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**INTERNATIONAL GRANTMAKING**

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# INTERNATIONAL GRANTMAKING

by

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## I. Introduction

- A. Private foundations that make grants to foreign organizations are required to comply with various rules, including rules under (1) the taxable expenditure rules of Code Section 4945, (2) U.S. laws prohibiting the use of funds to finance terrorism, and (3) the tax withholding rules.
- B. Under Section 4945, private foundations that make grants to foreign organizations have to exercise “expenditure responsibility” unless the recipient organization is the equivalent of a U.S. public charity. Private foundations may follow an equivalency determination process to make this determination, as described below.
- C. Furthermore, international grantmaking has become increasingly complex since September 11, 2001, as the federal government has taken a keen interest in the role of charities as a source of funding for terrorist organizations. The U.S. government has taken several steps to curb abuse of charitable funds. This outline:
  - 1. briefly reviews the steps the U.S. government has taken to prevent the diversion of charitable funds to terrorist activities, including Executive Order 13224 and the Patriot Act,
  - 2. provides a summary of the revised Treasury Guidelines, which establish voluntary due diligence procedures for U.S. charities making grants and conducting activities overseas, and
  - 3. 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.
- D. Finally, this outline also includes a brief overview of tax withholding issues specific to foreign grantmaking.

## II. Requirements for International Grants under Section 4945

- A. Section 4945 imposes an excise tax on private foundations and their managers for making payments that fall within the definition of “taxable expenditures” – including grants made to an organization other than a public charity or exempt operating foundation – unless the grantor foundation exercises “expenditure responsibility” over the grant.
- B. A private foundation therefore must know how a foreign organization that has not received recognition of Section 501(c)(3) status from the IRS would be characterized under U.S. law. The IRS has provided that a foundation may either:

1. conduct a “foreign equivalency determination,” so that it would need to exercise expenditure responsibility over a foreign grant only if it determines the grantee to be other than the equivalent of a Section 501(c)(3) public charity, or
  2. choose instead to exercise expenditure responsibility over the grant without making an equivalency determination, regardless of how the grantee organization would be characterized under U.S. law.
- C. Conducting an equivalency determination requires a foundation to make a “good faith determination” and “reasonable judgment” that a foreign grantee meets the criteria to be deemed a Section 501(c)(3) public charity, based either on an affidavit from the grantee or on an opinion of counsel.<sup>1</sup>
1. Foundations typically conduct equivalency determinations by obtaining an affidavit from the grantee, which must describe the grantee’s founding documents, its purposes and activities, its dissolution arrangements, certain financial information and the restrictions it faces with respect to private benefit, noncharitable activities, lobbying and campaigning.
  2. An affidavit must be “currently qualified,” meaning that the information reflects the latest complete accounting year or has been updated to reflect the organization’s current data. The affidavit must also be in English, and be signed by one of the grantee’s principal officers.
- D. If a private foundation begins the equivalency determination process and determines that the organization is the equivalent of a U.S. private foundation, then it not only must exercise expenditure responsibility but it also cannot treat the grant as a qualifying distribution until the foreign organization redistributes the funds.<sup>2</sup>
1. This requirement can be a complicating factor; foreign organizations often have difficulty understanding what they must report to the private foundation.
- E. The IRS issued a “general information” letter on April 18, 2001 (see attached) to clarify that a foundation is not required to conduct an equivalency determination before deciding to exercise expenditure responsibility.<sup>3</sup> In this way, the foundation can treat the grant as a qualifying distribution immediately. The letter also clarifies that:
1. A private foundation may turn to expenditure responsibility at any point, such as when its efforts to make an equivalency determination have been inconclusive.

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<sup>1</sup> Treas. Reg. § 53.4945-5(a)(5).

<sup>2</sup> Treas. Reg. § 53.4942(a)-3(a)(6).

<sup>3</sup> Although general information letters are advisory in nature and have no binding effect on the IRS, they are intended to provide clarification of well-established interpretations of law.

2. A private foundation is not affected by another foundation's decision to rely upon an equivalency determination with respect to the same grantee in lieu of exercising expenditure responsibility.
- F. Foreign grantees that are not the equivalents of U.S. charities must keep grant funds in a segregated account.<sup>4</sup>

### III. Executive Order 13224 and the Patriot Act

- A. 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.
- B. The Executive Order also prohibits donations of food, clothing, medicine and other humanitarian items to persons who are listed above.
- C. 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.
- D. In October 2001, Congress passed the Patriot Act, which covers numerous security-related issues and is intended to strengthen the government's ability to combat terrorism.
- E. While the Patriot 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.<sup>5</sup> The Patriot Act broadly defines "material support" to include expert advice or assistance.
- F. The Patriot 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.<sup>6</sup>

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<sup>4</sup> Treas. Reg. § 53.4945-6(c).

<sup>5</sup> 18 U.S.C. §§ 2339A and 2339B, as amended by the Patriot Act.

<sup>6</sup> 18 U.S.C. § 2339C.

- G. The U.S. government has blocked the assets of at least six U.S. charities believed by the Treasury Department to have links to al Qaeda and Hamas under Executive Order 13224 and the Patriot Act.
- H. Finally, new Code Section 501(p) was enacted as part of the Military Family Tax Relief Act of 2003, effective November 11, 2003. Section 501(p) suspends the tax-exempt status of any organization that is designated or identified by U.S. federal authorities as a terrorist organization or a supporter of terrorism.
  - 1. The IRS is responsible for publishing the names of any organizations suspended pursuant to this provision.
  - 2. Contributions to suspended organizations are not deductible.
  - 3. Following the enactment of Section 501(p), the IRS announced the suspension of exemption for three organizations: Benevolence International Foundation, Inc., Global Relief Foundation, Inc., and Holy Land Foundation for Relief and Development, Inc. On June 24, 2004, the IRS added the Rabbi Meir Kahana Memorial Fund to the list of suspended organizations.

#### IV. The Treasury Guidelines

- A. 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,” which is intended to establish specific voluntary due diligence procedures for U.S. charities making grants and conducting activities overseas. The Treasury Department issued an amended version of the Guidelines on December 5, 2005 (see attached).<sup>7</sup>
  - 1. The original Guidelines were widely criticized by the nonprofit sector as unnecessarily burdensome and poorly tailored to the objective of preventing funding of terrorist organizations. According to a Treasury press release, the revised Guidelines became effective immediately, although Treasury accepted comments on the revised Guidelines until February 1, 2006, which it will consider when finalizing the Guidelines.
  - 2. There has been significant opposition to the Treasury Guidelines from many organizations in the grantmaking community, and at least one umbrella organization –

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<sup>7</sup> The revised Guidelines, the introduction to the revised Guidelines, and the Treasury press release regarding the Guidelines are available at the following links:

Guidelines: [http://www.treas.gov/offices/enforcement/key-issues/protecting/docs/guidelines\\_charities.pdf](http://www.treas.gov/offices/enforcement/key-issues/protecting/docs/guidelines_charities.pdf)

Introduction: <http://www.treas.gov/offices/enforcement/key-issues/protecting/charities-intro.shtml>

Press Release: <http://www.treas.gov/press/releases/js3035.htm>

Morgan Lewis’ client update: <http://www.morganlewis.com/pubs/EOGuidelinesLF12-8.pdf>

the Council on Foundations – has requested that the Treasury Department reconsider the Guidelines.<sup>8</sup>

3. It is not clear that the revised Guidelines are an improvement on the original Guidelines. Several aspects of the revised Guidelines are similar to the prior version. Some aspects of the new so-called “best practices” in the 2005 Guidelines are troubling.
  4. The initial Guidelines were 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. Accordingly, the 2005 Guidelines recognize that charities should be permitted to use a risk-based approach in determining what due diligence is needed to guard against the possibility of diversion of grant funds or other payments to terrorist activities.
    - a. Numerous organizations submitted comments to the Treasury Department and the IRS regarding the Treasury Guidelines. 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 this more tailored, risk-based approach.
  5. The revised Guidelines were amended apply to both domestic and foreign distributions of funds, now stating that “charities should consider taking the following steps before distributing any charitable funds.” The Guidelines also refer simply to “recipients,” rather than using the term “foreign recipient organizations” found in the original Guidelines.
- B. The Treasury Guidelines set forth a high level of due diligence and accountability. They are voluntary, and thus, unlike Executive Order 13224 and the Patriot Act, do not constitute actual prohibitions on activities. However, the press release 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.”<sup>2</sup>
- C. The Guidelines are divided into five sections, with the first four sections applying to the grantmaking charity, and the last section involving due diligence procedures for making grants to foreign organizations. The five sections are as follows:
1. Fundamental Principles of Good Charitable Practice: setting forth four basic principles regarding the conduct of charitable organizations.

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<sup>8</sup> See <http://www.independentsector.org/programs/gr/TreasuryComments.pdf>. Also, see the guidelines developed by a group of charitable sector organizations and advisors to propose alternative ways of safeguarding charitable funds from diversion to terrorist uses, available at: [www.independentsector.org/programs/gr/CharityPrinciples.pdf](http://www.independentsector.org/programs/gr/CharityPrinciples.pdf).

<sup>2</sup> The term “charity” as used in the Treasury Guidelines refers to both public charities and private foundations.

2. Governance: addressing the grantmaking charity's organizing documents and governing board.
  3. Disclosure and Transparency in Governance and Finances: addressing the grantmaking charity's disclosure and reporting responsibilities.
  4. Financial Practice/Accountability: addressing the grantmaking charity's financial accountability responsibilities.
  5. Anti-Terrorist Financing Procedures: outlining steps a charity should take before distributing any charitable funds.
- D. 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 guidelines within each section are presented as a series of specific "Charities should..."
- E. Other than the notation in the 2002 version 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..." the Guidelines do not indicate the source of these recommended actions.
- F. In the fifth section, "Anti-Terrorist Financing Procedures," the Treasury Guidelines recommend that an organization obtain basic information about a recipient before making a grant, including the following:
1. the grant recipient's name in English, in the language of origin, and any acronym or other names used;
  2. the jurisdictions in which the grant recipient maintains a physical presence;
  3. any reasonably available historical information about the grant recipient that assures the charity of the recipient's identity, including (i) the jurisdiction in which a recipient organization is incorporated or formed, (ii) copies of incorporating or other governing instruments, (iii) information on the individuals who formed the organization, and (iv) information relating to the recipient's operating history;
  4. the address and phone number of each place of business of the grant recipient;
  5. a statement of the principal purpose of the recipient, including a detailed report of the recipient's projects and goals;
  6. names and addresses of individuals and organizations to which the grant recipient provides or proposes to provide funding, services, or material support, to the extent reasonably discoverable;

7. the names and addresses of any subcontracting organizations used by the grant recipient;
  8. copies of all public filings or releases made by the grant recipient; and
  9. the grant recipient's existing sources of income.
- G. The Treasury Guidelines also recommend that the charity conduct "basic vetting" of a potential grant recipient, including the following:
1. Conduct a "reasonable" search of public information, including the Internet, to determine whether the grant recipient is suspected of activity relating to terrorism, including terrorist financing or other support;
  2. Comply with all OFAC-administered sanctions programs, and verify (and be able to demonstrate that it verified) that the grant recipient does not appear on OFAC's master SDN List, which is maintained on OFAC's website;<sup>10</sup>
    - a. This represents an improvement over the 2002 Guidelines, which stated that charities should check not only the SDN List, but also several other specific lists, and "any other official list available to the charity."
  3. 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 employees, board members and other senior management at the recipient's principal place of business and for key employees at other locations. The charity should assure itself that none of these individuals is sanctioned by OFAC, and should be aware that other nations may have their own lists of designated terrorist-related individuals and organizations.
  4. Consider, on the basis of risk, consulting publicly available information (*e.g.*, through publicly available databases or Internet searches) to ensure that key employees, board members and other senior management are not suspected of activity related to terrorism.
  5. Require grant recipients to certify that they do not employ or deal with any entities or individuals that are sanctioned by OFAC or with any persons known to support terrorism.
- H. Several organizations have already noted that they are concerned about the new recommendation in the Anti-Terrorist Financing Procedures section of the revised Guidelines that a charity should "consult publicly available information, including information available via the Internet, to determine whether any of its key employees is suspected of activity relating to terrorism."

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<sup>10</sup> See [www.treas.gov/offices/enforcement/ofac/sdn](http://www.treas.gov/offices/enforcement/ofac/sdn).

1. The revised Guidelines explain that if a charity's vetting practices lead to a finding that "any of its own key employees, any of its recipients, or any of the key employees, board members, or other senior management of its recipients is suspected of activity related to terrorism," the charity should immediately report a "valid or potentially valid match...on the SDN List to OFAC" and "can provide information on any suspicious activity that does not involve an OFAC match through a referral form available on Treasury's website."
- I. Finally, the Treasury Guidelines recommend that in reviewing the financial and programmatic operations of the grant recipient, the charity should:
    1. require periodic reports from grant recipients on their activities and use of grant funds;
    2. require the grant recipient 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
    3. perform routine, on-site audits of the grant recipient to the extent possible and appropriate.
  - J. 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.
  - K. The IRS has not indicated that it will issue any formal guidance on diversion prevention procedures. However, in 2005 it began examinations of a sample of organizations that make foreign grants to ensure that grant funds are being used for their intended charitable purpose and are not diverted to terrorist activities or used for other inappropriate purposes, as well as to gather information on the existence and effectiveness of the current controls used to monitor foreign grants.
  - L. The IRS has also identified "Anti-Terrorism" as an ongoing critical initiative in its 2006 Implementing Guidelines, with plans to complete these examinations, analyze the data, address the need for possible guidance and issue a report. It will also target new organizations for examination.
- V. 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 to terrorist activities,

and then conducting its due diligence and grant administration accordingly.<sup>11</sup> 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.
  - a. 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.
  - b. 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.
2. Whether the potential grantee is an established organization with a history of legitimate charitable accomplishments.
  - a. 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.

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<sup>11</sup> As noted above, the Treasury Guidelines apply both to charitable organizations making grants to foreign and domestic organizations and to those charitable organizations 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 of other types of transactions, including the payment of consulting fees, the provision of goods, and so on.

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.
  - a. 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.
  - b. 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 OFAC's SDN List. Based on Executive Order 13224, the Patriot Act and the Treasury Guidelines, it would be advisable for charitable organizations to check the Treasury Department's SDN List before making:
  1. grants to foreign organizations,
  2. grants to domestic organizations that will use the grant funds to support activities overseas, and
  3. payments to foreign individuals and entities for activities conducted overseas by the charity itself.
    - a. A charity should document in its files that it checked OFAC's SDN List.
- 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 noncharitable purposes.
  1. 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.
  2. 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.<sup>12</sup>

3. 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.
4. In addition, with higher risk grants, grantmakers may determine that it would be appropriate to conduct a site visit.
5. Finally, grantmakers may wish to review their grant agreements to determine whether they provide sufficient guidance and protection.

## VI. Tax Withholding Issues

- A. As a general rule, foreign individuals ("nonresident aliens" or "NRAs") and foreign entities (collectively, "foreign persons") are subject to U.S. tax on their "U.S. source" income.
- B. The tax rules regarding withholding on payments to foreign persons essentially comprise an entirely different tax system from the rules used for payments to U.S. persons.
- C. Is the Foundation a Withholding Agent? As a general rule, a foundation making a payment of U.S. source income to a person whose address for payment is outside the United States is probably a withholding agent. A withholding agent is any person, whether U.S. or foreign, that has control, receipt, custody, disposal or payment of an item of income of a foreign person subject to withholding.<sup>13</sup>
  1. Items of income potentially subject to withholding include: compensation to employees, compensation to independent contractors, scholarships/fellowships, grants, stipends, prizes or awards, honoraria/guest speaker fees, travel reimbursements and royalties.
  2. Assuming the foundation is a withholding agent, it must determine whether to withhold tax based on documentation provided to it by the payee. The foundation may not rely on the documentation provided if it has actual knowledge or reason to know the claims made in the documentation are false.<sup>14</sup>
  3. As a withholding agent, the foundation is liable for any tax required to be withheld. This liability is independent of the tax liability of the foreign payee. If both parties fail

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<sup>12</sup> Private foundations that exercise expenditure responsibility for foreign grants may already collect some of this information as part of the pre-grant inquiry process.

<sup>13</sup> Treas. Reg. § 1.1441-7(a)(1).

<sup>14</sup> Treas. Reg. § 1.1441-1(b)(1).

to satisfy the U.S. tax liability, both parties are liable for the tax, as well as interest and penalties.<sup>15</sup>

4. As a withholding agent, a foundation must withhold at the standard rate of 30% on any payment subject to withholding to a foreign payee unless it has received documentation from the payee demonstrating that the payee is subject to a reduced rate of withholding or is exempt from withholding.

- a. Exceptions to the 30% withholding requirement include: foreign source income; income excluded from withholding under a Code provision; income subject to an income tax treaty provision permitting a reduced rate of withholding or exemption from withholding; scholarship/fellowship payments to holders of F, J, M, and Q visas (14% withholding rate); compensation to employees (graduated withholding); payments to a foreign tax-exempt entity (income from unrelated activity could be subject to withholding); payments to a designated international organization; and payments to purchase tangible personal property.<sup>16</sup>

D. Determining U.S. Residency Status. For tax purposes, an alien is an individual who is not a U.S. citizen. Aliens are classified as nonresident aliens and resident aliens. For individual payees, only NRAs are subject to the special withholding rules discussed in this outline. NRAs are taxed only on their income from sources within the United States and on certain income connected with the conduct of a trade or business in the United States.

1. Permanent resident aliens and certain other resident aliens are treated for tax purposes like U.S. citizens who are taxed on their worldwide income, instead of just their U.S. source income.
2. Certain rules apply in determining whether an individual payee is a foreign person and not a U.S. taxpayer (*i.e.*, the green-card test and the substantial presence test), as described in IRS Publication 519 (“U.S. Tax Guide for Aliens”).

E. Sourcing Rules. Specific rules must be applied in determining the source of a payment. The first step in figuring out the source of a payment is to know what type of income (e.g., compensation, grant, etc.) the foundation is paying.

1. Generally, most types of income from a U.S. payer are U.S. source, although certain exceptions apply, including for compensation, royalties, scholarships/fellowships, grants and prizes/awards.

F. Tax Documentation for Payments to Nonresident Aliens and Foreign Entities. All income payments made to an NRA or to a foreign entity are either:

1. Exempt from withholding because:

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<sup>15</sup> Sec. 1461; Treas. Reg. §§ 1.1461-1(a), 1.1441-7(a)(1), 1.1441-1(b)(1).

<sup>16</sup> See Treas. Reg. §1.1441-1(b)(4).

- a. payments are foreign source;
  - (i) Foreign source payments. For payments that are foreign source, a foundation has no obligation to obtain any type of withholding certificate from the payee if it has assured itself that the payee is a foreign entity. Organizations should consider developing their own form of documentation for foreign source payments, which serve to establish that the payee is an NRA or a foreign entity and that none of the funds paid will be U.S. source.
- b. exemption is permitted under a provision of the Code;
  - (i) Grants to foreign tax-exempt organizations. No withholding is required for such grants if the grantee is the equivalent of a U.S. Section 501(c) organization and the grantee provides a Form W-8EXP certifying that it is a foreign tax-exempt organization before payment is made. To complete Form W-8EXP, the grantee must either certify that it has been issued an IRS determination letter concluding that it is described in Section 501(c) or attach an opinion of U.S. counsel reaching such conclusion.
  - (ii) Grants to international organizations. For international organizations designated by Executive Order, no withholding or documentation is required, and no Taxpayer Identification Number (“TIN”) – an identification number used by the IRS in the administration of tax laws – is required. Also, the grantor foundation must file Form 1042-S to report any grant funds used for U.S.-based activities.
- c. exemption is permitted under an income tax treaty; or
  - (i) Payments subject to a tax treaty exemption. To exempt an NRA or foreign entity from federal income tax withholding under an income tax treaty, the withholding agent must receive documentation of the appropriate tax treaty exemption from the payee prior to making the first payment on either (A) Form 8233 (used for dependent (*i.e.*, employee) and independent (non-employee) compensation; this form is not used for payments to entities), or (B) Form W-8BEN (used for all non-compensation exemptions, including scholarship, fellowship, and royalty payments).

2. Taxable as:

- a. For foreign entities: non-employee compensation and all other payments (subject to withholding at 30%).
- b. For NRAs: employee compensation (subject to graduated withholding); scholarships/fellowships to F, J, M or Q visa holders (subject to withholding at 14%); or non-employee compensation and all other payments (subject to withholding at 30%).

- G. U.S. Tax Reporting Responsibilities. Form 1042-S is used by a payer to report all employee compensation payments to NRAs that are exempt from taxation under an income tax treaty, and all other income paid to an NRA or a foreign entity regardless of whether the payment is taxable and regardless of whether any amounts were withheld. However, Form 1042-S is not required where a payment is entirely foreign source.
1. Form 1042-S must be filed with IRS and provided to the grantee by March 15.
- H. Transactions involving payments to foreign persons can be extremely complicated. Foundations are advised to consult with their tax advisors regarding the application of these federal tax rules in the context of their own specific transactions.
1. In addition, there are instances where it may be a good idea to get legal assistance from a professional in the country where the foreign person resides, for example, if there is a possibility that the foreign payee could be treated as an employee of the foundation.