

CONSULTING FOR PURPOSE

Can a US (or UK) charity have a foreign charity as its sole member

I am often told by some advisors that regulators in the US or UK would not allow a domestic charity to have a foreign charity as its sole member. In fact there are charities in both jurisdictions that have a foreign charity as its sole member and I have helped a number establish such structures.

In this article I have focused on the position of founding charities that have set up or are working closely with charities in the USA as in my experience there is often confusion as to what can and can't be done. Whilst the rules discussed are particular to organisations that work with or are affiliated to charities in the US the general principles have wider application in many other geographies.

Nonprofits often focus on empowerment and equity, but the reality is often that who pays the piper calls the tune and even in partnership arrangements there is an acknowledgement that sometimes some partners are more equal than others. This often means that regardless of a strong desire to embrace equality, realities make it hard to decouple finances, size, operational capacity from power and influence within the global family. Therefore, when considering the issues of structure and relationships it is important to recognise the intersection of any governance and structural changes with the realities of the operating and financial dependencies between entities.

In addition to the operational or non operational decision non profits have to consider how they will be structured and the models they will follow in shaping their relationships with other stakeholders. This can be more relevant as plans for further expansion are developed. It is important to recognise that the models themselves are not clearly demarcated or mutually exclusive and many operate in a hybrid way by embracing elements of the different models. Some focus on greater centralisation and control while others prefer greater autonomy.

Many non profit organisations have closely connected entities in different part of the world and are structured as an 'international family'. Some of these operate through federated structures, linking organisations and / or branches. In many of these structures there is a founding entity that supports and helps build capacity.

There is sometimes difficulty is gaining consensus on all aspects in the early stages of alliances. Often arrangements are intentionally kept loose and reporting lines and roles are blurred as it is thought that this will avoid conflict and that matters can be resolved through custom and practice. My experience is that this approach can lead to challenging issues and can be too dependent on individual relationships, which change over time. In often see that relationships suffer without clarity as different parties interpret loosely framed protocols in different ways. To get the necessary buy in and acceptance can require care and sensitivity. Where there are strong differences of views an independent third party, trusted by all sides of the inevitable difference of views, can help arrive at the solutions that are in the best interest of the alliance.

Key strategic imperatives will be decisions on the type of relationship wants between the different parts of the global family as well as the relationships with any other operations or field offices that are set up in the future. These decisions will help define the structure. Deciding on such issues can be difficult as there are many different perspectives and points of view. However, ambiguity is not a satisfactory option and there are no stereotyped answers for what is right. What is important is that there should be a focus on what is the most effective way of delivering mission.

There are different approaches ranging from very loosely organised structures of completely autonomous members brought together by common interests to others where they are closely integrated, reflecting a high centralised ownership or control, or even a common corporate entity. Many non profits enjoy a great deal of flexibility between models and their governance and operational models incorporate characteristics that cater to their needs. The range between the different ends of the spectrum and the permutations between the two ends underlies the challenges and opportunities non profit groups face and there are particular sensitivities and tensions that need to be recognised.

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Even in a very loose autonomous structure there is need for an appropriate coordination over risk management and operating environment and this includes the establishment of clear policies, clearly defined lines of responsibility and delegation of authority. There is recognition that simply sharing a name or brand or where one entity is seen to be a key funder of another requires coordination of approach and policies to manage reputation issues that can impact on the global brand.

At the same time the rules should not create unnecessary bureaucracies or stifle initiatives. Non profits recognise that they have a duty to ensure that they exercise proper stewardship over all activities in the most effective way whilst complying with local laws and regulations. In similar structures there are often sensitivities about when and where the roles and responsibilities of different governance bodies in the 'international family' begin and end.

In addition, some founding entities have found that they have expended resources setting up an overseas non profit and building its capacity only to find that the overseas organisation breaks away or diverts from mission once it has an established fundraising base. There are many models of framework agreements and protection of intellectual property right arrangements that restrict the use of the name and logo of the founding organisation. Notwithstanding this I have seen examples where at some stage in the future the overseas entity may have a board that is not ready to work with the founding organisation. In such situations where an overseas entity wants to break away they are often able to do so, albeit without the use of the intellectual property.

I am often told a breakaway is not a concern for the founding charity as they trust the present individuals in place. In my experience, with the passage of time and changes in individuals, tensions and sensitivities can sometimes lead to acrimony. This has led founding organisations to try to ensure that they have a structure where this risk is mitigated. This has to be managed sensitively without implying that one group of individuals does not trust another group of individuals.

What is the structure trying to deliver?

In my work I have found that there are often some key aspirations that organisations are trying to achieve:

- There is goal congruence and operational synergies between all parts with a mechanism to ensure that the overarching mission is preserved and furthered in the most effective and equitable way.
- laws and regulations are complied with, and fiscal benefits are availed of where possible.
- There is a strong relationship between all the operations taking account of governance, mission and operations.
- The internal structures and governance arrangements are appropriate to deliver on the mandate.
- Structures are not overly complex and should allow the different parts to be nimble and agile in an uncertain world so that they are fit for purpose both now and into the future.
- The structure should facilitate better resource management to grow income and help to increase impact in all the relevant geographies.
- Different perspectives of varied stakeholders, this includes policy makers, regulators and funders, should be considered.
- The risk of the entities breaking away from each other at some stage should be mitigated
- The development impact, organisational performance, and financial reporting should be presented in a coherent fashion. For some entities this means that the financial reports should represent the full income and expenditure of all the entities in the "group".

Not all the criteria will be of equal importance, and some may pull against others. Indeed, some of the attributes above may harbour a difference of views in the degree of importance of each, as well as in how they need to be prioritised and addressed.

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Charities are often told that there are inherent conflicts in achieving all of these and that regulatory requirements mean that the domestic charity needs to be independent and have an independent board which would preclude some of the options. However, in my experience careful planning and observance of certain requirements can provide structures and arrangements that allow these criteria to be met albeit that sometimes local laws and regulations may lead to compromises.

When boards tell me that they want to have a structure where multiple semi or fully autonomous members are closely linked to a central organisation. I usually recommend that the structural aspects of the attributes above can be best met when the founding entity, which often is the initial funding entity, is the sole member of the other entities.

This structure is possible whether the founding entity is in the UK or US. UK and US charity law requires trustees to act independently and take decisions which are in the best interest of their charity and I do not see that this is incompatible with one entity being the sole member of another.

US non profits

As a generality (there are some treaty exceptions for charities in Canada, Israel and Mexico) US donors cannot get an income tax deduction for direct contributions to foreign charities. Section 170(c) of the Internal Revenue Code (IRC) provides that an income tax deduction is permitted only if the donee organisation was created or organised in the United States or any possession thereof, or under the law of the United States, any state, the District of Columbia or any U.S. possession.

Most US nonprofits are classified under section 501(c)(3) of the IRC. Broadly section 501(c)(3) organisations are classified as either private foundations or public charities and are distinguished primarily by the level of public involvement in their activities. Public charities generally receive a greater portion of their financial support from the general public or governmental units and have greater interaction with the public. A private foundation, on the other hand, is typically controlled by a small group of individuals, and derives its income from fewer sources. Private foundations are subject to various operating restrictions and to certain excise taxes if they do not comply with those restrictions.

Most founding organisations based outside the US set up public charities so as to be able to receive tax exempt donations in the US for application outside the US.

Can US donors get tax deductions for donations that will be used overseas?

IRC section 170(c)(2)(A) which includes the tax deductibility provisions of the Code relates only to the place of creation of the charitable organisation to which deductible contributions may be made and does not restrict the area in which deductible contributions may be used.

However, this is not as simple as it may seem. IRS Rulings explain that “Organizations making grants to foreign organizations have one procedural problem that is not usually encountered with grants to domestic organizations. Since most foreign organizations have not been recognized under IRC 501(c)(3), the domestic organization in this situation is required to exercise supervision and control over the use of the funds as provided for in Rev. Rul. 68-489, 1968-2 C.B. 210. Rev. Rul. 68-489 and also requires sufficient records that grants have been used for IRC 501(c)(3) purposes”.

If payments are made to a foreign organisation that have not been reviewed and approved in advance by the Board of the domestic organisation contributions to the domestic organisation are not deductible. This is because the domestic organisation is seen to be acting as a conduit for the foreign organisation. Therefore, for contributions to be deductible the US charity’s board must ensure that grants made by the US charity to foreign recipients have been reviewed and approved in advance to ensure that the exempt purpose of the US charity is furthered.

It is important to ensure that the US charity is not seen as being a mere conduit. IRS Revenue Ruling 63-252 requires that contributions to a section 501(c)(3) organisation that transmits the funds to a foreign charitable organisation are deductible only if it can be shown that the contribution is in fact to or for the use of the US organisation.

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The US organisation can remit these funds to an overseas entity but it must be clear that the US organisation is not serving as an agent for, or conduit of, a foreign charitable organisation. This means that the US board must exercise discretion and control over its grants.

How can a US charity demonstrate discretion and control?

To ensure that the US charity's tax deductibility is not jeopardised its board must be able to show that it retains discretion and control of the funds sent overseas. To do this it must record and implement procedures and policies as follows:

1. The making of grants and contributions and otherwise rendering financial assistance for the purposes expressed in the constitution of the US charity must be within the exclusive power of the US board
2. In furtherance of the US charity's charitable purposes, the US board must have power to make grants to any organisation organized and operated exclusively for charitable, scientific or educational purposes within the meaning of IRC section 501(c)(3) (for example, the US charity supports a specific charitable cause, rather than a specific foreign organisation)
3. Prior to approving the authorisation of funds the US board must review all requests for funds from grantees, make appropriate pre-grant inquiries, and determine the specific use to which the funds will be put (and repeat grantees must continue to provide information regarding the use of funds).
4. The US board should take affirmative steps to ensure that the funds were expended for the purposes which were approved (for example, requiring grantees to submit periodic reports or accountings, engaging accountants to audit grantees, sending representatives or agents for field investigations, etc.)
5. The US board may, in its absolute discretion, refuse to make any grants or contributions or otherwise render financial assistance to or for any or all the purposes for which funds are requested.

Whilst they may appear cumbersome there are well recognised approaches that are pragmatic and meet requirements. These policies are important to ensure that the US charity is not seen simply as a fundraising arm or conduit for funds raised in the US. If the conclusion was that it was operating as a conduit its tax status would be jeopardised. In my experience the articles / byelaws of US charities working with foreign entities include similar provisions governing the making of grants and awards. It is important to be able to demonstrate that the charity is following these policies in practice.

In addition, there are other requirements to ensure that the funds are properly applied and US charities are subject to broad anti-terrorism legislation that requires them to undertake specific due diligence before making grants or other payments.

All these requirements are similar to those that are required by charities in many other countries. For example, regulators in UK have similar provisions when a UK charity sends funds overseas.

How can the founding organisation protect the relationship?

Founding charities often mitigate the risk of the US charity breaking the relationship by being the sole member of the US charity with the power to appoint the majority of the board. A sole corporate member may also have the power to remove directors (with or without cause), and to approve certain fundamental transactions of the corporation (such as amending governing documents, merging, dissolving, etc.) Care is needed as to how this can be done.

The application for tax exemption must disclose (i) the number of directors that are U.S. citizens or residents and their percentage of the entire Board of Directors, (ii) whether the directors are subject to voting or other restrictions, and (iii) whether the directors are also directors, officers, or employees of the foreign charity.

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Whilst there does not appear to be a legal requirement the IRS seems to place importance on the US charities having the majority of directors who are U.S. citizens who are not affiliated to the founding charity. The critical point is that the US charity's board must be seen to exercise their discretion and control in grant making and not be acting on behalf of the founding foreign charity.

In addition, state laws need to be considered. For example, charities set up in New York must note that no corporation having members may have fewer than three members unless each such member is a corporation, at least one of which has three or more members.

Can the US charity be consolidated into the financial statements of the overseas founding charity?

This would depend on the relevant accounting standards that are applicable for the founding charity and the accounting rules for defining a parent and subsidiary relationship.

The concern that is often expressed as a stumbling block is that the US charity must be seen to be more than a conduit and being a subsidiary may indicate that its board is not able to meet the discretion and control tests discussed above.

This is a common discussion point when considering parent subsidiary relationships and there is sometimes seen to be a dichotomy between the duties of board members of a subsidiary company with the concept of 'control' by a parent organisation. This is an issue which has been managed by the Boards of subsidiaries in all sectors and charitable subsidiaries are not unique in this regard. Corporate or trust fiduciary duties imposed on directors and trustees of charitable organisations dictate that the subsidiary organisation's board must act in the best interests of the subsidiary organisation and must exercise independent judgment in making decisions for the supporting organisation. This comports with the specific IRS requirement that domestic charities that make grants to overseas entities must exercise discretion and control over the application of funds. The fact that the board of the subsidiary may be appointed by another organisation should not impact on this.

The important point is that the discretion and control must be over the distribution of funds and the detailed requirements discussed above can be met and indeed even expressly covered in a framework agreement and bylaws. Therefore, necessary discretion and control over grant making is not in itself incompatible alongside the parent subsidiary tests.

Can a US charity support a named charity overseas

It is accepted by the IRS that supporters of a specific non US charity often set up a US charity whose primary purpose is to support the overseas charity. The name used for the US entity is often "American Friends Of ..." but this is not a legal requirement. The "Friends Of" organisation is a US charity and is subject to US regulations. If it has public charity status donations to it are deductible for US income tax purposes in the same way as gifts to any other US public charity. It is important that it is not a mere conduit and must have a board that exercises discretion and control over distributions. However, the board can, in its discretion, make all of its distributions to the foreign charity after whom it is named.

What are the other options if the US charity does not qualify as a public charity

In some cases the US charity's income mix may mean that it does not qualify for public charity status and in such cases it can consider the route of being a "supporting charity" if the charity it is supporting, even if it is overseas, can demonstrate that it is equivalent to a US public charity. A supporting charity operates under IRC Section 509(a)(3) and either makes grants to, or performs the operations of, a public charity similar to a private foundation. However, unlike donations to a private foundation, donors to a supporting charity can avail themselves of the same higher deduction rate as donations to public charities.

There are special requirements to qualify as a supporting charity and prima facie it may seem that having such a relationship with a charity that is being supported overseas is incompatible with the requirement that the US charity must exercise discretion and control over the funds it remits overseas. However, although not very common this is possible.

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Care must be taken to ensure that the supporting charity is structured and operated in a way that shows that its directors exercise control and discretion over its grant making and that it is not a mere conduit.

In conclusion

The IRS has provided many examples of what does and does not work and has concluded that "the test in each case is whether the organisation has full control of the donated funds, and discretion as to their use, so as to ensure that they will be used to carry out [the domestic organisation 's] function and purposes."

This reiterates the key issue as being the discretion and control over the use of the funds. As long as this can be evidenced and, subject to the matters discussed above being observed, matters such as an overseas founder being a sole member with the ability to appoint and remove the majority of the board or consolidating the US charity into the group financial statements should not adversely impact on the tax status of the US charity.

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Pesh Framjee has been working globally with public benefit entities for over 35 years. He was the partner leading teams working with Public Benefit and social purpose organisations at Crowe, Deloitte, Arthur Andersen and BDO Binder Hamlyn. During this time these firms have been listed as the UK's lead provider of audit and related services to such organisations for 30 consecutive years. He is Special Advisor to the Charity Finance Group and is a member of the Charity Law Association and of the Practitioner Advisory Group developing a new International Non Profit Accounting Standard. He has founded Consulting for Purpose that provides wide ranging consultancy services focusing on governance, structures, effective management and strategy for Public Benefit entities and their funders.