International Activities Conducted by Tax-Exempt Organizations, Center of Attention at the Internal Revenue Service

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International activities conducted by tax-exempt organizations have been a high-focus area for decades. Today, this subject continues to be a high enforcement priority for the IRS, who actively seeks to ensure that foreign assets and expenditures are used for charitable purposes. Tax laws prohibit the diversion of charitable assets to any noncharitable purpose; this includes financial support of terrorist organizations and activities. Needless to say, cooperation and partnerships with other federal agencies are crucial to combat the existing abuses in this area.

Tax-exempt organizations are increasingly engaging in charitable or other exempt activities outside of the United States. With globalization, international activities can be divided into three broad categories: charitable giving, direct program activities, and investing. IRS examinations of international activities of tax-exempt organization have revealed that there are cases of inadequate recordkeeping, lack of discretion and control over the disposition of funds, and tax reporting noncompliance with respect to foreign investments. To strengthen these weaknesses, the IRS has instituted a number of rules to oversee offshore activities. The IRS continues to elevate and exercise oversight in this area – and this is the focus of this article.

To no surprise, international tax issues have appeared on the IRS Tax Exempt and Government Entities (TE/GE) Priority Workplan (Workplan) as a strategic area of focus by the IRS. Issues of concentration include oversight on funds spent outside the United States, including funds spent on potential terrorist activities, exempt organizations operating as foreign conduits, and Report of Foreign Bank and Financial Accounts Requirements (FBAR). Other important areas relevant in this context have also appeared in the Workplan, such as non-exempt purpose activity and private inurement and protection of charitable assets.

In 2008, the IRS incorporated Schedule F (Statement of Activities Outside the United States) as part of the redesigned Form 990 (Return of Organization Exempt From Income Tax) to provide a more comprehensive picture of an organization's international activities. As a result, it compelled tax-exempt organizations to adopt new recordkeeping practices, similar to rules followed by private foundations. Schedule F requests information about activities conducted outside the United States, including grants and other assistance, program-related investments,

fundraising activities, unrelated trade or business activities, program services, investments, or maintaining offices, employees, or agents for the purpose of conducting any such activities in regions outside the United States. Tax-exempt organizations are required to describe their foreign operations on a region-by-region basis and provide information regarding grants or assistance made to foreign governments, organizations and/or individuals – all this information is made publicly available.

In rare cases, tax-exempt organizations may be utilized to support terrorist activities. To mitigate these risks, careful screening now takes place when applying for federal tax exemption. New tax-exempt organizations who seek formal recognition of tax exemption are subject to increased disclosures when filing Federal Form 1023 (Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code). New applicants should be aware of the increased scrutiny and implement sufficient internal controls to lessen the risk of providing funding, whether it be directly or indirectly, to organizations or individuals with links to terrorism.

The Internal Revenue Manual (IRM), the official instruction manual for personnel of the IRS, provides guidance on Anti-Terrorism and Other Emerging Issues (IRM 7.20.06). The manual provides extensive training to IRS personnel and directs them to review cases for potential indicators in terrorism and be alert of heightened risk of diversion of funds to terrorism, conduct name or address matches against the Comprehensive List of Terrorists and Groups, and escalate any incidents for further review if there is any evidence of terrorism or the diversion of funds.

Applicants seeking tax exemption must be ready to disclose the countries in which the organization will operate or make grants to; indicate whether it will check the OFAC Specially Designated Nationals and Blocked Persons List (SDN) for names of individuals and entities with which the organization will have dealings with; whether it has any other practices to ensure that foreign expenditures or grants are not diverted to support terrorism or other noncharitable activities; which funds or goods have been, or will be, distributed and for what purpose; how it will process grant requests, including its application, review and approval process; and how it will ensure the funds or goods are used for the intended purposes.

Charitable Giving

In a series of articles from the Exempt Organizations Continuing Professional Education (*CPE*) Technical Instruction Program, the IRS addressed the deductibility of charitable contributions which 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 country of creation of the recipient organization is of importance—not the country of use. If the recipient is a domestic organization, the fact that a portion of its funds is used to further charitable purposes in foreign countries, such as missionary work, does not adversely affect the deductibility of the contribution as set forth in Treas. Reg. section 1.70A-8(a)(1). There are special rules (not covered by this article) applicable to certain countries with tax treaties that do allow tax-deductible contributions, such as Canada, Israel, and Mexico.

The country of creation alone is not sufficient to qualify for a tax-deductible contribution. There are earmarking and conduit restrictions which are so eloquently articulated in *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 stating: "A given result at the end of a straight path is not made a different result because reached by following a devious path." Stipulated in Rev. Rul. 63-252, the requirements under IRC section 170(c)(2)(A) 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." There are numerous noteworthy court cases where a charitable deduction is unfortunately barred because it is deemed an "incomplete gift" where the donor did not surrender dominion and control.

Bearing all of the above in mind, "friends of" organizations are typically established on U.S. soil to support a foreign organization and aid in charitable giving. These organizations qualify as tax-exempt charitable organizations under IRC section 501(c)(3) and must satisfy certain requirements in order for a U.S. taxpayer to receive a tax deduction for its charitable contributions. Importantly, it cannot be organized and operated solely as a conduit to solicit earmarked funds on behalf of a pre-existing foreign entity.

Public charities can engage in grant-making on an international level. It must, however, exercise reasonable care to ensure that its assets are used solely for charitable purposes. This due diligence can be achieved many ways – and by maintaining certain protocols, such as retaining discretion and control over the use of funds raised and exercising oversight through grant agreements and periodic reporting, it protects the misuse of charitable assets. Private foundations also can make grants to foreign charities but are subject to stricter rules. Private foundations must exercise "expenditure responsibility, a process which is defined in Treas. Reg. section 53.4945-5(b), or obtain an "equivalency determination," which is a "good-faith determination" issued by a qualified tax practitioner that the grantee foreign organization is the equivalent of a U.S. public charity.

Direct Program Activities

Domestic tax-exempt organizations can conduct the same exempt activities in a foreign country as in the United States. Although it may be hard to believe, direct activities seem to be less scrutinized by the IRS than charitable giving. With charitable giving, there is a greater lack of direct fiduciary responsibility over the expenditures and ability to ensure the funds are being used rightfully for exempt purposes; when operating a charitable program physically oversees, the domestic organization is not acting as an intermediary for a foreign-based organization.

Cross-border operations can involve U.S. citizens living in and operating the program in a foreign country or it can be staffed by foreign nationals, or a combination of both. Foreign independent contractors and agents may be hired. Foreign offices and locations may be maintained. These types of foreign activities are generally reportable on Form 990, Schedule F if the applicable $10,000 revenue or expense thresholds are met. Special tax considerations apply when making payments to a foreign person. Alas, there are tax treaty considerations, tax withholding rules, decisions on whether the payment is U.S. or foreign sourced income, and reporting obligations.

Investing

Foreign bank or other financial accounts. When creating an international presence, bank accounts or other financial accounts will be established overseas. Maintaining authority over a foreign bank account or other assets may elicit the filing of a Report of Foreign Bank and Financial Accounts (FBAR) Financial Crimes Enforcement Network (FinCEN) Form 114. The filing requirement is imposed on any U.S. person that has a *financial interest* in or *signature authority* over foreign financial accounts with an aggregate value that exceeds $10,000 at any time during the calendar year. A financial interest over a foreign financial account may be direct, indirect, or by constructive ownership.

The tax-exempt organization is required to file an FBAR to report its accounts for which it has a financial interest, but there is more—executives and employees of the tax-exempt organization that have signature authority over the foreign financial accounts also have an obligation to file an FBAR. In addition, cryptocurrency investors are facing increased scrutiny from the IRS, and the landscape is changing rapidly. There is so much more that remains to be seen in the new world of virtual currency and what it could mean for holders of virtual currencies in foreign accounts.

Foreign investments. Tax-exempt organizations with outbound activities in foreign jurisdictions are subject to strict U.S. international tax reporting requirements that require certain disclosures to the IRS on Form 990, Schedule F. The failure to file a required form may result in substantial penalties for noncompliance. Many, if not all, of the international tax reporting forms noted below are technical and require extensive specialized knowledge in international tax to prepare them accurately.

- Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation)
- Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts), and/or Form 3520-A (Annual Information Return of Foreign Trust with a U.S. Owner)
- Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations)
- Form 5713 (International Boycott Report)
- Form 8271 (Investor Reporting of Tax Shelter Registration)
- Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund)
- Form 8858 (Information Return of U.S. Persons with Respect to Foreign Disregarded Entities and Foreign Branches)
- Form 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships)

Beginning in the tax year 2012, the IRS requires the use of Unique Reference Identification (URI) numbers for Forms 5471, 8858, and 8865. These forms collect information on a U.S. taxpayer’s interest in foreign corporations, disregarded entities, and partnerships, respectively.

The URI allows the IRS to identify more easily a taxpayer's investments in foreign entities and to compare investment activity from year to year.

At one time, there was a lack of reporting for foreign disregarded entities until a regime was created to significantly enhance the IRS's ability to administer the international tax rules and to identify and address specific issues that arise in applying the check-the-box regulations in the international arena–which create the Form 8858. Specifically, the tax code requires all U.S. persons to file IRS Form 8858 with respect to "any foreign business entity" that such person controls, including owners of "foreign disregarded entities" (FDEs). Beginning with the tax year 2018, the IRS requires U.S. taxpayers to file Form 8858 to report foreign branches.

In addition, beginning with the tax year 2021, pass-through entities will be subject to expanded reporting with respect to international activities. Just recently, the IRS released draft instructions for the new complicated Schedules K-2 and K-3. These schedules each involve 20 pages of disclosures related to cross-border international activities. Very specific information must be disclosed relating to foreign tax credits, Subpart F income, global intangible low-taxed income (GILTI), distributions from controlled foreign corporations (CFCs), and payments of interest and royalty expense in certain hybrid transactions that could give rise to disallowed deductions. As the famous saying goes, it's really *complicated* to make something *simple,* but very *simple* to make something *complicated.*

Now this may not be the end, but for right now it does demonstrate one thing— foreign activities conducted by tax-exempt organizations are of compelling interest to the IRS and, therefore, viewed with more scrutiny and exposed to stricter rules. More oversight results in new regulations and legislation, additional tax compliance and reporting requirements, and increased audits and examinations. The heightened scrutiny by the IRS may be very well justified and just a small price to pay in order to protect and safeguard charitable assets.

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