

**ALI-ABA COURSE OF STUDY
TAX-EXEMPT CHARITABLE ORGANIZATIONS**

COSPONSORED BY THE ABA SECTION OF TAXATION

**CHARITIES AND THE WAR ON TERROR:
RECENT DEVELOPMENTS AFFECTING INTERNATIONAL GRANTMAKING**

**DECEMBER 5, 2003
The Hilton Embassy Row Hotel
Washington, D.C.**

BY

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I. Introduction

There have been several recent developments that affect how charitable organizations conduct their international grantmaking programs and their own overseas activities. Since September 11, 2001, the Federal government has taken a keen interest in the role of charities as a source of funding for terrorist organizations. According to the former General Counsel of the Treasury Department, David Aufhauser, the U.S. government believes that charities are the second principal source of funds supporting terrorism.^{1/} The U.S. government has taken several steps to curb abuse of charitable funds, including blocking the assets of at least three U.S. charities considered to have funded foreign organizations designated as foreign terrorist organizations. In addition, on November 7, 2002, the Treasury Department issued a document entitled “U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: *Voluntary* Best Practices for U.S.-Based Charities” (the “Treasury Guidelines” or the “Guidelines”), which is intended to establish specific voluntary due diligence procedures for U.S. charities making grants and conducting activities overseas.

^{1/} Speech to the Exempt Organizations Committee, American Bar Association Section of Taxation, May 9, 2003. No documentation has been provided to corroborate Mr. Aufhauser’s statement. Mr. Aufhauser has clarified that it is the government’s view that most of the funding from charities for terrorist organizations has come from foreign charities, not U.S.-based charities.

This outline briefly reviews the steps the U.S. government has taken to prevent the diversion of charitable funds to terrorist activities, provides a summary of the “best practices” included in the Treasury Guidelines, and discusses several steps that grantmaking organizations may wish to consider incorporating into their pre-grant evaluation and grant administration processes and before making payments to foreign individuals and entities.

II. Legal Overview

A. Executive Order 13224 and the Patriot Act

Shortly after September 11, 2001, President Bush issued Executive Order 13224, which blocks the property of and prohibits transactions with certain “persons” (both individuals and organizations) who (1) are identified as terrorists on a list attached to the Executive Order (the “Executive Order Annex List”), (2) are determined by the Secretary of State to have committed or pose a risk of committing acts of terrorism, and (3) fall into one of several other categories of persons who support, are owned or controlled by, or are associated with terrorists. The Executive Order also prohibits donations of food, clothing, medicine and other humanitarian items to persons who are listed above. Enforcement of blocking actions is administered by the Treasury Department’s Office of Foreign Assets Control (“OFAC”). OFAC publishes the Specially Designated Nationals List (“SDN List”), which includes individuals, groups, and entities identified as terrorists (also narcotics traffickers and persons designated under various programs) and individuals and entities owned or controlled by, or acting on behalf of, countries targeted by OFAC as part of economic sanctions programs.

In October 2001, Congress passed the Patriot Act (the “Act”), which covers numerous security related issues and is intended to strengthen the government’s ability to combat terrorism. While the Act covers much that is not directly relevant to charities, the applicable provisions impose criminal and civil penalties on anyone who either knowingly or intentionally provides “material support” to terrorists or foreign terrorist organizations.^{2/} The Act broadly defines “material support” to include expert advice or assistance. The Act also prohibits, among other things, fundraising and providing funds with the intention or knowledge that the funds will be used to commit a terrorist act.^{3/}

B. Current Legislative Proposals

Both the House and Senate versions of pending charitable giving legislation (H.R. 7 and S. 476) contain a provision which, if enacted, would amend the tax laws to provide for the suspension of an organization’s tax-exempt status for any period in which it is designated a terrorist organization or a supporter of terrorism. The IRS would be responsible for publishing the names of any organizations suspended pursuant to this provision. Contributions to designated organizations would not be deductible during the period of the suspension. While this provision

^{2/} 18 U.S.C. §§ 2339A and 2339B, as amended by the Patriot Act.

^{3/} 18 U.S.C. §§ 2339C.

has passed both the House and the Senate, the charitable giving legislation in which it is included has not been sent to conference and may remain stalled through the end of the year.

III. The Treasury Guidelines

The actions blocking the assets of several U.S. charities believed by the Treasury Department to have links to al Qaeda and Hamas were taken under Executive Order 13224 and the Patriot Act. The Treasury Guidelines (see attached) were released in November 2002 in response to inquiries from Arab American and American Muslim communities on charitable best practices following the blocking actions. The Treasury Guidelines are voluntary, and thus, unlike Executive Order 13224 and the Patriot Act, do not constitute actual prohibitions on activities. However, the press release (see attached) accompanying the Treasury Guidelines states that charities that implement the Guidelines effectively will experience a “corresponding reduction in the likelihood of a blocking order against any such charity or donors who contribute to such charity in good faith . . .”^{4/} The Treasury Guidelines apply only to grants and payments made to foreign organizations.

The Treasury Guidelines require a high level of due diligence and accountability. They have been criticized as adopting a “one size fits all” approach to international grantmaking that is unnecessarily burdensome and poorly tailored to the objective of preventing the funding of terrorist organizations. To complicate matters, there are several provisions that are difficult to interpret and which may conflict with state law. There has been significant opposition to the Treasury Guidelines from many organizations in the grantmaking community, and at least one umbrella organization (the Council on Foundations) has requested that the Treasury Department reconsider the Guidelines. To date, the Treasury Department has not responded to these comments.

The Guidelines are divided into four sections: Governance, Disclosure and Transparency in Governance and Finances, Financial Practice/Accountability, and Anti-Terrorist Financing Procedures. The first three sections apply to the grantmaking charity, while the last section involves due diligence procedures for making grants to foreign organizations. As suggested by the section headings, the first three sections address the grantmaking charity’s (1) organizing documents and governing board, (2) disclosure and reporting responsibilities, and (3) financial accountability responsibilities. In some instances, the standards reflect existing requirements applicable to charities; in other instances, the Guidelines set out standards that exceed the requirements of most state statutes and federal law. The statements within each section are presented as a series of specific “do’s and don’ts.” Other than noting that the Treasury Guidelines are “consistent with the principles espoused in both the private and international public sectors – e.g., the Better Business Bureau, the Evangelical Council for Financial Accountability and most recently, the Financial Action Task Force . . .”, they do not indicate the source of these recommended actions.

^{4/} The term “charity” as used in the Treasury Guidelines refers to both public charities and private foundations.

The fourth section, “Anti-Terrorist Financing Procedures,” outlines steps a charity should take before making a grant to a “foreign recipient organization” (“FRO”). The Treasury Guidelines recommend that an organization obtain basic information, including the following, about an FRO before making a grant:

- FRO’s name in English, in the language of origin, and any acronyms used;
- jurisdictions in which the FRO maintains a physical presence and where it was incorporated or formed;
- address and phone number of any place of business of the FRO;
- names and addresses of organizations to which the FRO provides or proposes to provide funding, services, or material support and any subcontracting organizations used by the FRO;
- copies of all public filings or releases made by the FRO; and
- the FRO’s existing sources of income.

The Treasury Guidelines also recommend that the charity conduct “basic vetting” of a potential FRO, including the following:

- conduct a “reasonable” search of public information, including the Internet, to determine whether the FRO is or has been implicated in “any questionable activity”;
- verify (and be able to demonstrate that it verified) that the FRO does not appear on “any” list of the U.S. government, the United Nations, or the European Union identifying it as having links to terrorism or money laundering;
- obtain the full name in English, in the language of origin, and any acronym or other names used, as well as nationality, citizenship, current country of residence, place and date of birth for key staff. The names should be run through public databases and compared to the lists above; and
- require FROs to certify that they do not employ or deal with any entities or individuals on the lists referenced above, or with any entities or individuals known by the FRO to support terrorism.

Finally, the Treasury Guidelines recommend that in reviewing the financial operations of the FRO, the charity should:

- identify the financial institutions with which the FRO maintains accounts and confirm that none of the of the institutions is a shell bank, operating under an offshore license, licensed in a jurisdiction that has been determined to be non-cooperative in the international fight against money laundering, licensed in a jurisdiction that has been designated by the Secretary of the Treasury to be a primary money laundering concern; or licensed in a jurisdiction that lacks adequate anti-money laundering controls and regulatory oversight.
- require periodic reports from the FRO on its activities and the use of grant funds;
- require the FRO to take reasonable steps to ensure that funds are not diverted to terrorist organizations and to apprise the charity of the steps it has taken to meet this goal; and
- perform routine, on-site audits of the FRO wherever possible and feasible.

Following the issuance of the Treasury Guidelines, the IRS requested comments from the public on how it might clarify the existing requirements that Section 501(c)(3) organizations must meet with respect to international grantmaking and international activities (IRS Announcement 2003-29). The IRS also requested comments on the Treasury Guidelines, specifically which of the best practices recommended are currently used by charitable organizations. Numerous organizations have participated in preparing comments to the Treasury Department and the IRS regarding the Treasury Guidelines and Announcement 2003-29. At least two submissions, one by the Council on Foundations and one by the Committee on Exempt Organizations of the American Bar Association's Section of Taxation, have recommended an approach that would have the charity assess the risk of diversion for a particular grant to a foreign organization and take appropriate steps to safeguard the funds based on the level of risk involved in lieu of simply requiring the same steps for all grants to all foreign organizations. The IRS has not indicated that it will issue any formal guidance on diversion prevention procedures. However, as part of its 2004 Implementing Guidelines, the IRS has announced that it will be pursuing a major compliance initiative to help ensure that charitable funds are not diverted for terrorist activities.

IV. Steps Grantmakers Can Take

A. Perform a Risk Assessment

As stated in the title to the Treasury Guidelines, the Guidelines are voluntary but, in the current environment, they clearly cannot be ignored. While it should not be necessary for a charitable organization to ensure that it complies with every single "best practice" listed in the Treasury Guidelines, organizations may wish to consider evaluating each proposed grant or payment to a foreign individual or organization to determine whether it presents a risk that the funds could be diverted for terrorist activities, and then conducting its due diligence and grant administration accordingly.^{5/} Relevant factors in making such an evaluation might include:

1. Whether the grantmaker has prior experience with the potential grantee, and whether the potential grantee has a record of using grant funds for the intended purposes. Clearly, if the grantmaker has had a positive experience with the proposed grantee previously, it is reasonable for the grantmaker to conclude that the grant likely poses less risk of diversion than if the grantmaker has no prior history with the grantee. Even if the grantmaker has no prior experience with a proposed grantee, it may be able to obtain references regarding the proposed grantee from trusted sources that would lead it to conclude that the grant likely poses little risk of diversion.

^{5/} As noted above, the Treasury Guidelines apply to charitable organizations both making grants to foreign organizations and conducting activities overseas themselves. Similarly, Executive Order 13224 and the Patriot Act are directed broadly at transactions with terrorists and persons and entities associated with terrorism. While the terms "grant" and "grantmaker" are used in this memorandum for simplicity, it is important to keep in mind that charitable organizations may need to evaluate the possibility of diversion for noncharitable purposes for other types of transactions, including the payment of consulting fees, the provision of goods, etc.

2. Whether the potential grantee is an established organization with a history of legitimate charitable accomplishments. The grantmaker will likely need to conduct more thorough due diligence prior to making a grant to an organization that is newly formed and has little or no record of charitable accomplishments. In this instance, references from trusted sources regarding the charitable accomplishments of the proposed grantee's directors and/or officers may be useful in relieving concerns about the possible risk of diversion.
3. Whether the proposed grantee currently receives funding from an agency of the U.S. government that conducts its own vetting process.
4. Whether the potential grantee or the project to be funded is located in a country that has been identified by the U.S. Secretary of State as a state sponsor of terrorism (see <http://www.state.gov/s/ct/rls/pgtrpt/2002/html/19988.htm> for the latest State Department report on state sponsors of terrorism).
5. Whether the grant is for the proposed grantee's general support or for a specific project. A grant agreement that gives the potential grantee unlimited discretion regarding the use of grant funds is likely to pose a somewhat greater risk of diversion than a grant that is restricted to use for a specific project.
6. Whether the proposed grantee has strong leadership and adequate internal financial controls. For example, a grant to a grantee that has an on-site professional staff and record-keeping systems likely poses somewhat less risk of grant diversion.

There are, of course, other factors that the grantmaker may consider relevant in evaluating a particular grant, and none of these factors standing alone should necessarily be viewed as a definitive indication that a grant is more or less likely to be at risk of diversion. It would be advisable for the grantmaker to document its risk analysis based on the above factors and any others that it believes are appropriate for each grant or payment to a foreign organization. For any grants or payments that the grantmaker concludes may pose a higher risk of diversion, the grantmaker may wish to consult with legal counsel to consider what additional due diligence steps would be appropriate.

B. Check Government Lists of Terrorists

Based on Executive Order 13224 and the Patriot Act, it would be advisable for charitable organizations to check the Treasury Department's SDN List, which includes the individuals and entities named on the Executive Order Annex List and those identified by the State Department pursuant to Executive Order 13224, before making (1) grants to foreign organizations, (2) grants to domestic organizations that will use the funds to support activities overseas, and (3) payments to foreign individuals and entities for activities conducted overseas by the charity itself. Furthermore, given the broad wording of the list-checking provision in the Treasury Guidelines, charitable organizations making grants or payments to foreign individuals or organizations may determine that it would be appropriate to check several additional lists, at least with respect to an initial grant or payment. A list of the Internet addresses for several watchlists of terrorists and

terrorist organizations is attached. A charity should reflect in its files what names it checked and which lists were reviewed.

Please be aware that the terrorist watchlists are generally quite long, many are supplemented regularly, and are not readily searchable, so checking them can be burdensome. There are various companies that have produced software that consolidate the numerous terrorist watchlists into a searchable format. Depending on the organization's anticipated level of future foreign grants or payments, it may wish to consider purchasing such software. Although the federal government recently created the Terrorist Screening Center, which consolidates terrorist watchlists, the Center currently is available only to government security screeners and law enforcement officials.

C. Additional Steps

Public charities and private foundations use a variety of pre-grant due diligence practices that are suited to the particular organization and its grantees. Each organization will have to determine what steps--beyond checking the SDN List--make sense in the context of a particular grant or payment in order to limit the possibility that grant funds or payments could be used for non-charitable purposes. For those grants or payments that an organization determines are very low risk (for example, repeat grants by a U.S. "Friends of" organization to a foreign university), it may be sufficient for the grantmaker to check the SDN List and perhaps other lists infrequently, unless the grantmaker becomes aware of information that changes its assessment of the risk associated with the grant. For grants or payments that may present a somewhat higher risk of diversion, the grantmaker may determine that it is appropriate to examine the recipient's organizational and registration documents, financial statements, and to ascertain whether the potential grantee has adequate internal controls and accounting procedures for tracking grant funds and providing required reports to the grantmaker.^{6/} Grantmakers may also wish to solicit information from other public charities or private foundations that have worked with the potential grantee and to collect information to ascertain whether the grantee's key personnel are well qualified to conduct the proposed program. In addition, with higher risk grants, grantmakers may determine that it would be appropriate to conduct a site visit. Finally, grantmakers may wish to review their grant agreements to determine whether they provide sufficient guidance and protection.

^{6/} Private foundations that exercise expenditure responsibility for foreign grants may already collect some of this information as part of the pre-grant inquiry process.

Addresses for Government Lists

1. Treasury OFAC Specially Designated Nationals List:
www.ustreas.gov/offices/enforcement/ofac/sdn

This list includes:

- a. Executive Order Annex List
- b. Department of State Comprehensive List of Terrorists and Groups Identified Under Executive Order 13224 (www.state.gov/s/ct/rls/fs/2002/12327.htm)
- c. Department of State List of Foreign Terrorist Organizations (www.state.gov/s/ct/rls/fs/2002/12389.htm)
- d. Executive Orders 12947 and 13099 Lists of Terrorists Who Threaten to Disrupt the Middle East Peace Process (50 U.S.C. §1701 note; 63 FR 45167).

2. Department of State Terrorist Exclusion List (for immigration purposes)
www.state.gov/s/ct/rls/fs/2002/15222.htm

3. FBI List of Most Wanted Terrorists
www.fbi.gov/mostwant/terrorists/fugitives.htm

4. Bureau of Industry and Security Entity List, Denied Persons Lists and Unverified List
www.bxa.doc.gov/complianceandenforcement

5. United Nations List Pursuant to Security Council Resolution 1390 (2002), Resolution 1267 (1999), and Resolution 333 (2000)
www.un.org/Docs/sc/committees/1267/1267ListEng.htm

1-WA/2075291.1