "it can't happen here".

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sincere efforts, because too many of the variables involved in assuring a particular outcome are outside the control of the taxpayer; (2) the punishment would otherwise be far too great for the violation; and (3) compliance costs to the organization are too great in the context of any benefit to the public fisc.

Code Section 4945 and Expenditure Responsibility for Private Foundations

At this point, I do not think that special modification of the expenditure responsibility rules is needed. The expenditure responsibility regulations (Treas. Reg. Section 53-4945-5(b)) open with the very important sentence that "[A] private foundation is not an insurer of the activity of the organization to which it makes a grant." A private foundation is deemed (*i.e.*, has the benefit of a safe harbor) to not have violated Code Sections 4945(1) or (2) if it "exerts all reasonable efforts" and "establishes adequate procedures": (1) to see that the grant is spent solely for the purpose for which it is made; (2) to obtain full and complete reports from the grantee on the expenditure of the funds; and (3) to make full and detailed reports with respect to the expenditures to the IRS.

The Treasury Department certainly can issue guidelines that will explain the various anti-terrorist laws and provide rational steps that a charity can take to reduce the possibility of having its funds diverted and to reduce the likelihood of being subject to a blocking order. Such guidelines, though, do not need to be specially integrated into expenditure responsibility rules. However, it might be useful for the IRS to issue guidance indicating that applying a risk-based approach is an acceptable *additional* way for private foundations to satisfy the first prong of expenditure responsibility (*i.e.*, to see that the grant is spent solely for the purpose for which it is made). I think we need to be

careful about suggesting or implying that a risk-based analysis is the only appropriate methodology under the Code and Treasury Regulations.

A Risk-Based Safe Harbor Approach for Public Charities: Pros and Cons

I have concerns about advocating the safe harbor route for the international grantmaking activities of public charities, at least in this political climate. Developing such a safe harbor will require the development of some sort of excise-tax based regime of penalties, similar to expenditure responsibility or intermediate sanctions, which if done well and right, will be a complex and long-term process. However, I recognize the appeal of some of the policy reasons for doing so.

First, there is no adverse consequence to a public charity that makes a grant that is not in furtherance of its exempt purposes, unless that activity rises to the level of the charity no longer being operated "exclusively" for charitable, etc. purposes and, even if the non-exempt operations are substantial, the IRS may be loath to use the revocation tool unless the violation is egregious. Second, is it "fair" that public charities be treated more leniently than private foundations? Third, in the dangerous times we live in, perhaps we should be more mindful of the seeming loophole provided by the loose tax regulation of public charities' making grants abroad.

There are several responses to the above three policy considerations. With respect to the first (no existing adverse consequence), it is the case only if there is no private inurement (otherwise Code Section 4958 is triggered) or there is no electoral dimension (otherwise Code Section 4955 and possible revocation are triggered). The question then becomes whether the developed law regarding private benefit is sufficient to address sloppy or perhaps deceptive or just plain inadvertently erroneous foreign grantmaking. I

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don't really see the IRS and the Federal tax laws taking the lead in stopping terrorism. It's one thing to suspend the exempt status of an organization designated as a terrorist organization by the President or a law enforcement agency, as per HR 7; it's quite another to use the tax laws to discourage or burden the international activities of charities with an ongoing and expensive set of do's and don'ts. (I will try to attach to this the Oct. 2 piece in *TaxNotes* that describes the fiscal 2004 EO work plan and comments by Steve Miller and Bobbi Zarin—I'll also bring copies to our meeting.)

The policy issue of treating public charities differently from private foundations is an ongoing debate, and perhaps the '69 Act either had it all wrong, or had it right at the time, but the nonprofit world has changed sufficiently that we need to further re-think the premises of 1969 (as in effect was done with intermediate sanctions). However, the analysis cuts both ways—why not eliminate or at least ease the expenditure responsibility regime for private foundations rather than impose it on public charities?⁴ This becomes a much larger discussion than the issue of developing procedures for international grantmaking.

Third, perhaps the ease with which public charities may distribute funds abroad is a luxury we cannot sustain in these times. Again, I don't think that the tax laws are the way to address this concern. Funding, helping, advising etc. terrorists is a punishable criminal act and the U.S.'s various law enforcement agencies and our judicial system have the responsibility to enforce these laws. I worry that developing an expenditure

⁴ Thus, I think the COF idea to create a safe harbor for grants to intermediary organizations that re-grant the funds is a good one from the private foundation perspective. Doing so may also reduce some of the burdens embraced by the IRS in PLR 9717024 (January 23, 1997) regarding private foundation grants to intermediary organizations which then re-grant funds to individuals. The letter ruling requires an initial or intermediary grantee to comply with the grantor foundation's procedures for grant making to individuals, comply with Code Section 4945(d)(3) and 4945(g) regarding private foundation grants to individuals and to report to the grantor foundation.

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responsibility regime for public charities will catapult the tax laws into the position of being used to as an easy way to target organizations and individuals that law enforcement agencies find difficult to "catch" using the anti-terrorism laws. That may be a foolish concern since the scope of the various laws and executive orders listed in footnote 1, above, is perhaps excessively broad. On the other hand, law enforcement agencies have used the tax laws as a way of prosecuting people believed to be involved in other, more serious criminal behavior, such as organized crime where prosecution for murder or robbery just isn't legally practical.

Tentative Conclusions

Although we have been thinking about the Treasury Guidelines for almost a year, the IRS Announcement 2003-29 came as a bit of a surprise in May. At this moment, I like the ideas of possibly broadening the expenditure responsibility safe harbor for private foundations to include a risk-based approach and integrating a safe harbor for private foundation grants to intermediary organizations that re-grant abroad. However, I think that development of safe harbors for public charities involved in international grantmaking may result in an overly intrusive set of rules that could adversely affect the quality of the international work done by U.S. charities. The comments on Ann. 2003-29 by the EO Committee demonstrate the thoughtful approach by private foundations, public charities and religious organizations. I'd like to think that the steps of a risk-based approach as proposed by both the COF and the EO Committee can be "adopted" by oversight organizations throughout the country, including private foundation grantors, and become a standard for grantmaking without becoming entangled in the Federal tax laws.

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