International Taxation of Philanthropy

Removing Tax Obstacles for International Charities

Ineke Alien Koele
# TABLE OF CONTENTS

**Preface**

v

**Chapter 1: Subject of study**

1. Philanthropic organizations in western democratic society in the twenty-first century 1
2. International tax barriers: the landlock 4
   2.1. Denomination of the landlock 4
   2.2. Non-discrimination provisions 6
   2.3. Rationale of the landlock 7
3. Historic attempts to resolve the landlock 12
   3.1. The Nebolsine Report 12
   3.2. The 1969 IFA Report 13
   3.3. Draft European Convention on the Tax Treatment in respect of certain Non-Profit Organizations 15
4. Recent developments 16
5. Attempts in bilateral tax treaties to resolve the landlock 20
   5.1. Philanthropic organizations are resident for bilateral income tax treaties 21
   5.2. Philanthropic organizations as a safe haven under limitation on benefits clauses 25
   5.3. Treaties that exempt philanthropic organizations from source taxation in respect of income generally or specified items of income 29
      5.3.1. General exemption from income (withholding) tax 29
      5.3.2. Non-discrimination 32
      5.3.3. Income tax deductions 34
   5.4. Conventions that resolve the landlock with regard to gifts or bequests to foreign philanthropic organizations 35
6. Thesis 37
   6.1. Motivation for research 37
   6.2. Object of research 39
   6.3. Methodology 40
   6.4. Thesis 42
Table of contents

Chapter 2: Terminology and general features of philanthropic organizations

2.1. Terminology: non-profit entities, NGOs, charities and philanthropic entities 43
2.2. Essential features of philanthropic organizations 47
2.2.1. Prohibition to distribute profits 48
2.2.1.1. United States 49
2.2.1.2. Germany 51
2.2.1.3. The Netherlands 51
2.2.2. Pursuing a valid public purpose for public benefit 52
2.2.2.1. United States 53
2.2.2.2. Germany 55
2.2.2.3. The Netherlands 57
2.2.2.4. Conclusion 59
2.2.3. Private and self-governing 59
2.3. Political philosophy of preferential tax status 61
2.3.1. Economic theories 62
2.3.2. Interdependence theory and the tax expenditure approach 63
2.3.3. The philosophy of pluralism 65
2.3.4. Conclusion 68

Chapter 3: Conditions for tax relief in the United States 69

Introduction 69
3.1. Legal appearance of philanthropic organizations 70
3.1.1. Non-profit corporation 71
3.1.2. Unincorporated association 72
3.1.3. Lifetime or testamentary trust 73
3.1.4. Multi-member limited liability company 74
3.2. Requirements for exemption 75
3.2.1. Organizational test 75
3.2.2. Operational test 76
3.2.2.1. Primary purpose test instead of exclusivity 77
3.2.2.2. Commensurate test 78
3.2.2.3. Prohibition on legislative and political activities 79
3.2.2.4. Private benefit test 80
3.2.3. Conclusion 84
3.3. Distinction between private foundations and public charities
3.3.1. What type of organization will qualify as a public charity?
3.3.2. Main differences between private foundations and public charities
3.3.2.1. Prohibition on self-dealing: Sec. 4941
3.3.2.2. Commensurate expenditure test (minimum distribution requirement): Sec. 4942
3.3.2.3. Excess business holdings: Sec. 4943
3.3.2.4. Jeopardizing investment: Sec. 4944
3.3.2.5. Taxable expenditures: Sec. 4945
3.3.2.6. Excise tax on investment income: Sec. 4940
3.4. International philanthropy and income taxation
3.4.1. Permissible foreign operations
3.4.2. Income tax deduction for contribution by individuals
3.4.2.1. Direct foreign operations: form over substance
3.4.2.2. US feeder organizations: substance over form
3.4.2.3. Split-interest trusts
3.4.2.4. Attracting funds directly from non-resident individuals
3.4.3. Income tax deduction for contributions by corporations
3.4.4. Income tax deduction for contributions by trusts and estates
3.4.5. Private foundations: how to avoid excise taxes in international grantmaking
3.4.5.1. Determination letter or good faith determination
3.4.5.2. Expenditure responsibility
3.4.5.3. Out-of-corpus rule
3.4.5.4. IRS endorsed streamlining of international grantmaking procedures
3.4.5.5. Scheme for international granting by US private foundations
3.4.6. Practices in international grantmaking
3.4.6.1. Prohibition on earmarking
3.4.6.2. Use of a supporting organization
3.4.6.3. Increasing compliance
3.4.6.4. Donor-advised funds
3.4.7. Conclusion
3.5. Foreign philanthropic organizations and income taxation
3.5.1. Recognition required as an exempt organization
3.5.2. Special rules for foreign private foundations
## Table of contents

3.6. International philanthropy and estate and gift tax 135  
3.6.1. General rule: no landlock 135  
3.6.2. Exception: foreign private foundations that do not meet US requirements 137  
3.6.3. Exception: non-resident alien bequests or gifts 138  
3.6.4. Exception: split-interest trusts 139  
3.7. Avoidance of virtual double taxation 139  
3.7.1. Individuals and the foreign tax credit 140  
3.7.1.1. US resident with foreign-source income 141  
3.7.1.2. Non-resident US citizen with US-source income 143  
3.7.2. Corporations and the foreign tax credit 144  
3.7.3. Unilateral relief for foreign gift and estate taxes 145  
3.8. US treaty policy on international philanthropy 146  
3.8.1. Income tax exemption for foreign exempt organizations 146  
3.8.2. Income tax issues for US taxpayers: individuals, corporations and private foundations 148  
3.8.3. Gift and estate tax treaties 153  
3.9. Conclusion 154  

Chapter 4: Conditions for tax relief in Germany 161  

Introduction 161  
4.1. Legal appearance of philanthropic organizations 164  
4.1.1. The Corporation 165  
4.1.2. Association (Verein) 167  
4.1.3. Foundation (Stiftung) 168  
4.1.3.1. Purpose 169  
4.1.3.2. Assets 171  
4.1.3.3. Organization 172  
4.1.4. Trust (Unselbständige Stiftung or Zweckvermögen des privaten Rechts) 173  
4.2. Requirements for exemption 174  
4.2.1. Organizational test 175  
4.2.2. Operational test 177  
4.2.2.1. Exclusivity test: primary purpose test? 178  
4.2.2.2. Commensurate test 180  
4.2.2.3. Prohibition on political activities 182  
4.2.2.4. Private benefit test 182  
   i. Association and the private benefit of members 183  
   ii. Exclusivity versus private benefit 183  
   iii. Private benefits expressly allowed for founders and their relatives 184
Table of contents

iv. Private benefits reserved or stipulated contractually 185
v. Benevolent purpose 186
4.2.2.5. Operational responsibility 187
4.2.3. Conclusion 191
4.3. Instructional provisions backed by harsh tax consequences 192
4.3.1. Liability for faulty contribution receipts 192
4.3.2. Retroactive revocation of exemption (control of destination) 194
4.3.2.1. Income tax 194
4.3.2.2. Inheritance and gift tax 195
4.4. International philanthropy and income taxation 196
4.4.1. Permissible foreign operations 196
4.4.2. Income tax deduction for contributions by individuals 199
4.4.2.1. Direct foreign operations 201
4.4.2.2. Feeder organizations 202
4.4.2.3. Split-interest gifts 204
4.4.2.4. Attracting funds directly from non-resident individuals 204
4.4.3. Income tax deduction for contributions by corporations 204
4.4.4. Practices in international grantmaking 205
4.4.4.1. Transnational Giving Europe Network 205
4.4.4.2. Earmarking of gifts 206
4.4.5. Conclusion 208
4.5. Foreign philanthropic organizations and income taxation 209
4.5.1. Tax position of foreign philanthropic organizations 209
4.5.2. Influence of the EC Treaty: Walter Stauffer case 211
4.6. Philanthropy and inheritance and gift tax 215
4.6.1. General rule: landlock 215
4.6.2. Exception: reciprocity agreement 216
4.6.3. Exception: earmarked contribution for specified philanthropic purpose 217
4.6.4. Non-resident gifts or bequests: landlocked, but same exceptions apply 219
4.7. Avoidance of virtual double taxation and philanthropy 220
4.7.1. Individuals and avoidance of double income taxation 221
4.7.1.1. German resident with foreign-source income 221
4.7.1.2. Foreign resident citizen with German-source income 222
4.7.2. Corporations and avoidance of double income taxation 223
4.7.3. Avoidance of double inheritance or gift taxation 224
### Table of contents

4.8. German treaty policy on international philanthropy 225  
  4.8.1. Income tax treaties: income tax exemption for foreign exempt organizations 225  
  4.8.2. Treaty exemption from gift and inheritance tax 227  
  4.9. Conclusions 228  

Chapter 5: Conditions for tax relief in the Netherlands 233  

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1.</td>
<td>Legal appearance of philanthropic organizations</td>
<td>233</td>
</tr>
<tr>
<td>5.1.1.</td>
<td>Corporation</td>
<td>238</td>
</tr>
<tr>
<td>5.1.2.</td>
<td>Association (<em>vereniging</em>)</td>
<td>239</td>
</tr>
<tr>
<td>5.1.3.</td>
<td>Foundation (<em>stichting</em>)</td>
<td>240</td>
</tr>
<tr>
<td>5.1.3.1.</td>
<td>Purpose</td>
<td>241</td>
</tr>
<tr>
<td>5.1.3.2.</td>
<td>Assets</td>
<td>243</td>
</tr>
<tr>
<td>5.1.3.3.</td>
<td>Organization</td>
<td>243</td>
</tr>
<tr>
<td>5.1.4.</td>
<td>Unincorporated fund</td>
<td>244</td>
</tr>
<tr>
<td>5.2.</td>
<td>Requirements for privileged tax status</td>
<td>244</td>
</tr>
<tr>
<td>5.2.1.</td>
<td>Organizational test</td>
<td>248</td>
</tr>
<tr>
<td>5.2.2.</td>
<td>Operational test</td>
<td>249</td>
</tr>
<tr>
<td>5.2.2.1.</td>
<td>Primary purpose test</td>
<td>252</td>
</tr>
<tr>
<td>5.2.2.2.</td>
<td>Commensurate test</td>
<td>254</td>
</tr>
<tr>
<td>5.2.2.3.</td>
<td>Other prohibitions</td>
<td>256</td>
</tr>
<tr>
<td>5.2.2.4.</td>
<td>Private benefit test</td>
<td>257</td>
</tr>
<tr>
<td>i.</td>
<td>Association and the private benefit of members</td>
<td>257</td>
</tr>
<tr>
<td>ii.</td>
<td>Fiscal transparency of foundations</td>
<td>259</td>
</tr>
<tr>
<td>iii.</td>
<td>Private benefits expressly allowed in organizational documents</td>
<td>260</td>
</tr>
<tr>
<td>iv.</td>
<td>Private benefits reserved or stipulated contractually</td>
<td>261</td>
</tr>
<tr>
<td>5.2.3.</td>
<td>Conclusion</td>
<td>265</td>
</tr>
<tr>
<td>5.3.</td>
<td>Directional provisions secured by harsh tax consequences</td>
<td>266</td>
</tr>
<tr>
<td>5.4.</td>
<td>International philanthropy and income taxation</td>
<td>267</td>
</tr>
<tr>
<td>5.4.1.</td>
<td>Foreign operations allowed</td>
<td>267</td>
</tr>
<tr>
<td>5.4.2.</td>
<td>Income tax deduction for contributions by individuals</td>
<td>268</td>
</tr>
<tr>
<td>5.4.2.1.</td>
<td>Direct foreign operations</td>
<td>272</td>
</tr>
<tr>
<td>5.4.2.2.</td>
<td>Feeder organizations</td>
<td>272</td>
</tr>
<tr>
<td>5.4.2.3.</td>
<td>Split-interest gifts</td>
<td>276</td>
</tr>
<tr>
<td>5.4.2.4.</td>
<td>Attracting funds directly from non-resident individuals</td>
<td>277</td>
</tr>
<tr>
<td>5.4.3.</td>
<td>Income tax deduction for contributions by corporations</td>
<td>279</td>
</tr>
<tr>
<td>5.4.4.</td>
<td>Practices in international grantmaking</td>
<td>279</td>
</tr>
<tr>
<td>5.4.4.1.</td>
<td>Transnational Giving Europe Network</td>
<td>279</td>
</tr>
</tbody>
</table>
5.4.4.2. Increasing compliance 281
5.4.4.3. Donor-advised funds 282
5.4.5. Conclusion 283
5.5. Foreign philanthropic organizations and income taxation 285
5.5.1. The tax position of foreign philanthropic organizations 286
5.5.2. Recent improvements 290
5.6. Philanthropy and gift and inheritance tax 291
5.6.1. General rule: landlock 291
5.6.1.1. Release of the landlock as of 2008 293
5.6.1.2. Gift tax on distributions by philanthropic organizations: no landlock 294
5.6.2. Exception: reciprocity 295
5.6.3. Non-resident gifts and bequests 296
5.7. Philanthropy and avoidance of virtual double taxation 298
5.7.1. Individuals and avoidance of double income taxation 299
5.7.1.1. Dutch resident with foreign-source income 301
5.7.1.2. Foreign resident citizen with Dutch-source income 304
5.7.2. Corporations and avoidance of double income taxation 305
5.7.3. Avoidance of double gift or inheritance taxation 306
5.8. Dutch treaty policy on international philanthropy 307
5.9. Conclusion 309

Chapter 6: The dimension of European Community Law 315

Introduction 315
6.1. Application of EC Treaty to philanthropic organizations and their benefactors 317
6.1.2. Freedom of capital: Arts. 56-58 of the EC Treaty 319
6.2. Are foreign philanthropic organizations and domestic philanthropic organizations comparable? 325
6.2.1. Tension between freedom of movement and sovereignty of Member States 326
6.2.2. Comparability of foreign and domestic philanthropic organizations 330
6.2.3. The influence of existing tax treaties versus reciprocity requirements in national law 331
6.2.4. Influence of the tax treatment in other countries 332
6.3. Are there any justifications for the difference in treatment under landlocked provisions? 336
6.3.1. Promotion of culture and exception to state aid 337
6.3.2. The need for effective fiscal supervision 339
# Table of contents

6.3.3. The need to safeguard the cohesion of the tax system 343  
6.3.4. Combating crime 344  
6.4. Conclusion 345  

## Chapter 7: Appraisal and conclusions 349

Introduction 349  
7.1. Rationale of the landlock 351  
7.1.1. Rationale of the landlock; results of this study 351  
7.1.2. Political philosophy and international philanthropy 355  
7.1.3. No rationale whatsoever for virtual double income taxation 356  
7.1.4. Conclusion 357  
7.2. Key elements for a resolution of the landlock 358  
7.2.1. Equivalency of foreign philanthropic organizations 359  
7.2.1.1. Equivalency considerations: results of this study 360  
7.2.1.2. Conclusion 363  
7.2.2. Operational test and expenditure responsibility in international philanthropy 367  
7.2.2.1. Growing importance of due diligence for international philanthropic transfers 368  
7.2.2.2. The impetus of the threat of anti-terrorism financing measures 371  
7.2.2.3. The use of facilitators is not a conclusive resolution 374  
7.2.2.4. Conclusion 376  
7.3. Various scenarios for resolution of the landlock 377  
7.3.1. Public charities: foreign charity is responsible for conditions of domestic tax relief 380  
7.3.1.1. Equivalency test 381  
7.3.1.2. Operational test: expenditure responsibility 382  
7.3.1.3. Feeder organizations' restrictions for cross-border philanthropy 385  
7.3.2. Private foundations: donor is responsible for conditions of domestic tax relief 386  
7.4. Resolution of the landlock through national law, bilateral treaties or multilateral treaties? 389  
7.5. The beginning of a new paradigm of cross-border giving 391  

Samenvatting 393  

Bibliography 405  

xvi