

PHILANTHROPY AT RISK

U.S. ADMINISTRATIVE AND LEGISLATIVE PROPOSALS FOR CHANGE

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Introduction

On January 7, 2005, President Bush joined the Republican-led House and Senate in enacting the first public law of the 109 Congress to “accelerate the income tax benefits for charitable cash contributions for the relief of victims of the Indian Ocean tsunami.”¹ Donations to philanthropic organizations² had suddenly won widespread applause and the president was asking for more. As President Bush asserted, the generosity of America is best demonstrated through the efforts of private citizens who “have contributed millions of dollars for disaster relief and reconstruction.”³ Moreover, Bush outlined a unique plan to utilize the leadership skills of two former presidents – Clinton and the senior Bush – to “ask Americans to donate directly to reliable charities already providing help to tsunami victims.”⁴

It doesn't take much historic hindsight to realize that these recent actions put the president and Congress in an awkward position. For more than three years political leaders in Washington have viewed the philanthropic sector with suspicion as they search for possible terrorist connections and fraudulent practices. Government officials are now trumpeting the work of this very same sector. Does this signal a reversal in sentiments, the opening of a new era of trust between the approximately one million tax-exempt philanthropic organizations covered under section 501(c)(3) of the Internal Revenue Code⁵ and the political majority? Actions to date by, among others, the Treasury Department, the Internal Revenue Service (IRS), and the U.S. Senate Finance Committee suggest otherwise.

¹ Under Public Law 109-1, a taxpayer may treat contributions made in January 2005 to tsunami relief as if such contributions were made on December 31, 2004.

² In this document, the term philanthropic organizations will be used to refer to a broad range of nonprofit, grantmaking, humanitarian relief, and charitable organizations.

³ President George W. Bush, “President Asks Bush and Clinton to Help Raise Funds for Tsunami Relief,” Office of the Press Secretary, the White House, January 3, 2005. Available at <http://www.whitehouse.gov/news/releases/2005/01/print/20050103-12.html>

⁴ Ibid.

⁵ Mark Everson, Commissioner of Internal Revenue, written testimony before the U.S. Senate Committee on Finance, Hearing on Charitable Giving Problems and Best Practices (June 22, 2004) (IR-2004-81), available at <http://www.irs.gov/pub/irs-news/ir-04-081.pdf>.

While the proponents of change argue that restrictions apply to the entire range of philanthropic organizations, they result in different outcomes for different types of organizations. In particular, the impacts are most severe on (1) smaller organizations that have fewer resources for addressing increased administrative requirements; (2) organizations engaged in international philanthropic efforts, especially international grantmakers whose funding decisions are subject to heightened scrutiny and possible blocking; and (3) progressive social change organizations that lack political support under the current conservative and Republican majority in Washington.

This document provides background information and analysis of these efforts to change the rules and regulations governing the philanthropic sector. First, the motives for change are examined. In general, those seeking new restrictions describe legitimate concerns – stopping the financing of terrorism and preventing fraudulent practices such as the misuse of philanthropic resources for personal gain. However, many of the proposals overstep the boundaries of such general concerns, apparently aimed specifically

at progressive organizations. If put in full effect, these changes would unjustifiably prevent many such organizations from carrying out their fully legitimate philanthropic missions. Second, specific measures and proposals are reviewed. What are the stated purposes, and what are the expected effects, particularly on small and international philanthropic organizations? Some of the most significant efforts to date include the Treasury Department’s “Voluntary Best Practices Guidelines for U.S.-Based Charities” which address anti-terrorist financing concerns; the U.S. Senate Finance Committee’s staff discussion draft of tax-exempt governance proposals directed at preventing fraud by philanthropic organizations; and changes, both proposed and already implemented, in Internal Revenue Service reporting and auditing to cover both anti-terrorism and anti-fraud goals. Finally, this document introduces some of the efforts by philanthropic organizations to respond to and counteract the negative effects of these policy change efforts. Ultimately, the goal of this analysis is to better understand how to protect and advance the work of social change philanthropy when the rules of the game are changing.

Motives for Administrative and Legislative Policy Proposals

In a fragmented political system such as exists in the United States, public policies often evolve with overlapping, competitive and even contradictory objectives. Multiple committees of Congress and numerous administrative departments, agencies and programs are typically pursuing their own agendas. In the case of proposed policy changes directed at the philanthropic sector, two overt and distinct efforts have been launched. First are measures initiated in the immediate aftermath of the tragic events of September 11, 2001. Both President Bush and the U.S. Congress acted swiftly to set in place counter-terrorism procedures, including policies directed at philanthropic organizations. Severing the lines of financial support to international terrorists was the stated purpose of policies aimed at philanthropic organizations. Second are measures taken to address instances of fraudulent financial practices within the philanthropic sector. Actions to date are generally seen as finishing off the work that was started when legislative action was taken in 2002 to confront corporate financial abuse.

Though they are often experienced by philanthropic organizations as more layers of the same, the two sets of proposed restrictions have separate political and administrative histories. Any attempt to alter the course of these efforts must account for these separate policy histories. At the same time, it is important to recognize that these two policy arguments – focused on terrorism and fraud – don't fully explain the entire set of restrictions currently under consideration. It is increasingly clear that the current Republican administration and U.S. conservatives more generally are acting to weaken progressive organizations, and particularly progressive international grantmaking organizations. This comprises a third set of actions affecting the philanthropic sector. All told, the effects of these proposals are reinforcing and have resulted in a climate of great uncertainty, both for philanthropic organizations that are focused on addressing vital needs around the world and for those who fund such organizations.

U.S. Counter-terrorism and Philanthropic Organizations

While counter-terrorism measures are not new, legal and administrative changes put into effect over the past three years have significantly altered the conditions under which philanthropic organizations, and especially international grantmakers, pursue their missions. Among other burdens, philanthropic organizations and grantmakers face the threat of asset blocking and possible criminal sanctions and civil liabilities. In addition, these philanthropic organizations are expected to shoulder a greater share of the burden for ensuring compliance with anti-terrorism measures and conducting due diligence with respect to all transactions. While all philanthropic organizations are subject to counter-terrorism measures, the burden of compliance under new rules falls most heavily on those organizations with international missions.

Counter-terrorism actions taken by the Treasury Department, the IRS, and many other federal agencies are guided by **Executive Order 13224**, "Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit, or Support Terrorism," signed under emergency powers of the president on September 23, 2001.⁶ The Executive Order blocks assets of persons identified as foreign terrorists and explicitly bans donations of funds, goods, and services to terrorists or those designated as supporters of terrorism. Under the authority of the Executive Order, several federal government entities (including the Departments of State, Treasury and Justice) and international organizations have created lists of known or suspected terrorists. All philanthropic organizations must ensure that they are not supporting any individual or group identified on these multiple lists, or with anyone associated with those listed. However, the Executive Order is seen as extending beyond those listed to also include organizations that *could* be listed in the future. Further, a philanthropic organization or grantmaker can violate the Executive Order and be faced with enforcement action (including the blocking of their own assets) even if it does not know that an organization it is supporting is associated with terrorism. Prohibited types of transactions include direct financial, in-kind, material and technical assistance.⁷

The **USA PATRIOT Act** (an acronym which stands for Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism) was enacted by Congress as Public Law 107-56 just a month after the Executive order took effect.⁸ Title III of this Act is focused specifically on terrorist financing. While the PATRIOT Act does not directly address philanthropic organizations, lawmakers have greater authority under this Act to more closely scrutinize where grant money is going

⁶ President George W. Bush, "Executive Order on Terrorist Financing" (September 23, 2001, Executive order 13224), available at <http://www.whitehouse.gov/news/releases/2001/09/20010924-1.html>.

⁷ For more information on the background, interpretation and application of Executive Order 13224, see the "Handbook on Counter-Terrorism Measures," pp. 2-10, available at <http://www.cof.org/files/Documents/Publications/2004/CounterTerrorismHandbook.pdf>.

⁸ USA PATRIOT Act of 2001, Public Law 107-56 (115 Stat. 272) (2001), available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d107:h.r.03162>.

and to apply stiff criminal penalties in extreme cases. In particular, the Act amended existing anti-terrorist laws to strengthen federal government powers to investigate, mandate information sharing, require reporting by financial institutions of suspicious activities, and further prohibit support to terrorists and terrorist organizations. In addition, the PATRIOT Act imposes significant criminal penalties against those who provide “material support” (a broad category which is presumed to include grants) that is *willfully, knowingly* or *intentionally* used in terrorist acts.

It is the issue of knowledge or intention that is most troublesome to the philanthropic community. The fear is that, in spite of their best efforts and intentions, the philanthropic organization or grantmaker will be found guilty under criminal law for having willfully, knowingly or intentionally provided material support for terrorism. However, recent court cases have established that the law cannot be violated inadvertently; criminal guilt can be shown only where the philanthropic organization *knew* in advance that the recipient of material support was designated as a “foreign terrorist organization.”⁹

Given the sense of urgency under which lawmakers were operating in 2001, changes in national policy were set in place under broad, bipartisan political support. Treasury Department and IRS actions have had the most significant effects on the operations of philanthropic organizations, but additional federal policy developments have occurred in areas such as international trade and embargoes and foreign aid.

As of December 2004, the Treasury Department had frozen the assets of 397 individuals and other entities as terrorists or supporters of terrorism under the authority of Executive Order 13224.¹⁰ Of these, 23 are “U.S. public charities.” It sounds like the rest of the million tax-exempt organizations that have exhibited no reason for suspicion whatsoever are being made to exact a very high price. However, government officials argue that their assessment of philanthropic activities is based on incomplete information. Many believe that the philanthropic sector has significant potential in financing terrorist activities. As the General Accounting Office (GAO) noted, “The true extent of [such connections] is unknown, owing to the criminal nature of the activity and the lack of systematic data collection and analyses.”¹¹ Some have argued that terrorists are successfully utilizing “alternative financing mechanisms” to earn, move and store money. At least in theory, philanthropic organizations might collect donations that are used for terrorist activities from both witting and unwitting donors.¹² They might also be involved in fraudulently moving funds to support terrorist activities.¹³ After reviewing concerns such as these, the GAO recommended, first in April 2002 and again in November 2003, that the IRS establish a system of interstate information sharing for identifying suspicious transactions involving philanthropic organizations.¹⁴

While setting up a systematic and objective method for tracking down and analyzing information collected through both federal and state programs should have

⁹ For more information on the background, interpretation and application of the USA PATRIOT Act, see the “Handbook on Counter-Terrorism Measures,” pp. 10-15.

¹⁰ U.S. Department of the Treasury, Office of Terrorism and Financial Intelligence, “Terrorism and Financial Intelligence,” updated December 2004, available at <http://www.treas.gov/offices/enforcement>.

¹¹ U.S. General Accounting Office, “Terrorist Financing: U.S. Agencies Should Systematically Assess Terrorists’ Use of Alternative Financing Mechanisms,” a report to Congressional Requesters (GAO-04-163), November 2003, p. 23, available at <http://www.gao.gov/new.items/d04163.pdf>.

¹² The Holy Land Foundation for Relief and Development, an Islamic organization, had its assets frozen in December 2001 for allegedly collecting and providing nearly \$13 million in support for Hamas, a Palestinian organization linked by the U.S. government to terrorism.

¹³ The Global Relief Foundation and the Benevolence International Foundation had their assets frozen for allegedly funneling money to Osama bin Laden and Al-Qaida members.

¹⁴ GAO, “Terrorist Financing” (GAO-04-163), p. 35.

been an IRS priority, this has not yet been completed. In his June 2004 testimony before the U.S. Senate Finance Committee, Commissioner of Internal Revenue Mark Everson made it clear that “the need for better coordination with the states and with other federal agencies” remained unfinished business that would be addressed as part of the “IRS Strategic Plan” for the period 2005-2009.¹⁵ In lieu of a systematic method for objectively assessing the available data on financial transactions by the philanthropic sector, the IRS is instead relying on examining sample foreign grantmaking organizations.

Inasmuch as random audits are standard procedure for the IRS, not many have questioned the efficacy of this approach. However, it is clear that there are considerable risks in relying on a system of select examinations in that politics could very well guide the choice of which organizations to examine. This is very apparent to the National Association for the Advancement of Colored People (NAACP), which has refused to turn over documents for an IRS investigation launched before the November 2004 presidential election. According to press reports, IRS Commissioner Everson has acknowledged that the NAACP along with several dozen other nonprofit groups are under investigation following politically-motivated complaints by two members of Congress.

The NAACP was informed that “its tax-exempt status was in jeopardy because its chairman, Julian Bond, had attacked President Bush in a speech to the group’s national convention in July.”¹⁶ Contrast this with the benign neglect on the part of the IRS with respect to political advocacy efforts by Focus on the Family, a conservative Christian group and 501(c)(3) tax-exempt organization based in Colorado Springs. In a November 2004 cover article in the organization’s monthly magazine, *Citizen*, George Bush was clearly endorsed as the candidate of choice.¹⁷ As these examples illustrate, the IRS exercises substantial discretion in applying its powers of investigation and can effectively intimidate as well as significantly burden organizations selected for review.

Even if the IRS is eventually successful in establishing a systematic and non-arbitrary process for reviewing the financial records of philanthropic organizations, this does not address another major concern regarding **due diligence**,¹⁸ such as that which is outlined in the **Treasury Department’s “Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities.”**¹⁹ Nobody disputes the need for careful assessment of entities potentially receiving grants. However, there is major disagreement on how the due diligence gets accomplished. Much of the energy in recent policy applications has been focused

¹⁵ Everson, IRS Commissioner, June 2004 testimony before the Senate Finance Committee (IR-2004-81). Discussion of current and planned efforts to address greater information-sharing with state agencies is discussed under Goal 2, “Enhance Enforcement of the Tax Law” under the “IRS Strategic Plan, 2005-2009,” found at http://www.irs.gov/pub/irs-utl/strategic_plan_05-09.pdf.

¹⁶ Jim Drinkard, “NAACP Calls IRS Probe ‘Political,’ Refuses to Comply,” USA Today, January 30, 2005, available at http://www.usatoday.com/news/washington/2005-01-30-naacp-irs-probe_x.htm. Under the U.S. Tax Code, section 501(c)(3) tax-exempt organizations are forbidden from taking sides in political campaigns. The rule requires that nonprofits must avoid “reasonably overt communication” regarding candidate support or opposition. The NAACP is arguing that the IRS appears to be using a more expansive definition of political activity than it has in the past.

¹⁷ Karla Dial, “What’s At Stake,” *Citizen*, a monthly magazine printed by Focus on the Family, November 2004, available at <http://www.family.org/cforum/citizenmag/coverstory/a0034350.cfm>. In a letter dated February 1, 2005, Citizens Project, a Colorado Springs organization that monitors religious organizations, has asked the IRS to investigate whether the printing of this story is a violation of the law forbidding political endorsements. See http://www.citizensproject.org/FOF_Complaint_ltr.pdf. See also Associated Press coverage of this story in “Group Wants IRS to Investigate Focus on the Family,” February 2, 2005, available at <http://www.thedenverchannel.com/print/4157528/detail.html>.

¹⁸ Due diligence is a process of investigation and evaluation into the details of a potential investment or funding decision, including examination of operations and management and the verification of facts.

¹⁹ U.S. Department of the Treasury, “Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities” (November 7, 2002), available at <http://www.treas.gov/press/releases/docs/tocc.pdf>.

on establishing lists of terrorist organizations and those suspected of being tied to such organizations, and then requiring government agencies and philanthropic organizations to check their contacts against such lists.²⁰ For responsible, experienced international grantmakers this is highly insufficient. Due diligence means building a relationship of trust with a potential grantee such that (a) the grantmaker and grantee work together on mutually understood terms; and (b) the grantmaker believes (through references, endorsements, research, direct communications, etc.) that the grantee is capable of carrying out the activity for which the grant is being made. Different organizations have different procedures for investigating potential grantees, often dependent on the type of mission it pursues – human rights versus humanitarian relief, for example. Each is tailoring their efforts to match their mission against their own organizational styles and resources, and most have established very effective processes. It is questionable whether any system of “best practices” would match the needs of every philanthropic organization.

Measures to Address Fraud within Philanthropic Organizations

Aside from specific terrorist concerns, media coverage over the past couple of years has created a more general and growing sense of crisis in the philanthropic sector. A sampling of headlines points to good reason for dwindling public trust:

- “Some Foundations Spend Lavishly on Own Board Members,” *Baltimore Sun*, 5/11/03
- “Underfunded IRS Unable to Monitor Trusts,” *Boston Globe*, 10/9/03

Though the media has managed to isolate the abuses of just a handful of organizations, the entire sector has been implicated. In response to headlines such as these, the demands for new restrictions find broad public support.

Legislative and administrative actions focused on the philanthropic sector come on the heels of policy changes already enacted to address corporate governance and financial disclosure. In the wake of corporate financial scandals, including those affecting Enron, Arthur Anderson, and WorldCom, the U.S. Congress passed the Sarbanes-Oxley Act of 2002, “An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”²¹ Most observers consider the Sarbanes-Oxley Act as the single most important law affecting corporate affairs since the U.S. securities laws of the early 1930s. This Act applied to public companies, leaving out the nonprofit sector as well as non-public companies. However, it raised the bar for all corporate standards and paved the way for additional policy changes. In many respects the more recent proposals focused on fraud within the philanthropic sector mirror the requirements set in place by Sarbanes-Oxley.²²

- “Justices Rule Charity May be Charged with Fraud,” *New York Times*, 5/6/03
- “Billions in Charity Money Could be Saved, Study Says,” *New York Times*, 5/10/03

²⁰ Under Section IV.B. of the Treasury Department’s “Voluntary Best Practices” document philanthropic organizations are advised to “conduct basic vetting of potential foreign recipient organizations.” As described under this section, this principally requires that the philanthropic organization “demonstrate that it verified that the foreign recipient organization 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.”

²¹ Public Law 107-204, Stat. 745, signed into law on July 30, 2002.

²² This lengthy measure includes 11 titles covering a range of concerns such as board membership and activities; accounting standards; auditing requirements; officer accountability for the content of their corporation’s income tax returns; and investigations and disciplinary proceedings.

The **Senate Finance Committee** has taken the initiative in extending anti-fraud measures to philanthropic organizations. In June 2004 Senate Committee staff distributed a 19-page discussion draft outlining proposed changes to a wide variety of rules governing the philanthropic sector.²³ In that same month, the Finance Committee held a hearing to address perceived abuses in the nonprofit sector, using the staff document as the focus of hearing discussion.²⁴ As Committee Chair Chuck Grassley argued in his opening statement, “far too many charities have broken the understood covenant between the taxpayers and nonprofits – that charities are to benefit the public good, not fill the pockets of private individuals.” Grassley also noted that there is a “growing number of individuals who knowingly set up a charity to evade taxes,” and that still other organizations fall short due to “poor governance or failure to abide by best practices.” Committee minority leader Max Baucus found that a “proliferation of sloppy, unethical, and criminal behavior” within the nonprofit sector has led to “a crisis in confidence.” Hearing witnesses included IRS Commissioner Mark Everson, state officials, whistleblowers, and representatives of groups suggesting policy changes.

A month after the June 22 hearing, the committee convened a roundtable to generate additional feedback from the nonprofit sector on proposed restrictions.²⁵ While the 108th Congress adjourned in December 2004 without the introduction of new legislation addressing the proposals described by the Senate Finance Committee, members of Congress have continued to promise that legislation is forthcoming.

Indeed, Senate Finance Committee leaders announced at an April 5, 2005, hearing that they would be introducing “comprehensive charitable governance reform legislation” in the next few months. The House Ways and Means Committee has also held several oversight hearings on the tax-exempt sector, most recently examining in an April 20, 2005, hearing what the IRS is doing to improve compliance with the law. At the same time that Congress is preparing to take legislative action, the IRS is implementing administrative changes. It remains to be seen which institution will have greater influence over these developing policies.

Conservative Politics and Progressive Philanthropies

Two specific arguments have been advanced by the political leadership in Washington, one focused on counter-terrorism, the other on stemming fraud in the philanthropic sector. What hasn't been explained is how certain targets of policy change efforts fit into these arguments. For example, given that there is no evidence of either fraud or terrorist connections within existing donor advised funds, why the heightened restrictions on these funds? Among other proposals, the Senate Finance Committee is seeking to prohibit grants from donor advised funds to “nondomestic organizations” unless those organizations are included on an “IRS published list of approved foreign organizations.”²⁶ More generally, since the number of organizations found to be engaged in suspicious activities is so slim, one must wonder if any restrictions are truly warranted.

²³ U.S. Senate Finance Committee staff discussion draft, “Tax Exempt Governance Proposals” (June 2004), available at <http://www.finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf>.

²⁴ “Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities,” hearing before the U.S. Senate Committee on Finance, June 22, 2004. For transcripts of member and witness statements see <http://finance.senate.gov/sitepages/hearing062204.htm>.

²⁵ The Finance Committee invited 18 individuals to submit written comments on the discussion draft proposals, including individuals from academia, the legal sector (including the American Bar Association), professional organizations (such as the American Society of Association Executives and the American Hospital Association), and nonprofits and foundations (Independent Sector, Goodwill Industries, United Way of America, Council on Foundations, and the National Council of Nonprofit Associations). For a summary of the July 22, 2004, roundtable discussion, along with copies of supporting documents (including written testimony from each of the invited participants), see the Council on Foundations website at <http://www.cof.org/Content/General/Display.cfm?contentID=2088>.

²⁶ U.S. Senate Finance Committee staff discussion draft, p. 2.

Sentiments appear to be growing within the conservative and Republican ranks that the missions pursued by many philanthropic organizations fail to match conservative political ideals and therefore should arouse close watching, if not actual obstruction. In June 2003, the American Enterprise Institute (AEI) and the Federalist Society launched the website [NGOWatch.org](http://www.ngowatch.org) to bring “clarity and accountability to the burgeoning world of NGOs.”²⁷ This new website was announced at a June 11, 2003, conference – entitled “Nongovernmental Organizations: The Growing Power of an Unelected Few” – sponsored by the AEI, a Washington think tank that is considered highly influential with the Bush Administration.²⁸

As summed up by one reporter, the message delivered at the conference went as follows: “While non-governmental organizations (NGOs) such as Amnesty International, Greenpeace, and Oxfam have made significant contributions to human rights, the environment, and development, they are using their growing prominence and power to pursue a ‘liberal’ agenda at the international level that threatens U.S. sovereignty and free-market capitalism.”²⁹ One conference speaker elaborated by stating that NGOs are “destroying much of civil society, undermining governments and good governance, and this is holding back developing countries from enjoying the same quality of life that we do.”³⁰

Some analysts have started to make the connection between such opinions and the policy agenda now facing both legislators and administrators. For the groups who gathered for the AEI conference, “international NGOs raise concerns that go far beyond transparency and accountability.”³¹

If these were but the opinions of just a few it wouldn’t much matter to the policy debate at hand. However, an analysis of the grantmaking of politically conservative foundations finds that “nonprofit infrastructure” is one of the public policy emphases of recent conservative foundations’ grantmaking.³² Moreover, in a separate review of conservative foundations, the authors concluded with respect to funding strategies that “conservative foundations have overt political and ideological agendas and invest comprehensively to promote a given issue on every front. In the words of the director of one foundation, the right understands that government policies are based on information from a ‘conveyor belt from thinkers, academics and activists,’ and provides funding accordingly.”³³ It is clear that political leaders are attempting to use public anxiety created around the issues of terrorism and fraud as vehicles for addressing other political ends.

27 [NGOWatch](http://www.ngowatch.org/info.htm), a project of the American Enterprise Institute and the Federalist Society, <http://www.ngowatch.org/info.htm>

28 Conference transcripts, speaker biographies, and papers prepared for this event are all available from the American Enterprise Institute at http://www.aei.org/events/eventID.329,filter./event_detail.asp.

29 Jim Lobe, “U.S. Conservatives Take Aim at NGOs,” [OneWorld.net](http://www.oneworld.net), p.1, made available through Common Dreams News Center at <http://www.commondreams.org/headlines03/0612-09.htm>.

30 Mike Nahan of the Institute of Public Affairs in Australia, a conference cosponsor, quoted in the AEI Newsletter, August 2003, available at http://www.aei.org/news/newsID.18081/news_detail.asp.

31 Lobe, p. 2.

32 National Committee for Responsive Philanthropy (NCRP), press release announcing the publication of a new report, “Axis of Ideology: Conservative Foundations and Public Policy,” April 6, 2004. The report was based on a review of 79 conservative foundations and their grants to “nearly 350 archconservative policy nonprofit organizations between 1999 and 2001.” The report concluded that “Conservative foundations are brazen and confident in their grantmaking to advance a conservative political agenda, constituting a vital component for financing the right wing policy juggernaut... These conservative foundations know how to mobilize resources for their ideological causes.” Available at <http://www.ncrp.org/Releases/PR-04-06-2004.htm>.

33 People For the American Way, summary of a report first published in 1996, “Buying a Movement: Right-Wing Foundations and American Politics,” available at <http://www.pfaw.org/pfaw/general/default.aspx?oid=2055>. As the report points out, one of the unfortunate realities is that these trends stand in sharp contrast to the giving patterns of the large “progressive” foundations. The “enormous funding gap permits the conservative publications to focus more of their energies on ‘reporting’ and marketing their stories to mainstream press, and less on fundraising and advertising sales.”

Review of Select Policy Proposals Aimed at the Philanthropic Sector

Numerous efforts are currently underway to change the rules under which philanthropic organizations operate. Some of these efforts are overlapping. For example, the Treasury Department, the IRS and the Senate Finance Committee are all working through their own versions of “best practices” and “good governance” procedures. Other proposed changes by these three entities are quite distinct. The discussion that follows is far from comprehensive. It focuses instead on proposals that are likely to have the greatest impacts on vulnerable groups, including smaller philanthropic organizations, organizations engaged in international philanthropic efforts, and progressive social change organizations.

Treasury Department’s “Voluntary” Best Practices Guidelines for U.S.-Based Charities

The Treasury Department’s Office of Foreign Asset Control issued the “Voluntary Treasury Guidelines” on November 7, 2002. The Guidelines were published with the intent of assisting nonprofits and grantmakers in their compliance with government anti-terrorist financing measures.³⁴

The Voluntary Guidelines consist of four sections covering the following issues:

- *Governance:* Operating under governing instruments (such as charters, articles of incorporation and bylaws) and governing by a board of directors.
- *Disclosure/Transparency in Governance and Finances:* Keeping records on board members, key employees, and distribution and solicitations of funds.

- *Financial Practice/Accountability:* Adopting annual budgets, appointing a financial officer, conducting independent audits, and accounting for all receipts and disbursements of funds.
- *Anti-Terrorist Financing Procedures:* Collecting information about foreign recipient organizations, conducting basic vetting of potential foreign recipient organizations, and reviewing the financial operations of foreign recipient organizations.

Most controversial in these Guidelines is section IV listing specific steps that nonprofits and grantmakers are advised to take before any funds are distributed to foreign recipient organizations. These include a collection of very detailed information about not just foreign grantees but also of foreign vendors and foreign financial institutions. The Treasury Guidelines suggest that a grantmaker is responsible for grant monies until expended by the ultimate grantee. If fully instituted, the voluntary compliance measures would be particularly onerous to small philanthropic organizations that have neither the staff nor resources to conduct such detailed and time consuming monitoring. Indeed, some

³⁴ When it released the Voluntary Guidelines, the Treasury Department contended that they had been approached by members of the Arab American and American Muslim communities who were concerned about the decline of charitable giving in their communities after the Treasury Department had blocked the assets of three U.S.-based nonprofits deemed to be tied to organizations officially designated by the U.S. government as foreign terrorist organizations. They had asked for guidance on ways to enhance future giving to their organizations. The Voluntary Treasury Guidelines were developed in response. See the Department of Treasury Office of Public Affairs press release, “Response to Inquiries from Arab American and American Muslim Communities for Guidance on Charitable Best Practices” (November 7, 2002) (IRS Press Release PO-3607), available at <http://www.ustreas.gov/press/releases/po3607.htm>.

have called the procedures outlined in section IV as “logistically impossible.”³⁵ Further, the Guidelines seem to place “the nonprofit sector in the role of law enforcement or regulators, by requiring collection and assessment of information that is not needed for carrying out charitable activities.”³⁶

Though the Treasury Guidelines are still considered voluntary, some nonprofits in response have suspended program activities with international partners. Others have adopted a wait-and-see approach while awaiting conclusion of an inquiry launched by the Internal Revenue Service focused on international grantmaking and other international activities by the nonprofit sector. In a May 2003 announcement, the IRS requested public comment on “which of the best practices specified in the [Voluntary Treasury] guidelines organizations currently use,” and whether these are “useful in achieving compliance with federal income tax requirements.”³⁷ Though public comments were due by July 18, 2003, the IRS has yet to provide any direct response following on this review process.

U.S. Senate Finance Committee Legislative Proposals

Taking its cues from the Sarbanes-Oxley Act of 2002 addressing corporate fraud, the Senate Finance Committee has been discussing and drafting legislation

focused specifically on fraud in the philanthropic sector. However, not all of the issues under discussion by the Senate Finance Committee can be explained on the grounds of fraud prevention. Proposed donor advised fund (DAF) restrictions stand out in this regard in that there seems to be no evidence that such funds are more vulnerable to fraud than any other type of philanthropic entity. Highlighted below are brief summaries and discussion of DAF and several other key proposals under consideration by the Senate Finance Committee.

Donor advised fund (DAF) restrictions.

Twelve proposals relate to DAFs, though each is only briefly described in the Finance Committee staff discussion draft. Most focus on ensuring that contributions received by such funds are distributed in a timely fashion to philanthropic purposes, and that grants from such funds do not have a private benefit for the donor. After careful review of these proposals, a broad spectrum of philanthropic organizations and policy experts found little justification for singling out DAFs for special rules.³⁸ Other than the fact that DAFs currently have no statutory definition, they face the same potential for fraud or misuse as any other philanthropic activity.³⁹ The question then arises as to why the Senate Finance Committee has identified DAFs as a primary target for their 2005 legislative agenda.

³⁵ OMB Watch, “OMB Watch Comments on Treasury Department Anti-Terrorist Financing Guidelines,” comments provided to the IRS in response to IRS Announcement 2003-29 soliciting feedback on international grant-making and international activities by domestic 501(c)(3) organizations (August 11, 2003) (OMB article 1736), available at <http://www.ombwatch.org/article/articleview/1736/1/3/>.

³⁶ *Ibid.*, p. 1. For further discussion of and commentary on the Voluntary Treasury Guidelines, see the March 2004 “Handbook on Counter-Terrorism Measures: What U.S. Nonprofits and Grantmakers Need to Know” (produced by the Day, Berry & Howard Foundation for the organizations Independent Sector, InterAction, and the Council on Foundations), pp. 20-23, available at: <http://www.cof.org/files/Documents/Publications/2004/CounterTerrorismHandbook.pdf>.

³⁷ Internal Revenue Service, Announcement 2003-29, requesting “public comment on how the IRS might clarify existing requirements that section 501(c)(3) organizations must meet with respect to international grant-making and other international activities” (May 2003), p. 5, available at <http://www.irs.gov/pub/irs-drop/a-03-29.pdf>.

³⁸ Proposed restrictions on DAFs are the subject of extensive review by the Panel on the Nonprofit Sector, convened by Independent Sector for the explicit purpose of providing recommendations to the Senate Finance Committee as they develop their legislative proposals. Draft recommendations posted January 24, 2005, regarding the DAF proposals were prepared by a Work Group and are still under review by the Panel. Work Group recommendations are available at <http://www.nonprofitpanel.org/workgrouprecs/firstrecs>, “#10: Donor-Advised Funds.” For more information on the Panel on the Nonprofit Sector, see p. 18 of this document.

³⁹ *Ibid.*, p.2. The Work Group will recommend a definition that will “make clear, among other things, that a donor-advised fund is a separately identified fund or account consisting of assets owned by a charitable organization with respect to which there is an understanding between the donor and the charity that the charity will consider non-binding advice from the donor (or an advisor) regarding distributions of the amount held in the fund.”

Two proposals cause particular concern within the philanthropic sector: a proposal to prohibit private foundations from making grants to donor advised funds; and a proposal permitting grants by DAFs to nondomestic organizations only if the nondomestic organization appears on “an IRS published list of approved foreign organizations.”⁴⁰ Prohibitions against private foundation grants to DAFs would unnecessarily limit the ability of foundations to partner with certain other organizations that have direct knowledge of and experience with local conditions overseas, or to engage in collaborative activities with community foundations. Experts reviewing this issue recommend that if safeguards against abuse are shown to be inadequate (and there is no evidence that this is the case), then rules should be applicable to all organizations, not just donor advised funds.⁴¹

With regard to grants to foreign grantees, the general sense is that there are no special concerns requiring new rules applied only to DAFs. Instead, most recognize that through DAFs individuals can participate in international philanthropy in an effective and accountable way, tapping into the experience and expertise of the granting foundation.⁴² Indeed, proposing that grants be allowed only to “approved foreign organizations” appears to be one of the most blatant examples of political overreach. Those who would have the power to decide which organizations make the list and which do not would control the entire exercise of international philanthropy.

Five-year review of tax-exempt status by the IRS.

Every 5 years the IRS would determine whether a nonprofit continues to operate for exempt purposes, and if the original determination letter should remain in effect.⁴³ This proposal would allow the IRS to undertake a more thorough review of nonprofits than is possible under the Form 1023 exemption application and increase the audit rate across the nonprofit sector. While many nonprofits are not opposed in principle to the addition of new review processes, there is concern that such additional review could result in significant administrative and cost burdens to nonprofits, the majority of which are already in full compliance with IRS rules and regulations governing tax-exempt organizations.

IRS Form 990 revisions.

The Senate staff discussion draft includes numerous proposals for new requirements to ensure “accurate, complete, timely, consistent, and informative reporting” by tax-exempt organizations.⁴⁴ Proposals include: requiring the organization’s CEO to sign to the accuracy of the Form 990 return; imposing penalties for failure to file an accurate or complete Form 990, or failure to file in a timely manner; expediting and mandating electronic filing of the Form 990; establishing IRS standards for filing; requiring independent audits of Form 990; requiring increased disclosure of relationships with other organizations and insider transactions; requiring detailed disclosure of organizational goals, activities, and expenses; and

⁴⁰ U.S. Senate Finance Committee staff discussion draft, Item A.2., under “Exempt Status Reforms,” p. 1. Also, prohibition of foundation grants to DAFs is listed separately under Item C.3., “Grants and Expense Reforms,” p. 6.

⁴¹ Panel on the Nonprofit Sector, “#10: Donor-Advised Funds,” p. 9. See also comments produced by the Council on Foundations on the proposed prohibition of foundation grants to DAFs in “Comments on Discussion Draft on Reforms to Oversight of Charitable Organizations” presented to the U.S. Senate Committee on Finance in the July 22, 2004, Charitable Governance Roundtable, p. 10, available at http://www.cof.org/files/Documents/Government/04-jg_final_comments_for_roundtable1.pdf.

⁴² Panel on the Nonprofit Sector, “#10: Donor-Advised Funds,” discussed under footnote 4 appearing on p. 10.

⁴³ U.S. Senate Finance Committee staff discussion draft, Item A.1., under “Exempt Status Reforms,” p. 1.

⁴⁴ U.S. Senate Finance Committee staff discussion draft, Item E., 1-9., “Improve Quality and Scope of Forms 990 and Financial Statements,” pp. 7-10.

requiring increased disclosure of investments by nonprofits. While most nonprofits agree that Form 990 is in need of improvement, most of the proposals outlined by the Senate staff discussion draft would cause greater administrative and financial burden than IRS compliance benefit. There are two exceptions that would constitute improvements: clearer information and standards on how to file the forms (increasing the likelihood that the forms will be accurate, complete, timely, and so on) and electronic filing. It should be noted that the IRS is simultaneously reviewing Form 990 for revision, but the details of such proposed changes have not been made public.

Governance and “best practices” for exempt organizations.

The staff discussion draft includes 6 sets of proposals focused on strengthening corporate governance and responsibility within the nonprofit sector.⁴⁵ The stated objective is to restore integrity and public confidence to this beleaguered sector. The challenge as the Senate Finance Committee sees it is to determine how best to achieve this goal. Given the great diversity across the nonprofit sector, one-size-fits-all standards would create problems for many organizations. Specific proposals focus on board duties, board composition, and board/officer removal. Any new requirements in this area need to be designed so as not to discourage individuals from taking on the responsibilities associated with board service in the nonprofit sector. Other proposals address government encouragement of best practices, establishment of an accreditation process, and application of prudent investor rules. The suggested changes raise the question of who most appropriately should set the standards for best practices and accreditation decisions. In addition, new requirements would likely be costly (requiring organizations to pay fees to retain their accreditation

status) and time consuming, placing particular hardship on smaller organizations.

Internal Revenue Service Proposals

The IRS has taken a number of steps over the past couple of years to impose its own set of new restrictions on the philanthropic sector. IRS Commissioner Everson describes the IRS response to alleged abuses as broad-based, including “an enhanced examination program, stricter scrutiny in our application process, partnering efforts with the state attorneys general and the Federal Trade Commission (FTC), as well as warnings to consumers about our concerns. We will use all tools available to ensure that these organizations act lawfully, including revoking tax-exempt status where warranted.”⁴⁶

IRS current priorities (“FY 2005 Exempt Organizations (EO) Implementing Guidelines”).

Published in November 2004, the Implementing Guidelines comprise the “workplan” for the IRS Exempt Organizations Division in the coming year.⁴⁷ EO has four priority initiatives for FY 2005:

- *Abusive Tax Avoidance Transactions (ATAT)*: Under this initiative, EO plans to conduct examinations of donor advised funds to identify organizations with a high potential for abuse. Also subject to examination: IRC Section 501(c)(15) entities and producer-owned reinsurance companies; IRC Section 501(a)(3) supporting organizations; and Housing and Urban Development programs.
- *Anti-Terrorism*: EO plans to examine a sample of foreign grantmaking

⁴⁵ U.S. Senate Finance Committee staff discussion draft, Item G., 1-6., “Encourage Strong Governance and Best Practices for Exempt Organizations,” pp. 11-15.

⁴⁶ Everson, IRS, testimony before the U.S. Senate Committee on Finance (June, 22, 2004) (IR-2004-81), p. 4.

⁴⁷ Internal Revenue Service, Exempt Organizations Division, “FY 2005 Exempt Organizations (EO) Implementing Guidelines” (November 2004), available at: http://www.irs.gov/pub/irs-tege/implementing_guidelines_1104.pdf.

organizations to ensure that funds are used for their intended purpose and not diverted for terrorist activity. [Other IRS counter-terrorism initiatives are discussed in the next section, below.]

- *Credit Counseling:* Examinations initiated in FY 2004 will continue through the new fiscal year and will also include rigorous review of applications for exempt status from such organizations.
- *Excessive Compensation:* In FY 2005 the Tax Exempt Compensation Enforcement Project expects to send out approximately 2,000 compliance check letters and examine select returns.

IRS counter-terrorism measures.

IRS announcement 2003-29, released in May 2003, focused on a broad list of programs for review as to standards, controls and reporting requirements applied to international grants. The IRS asked for public comment on practices and safeguards in current use by nonprofits and foundations to ensure that grants to foreign recipients are not diverted for nonexempt purposes, including terrorist activities. The process was designed to provide information needed to clarify standards and requirements and revise tax return forms for 501(c)(3) organizations.

The IRS is apparently still drafting clarifications and revisions. However, in November 2004 it announced several fiscal year 2005 priorities in the area of counter-terrorism actions that would be applied to tax-exempt organizations.⁴⁸ Specifically, the IRS plans to:

- *Examine a sample of returns to determine the effectiveness of controls put in place to monitor the distribution of overseas grants and other assistance.*
- *Establish a Fraud and Financial Transaction Unit (FFTU) to address complex financial fraud cases.*
- *Provide legal and technical training regarding exempt organizations as needed to various government personnel.*
- *Monitor information provided through the determination process that would help identify organizations that are potentially involved in supporting terrorist efforts.*
- *Develop a data acquisition strategy to enhance IRS anti-terrorism efforts.*

Revision of IRS forms and instructions.

In October 2004 revised IRS Form 1023, the *Application for Recognition of Exemption*, was published to reflect tax law changes, to streamline the application process, and to gather information about potentially abusive transactions (focusing on organizational governance issues relating to compensation practices and conflicts of interest). The IRS asserts that the aim is to ensure that organizations seeking exemption meet all requirements before exempt status is approved. As already noted, IRS Form 990, the annual information return for exempt organizations, is still undergoing a comprehensive overhaul with the goal of requiring tax-exempt organizations to provide more information relating to abusive tax avoidance transactions. Revision efforts are focusing on improving the usefulness of Form 990 as a compliance tool and information source for the IRS, state taxing agencies and the general public. The IRS has not announced when this work will be completed.

⁴⁸ IRS, "FY 2005 Exempt Organizations (EO) Implementing Guidelines" (November 2004), p. 4.

Increased investigations and audits.

Over the past year, a select number of public charities, private foundations, tax-exempt credit-counseling organizations, and donor advised funds have been subject to IRS audits, investigations, and application reviews. The IRS argues that such investigations are necessary to identify problems, enable the development of better enforcement methods, focus educational efforts and improve the forms for collecting information.⁴⁹ What isn't clear are the criteria for selecting particular organizations for such scrutiny. IRS also announced that in summer 2004 it would launch a comprehensive enforcement project to explore issues of high compensation paid to individuals (more than \$1 million) by contacting "hundreds of organizations" of various sizes to obtain detailed information and supporting documents. By November 2004, the IRS planned to commence a market segment initiative focused on general compliance issues involving approximately 400 examinations of different categories of private foundations. In addition, in 2004 over 100 individuals were under audit in connection with allegations of donor advised fund abuse.

Development of a plain-language brochure for tax-exempt organizations describing "best practices"

In June 2004 the IRS stated that a plain-language brochure was being prepared "to set forth certain practices we believe will be useful in promoting good governance, ethics, and internal oversight" by tax-exempt organizations.⁵⁰ Though slated for fall 2004 publication, this brochure is not yet available. According to the IRS, the brochure "will explore practices that are not necessarily required by law but that may elevate the standards, conduct, and workings of exempt organizations. Although the IRS does not have authority to require organizations to follow

specific practices, organizations without effective governance controls are more likely to have compliance problems."⁵¹ Among other issues, the IRS expects to cover standards of integrity; governing boards; conflict of interest; record-keeping; and fundraising practices.

Other Federal Government Counter-Terrorism Actions Affecting Philanthropic Organizations

Under Executive Order 13224, "all agencies of the United States Government" were "directed to take all appropriate measures within their authority to carry out the provisions" of the order. While many other changes in government procedures have been suggested or implemented under this order, two more should be singled out for comment. First are actions related to embargoes and trade sanctions, powerful instruments of U.S. foreign policy administered by both the Treasury and Commerce Departments. In the post September 11 world, enforcement of embargoes and trade sanctions has increased such that nonprofits and grantmakers risk substantial civil and criminal penalties if assistance is provided to an embargoed country unless the activities are specifically exempt (due to humanitarian emergency relief activities, for example).⁵² Second, organizations funded by the U.S. Agency for International Development (USAID) face additional anti-terrorist measures under new certification requirements that apply to all USAID funding recipients, ensuring that such funds neither directly nor indirectly support terrorism.⁵³

⁴⁹ Everson, IRS (IR-2004-81). A number of specific current IRS compliance and enforcement actions are described.

⁵⁰ Everson, IRS (IR-2004-81), p. 7.

⁵¹ Everson, IRS (IR-2004-81), p. 7.

⁵² "Handbook on Counter-Terrorism Measures," pp. 15-17.

⁵³ *Ibid.*, pp. 23-25.

What Next?

The Philanthropic Sector Responds

Confronted by increasingly restrictive policies, numerous nonprofits and grantmakers have felt compelled to respond. They know that they are faced with new rules that might ultimately force them to cease addressing the critical social needs, human rights, development concerns and other service and support missions that define their existence. Many have responded to the requests for public comment and testimony with their own suggestions, and some have organized coalitions to ensure that their voices will be heard when decisions are made. Some recent actions include the following:

Handbook on Counter-Terrorism Measures: What U.S. Nonprofits and Grantmakers Need to Know

The Handbook, published on March 15, 2004, provides review and analysis of the laws, regulations and enforcement measures set in place in response to the events of September 11, 2001. The Handbook was produced by Independent Sector, InterAction, the Council on Foundations, and the Day, Berry & Howard Foundation to assist nonprofits and foundations in meeting new requirements.⁵⁴

Principles for International Charity

Following the Treasury Department's release of its "Voluntary Guidelines," a coalition of more than 25 philanthropic organizations – including Independent Sector, the Council on Foundations, InterAction, and Grantmakers Without Borders – joined forces to develop an alternative to the guidelines. In March 2005, the working group organized around this effort released a statement of "Principles for International Charity." The working group will submit the final "Principles" to the Treasury Department with a request that these replace the 2002 "Voluntary Guidelines."⁵⁵

ACLU v. U.S. Office of Personnel Management: Lawsuit filed November 10, 2004, to challenge the government's "watch list policy."

The American Civil Liberties Union (ACLU), together with an alliance of other philanthropic organizations, filed a lawsuit in the U.S District Court for the District of Columbia challenging the federal Office of Personnel Management's (OPM) Combined Federal Campaign requirement that obligates philanthropic organizations to check their employees and expenditures against several terrorist watch lists. As charged by the ACLU, "the watch list policy is vague, misleading, and violates the First and Fifth Amendments to the U.S Constitution." The case focuses on an OPM policy set in early 2004 requiring that philanthropic organizations participating in the federal government's annual "charity drive" certify that they do not knowingly employ people or give money to groups whose names appear on several terrorist watch lists.⁵⁶

Panel on the Nonprofit Sector.

With encouragement from the Senate Finance Committee, the Panel on the Nonprofit Sector was formed under the leadership of Independent Sector (IS). The Panel was asked to provide findings and

⁵⁴ The "Handbook on Counter-Terrorism Measures" is available at <http://www.cof.org/files/Documents/Publications/2004/CounterTerrorismHandbook.pdf>.

⁵⁵ A copy of the "Principles" can be found at http://www.independentsector.org/PDFs/treasury_guidelines.pdf.

⁵⁶ Information available at <http://www.aclu.org/SafeandFree/SafeandFree.cfm?ID=16239&c=206>.

recommendations focused on the oversight and governance of nonprofit organizations.⁵⁷ The Panel on the Nonprofit Sector is comprised of leaders from a wide spectrum of public nonprofits and private foundations from all parts of the country, reflecting diversity in mission, perspective, and scope of work.⁵⁸ In March 2005 the Panel released an interim report which pointed to the need for best practices, accepted standards and self-regulation. The report advocated more transparency to enable public oversight and confidence in tax-exempt entities. It concluded that the IRS should also recognize that additional reporting requirements would be more difficult for exempt entities that are small and lack resources.⁵⁹ A new set of draft recommendations was released for public comment by this same group on May 10, 2005, and a June report to the Senate Finance Committee is under preparation. While the scope of this effort is significant, it is unlikely that the interests of all nonprofits are being represented.

Further Information and Contacts

Clearly, this is a fluid set of issues, many of which are promised further action in the near future. The following contacts should be very valuable in terms of keeping abreast of ongoing developments.

Policy organizations:

- OMB Watch,
<http://www.ombwatch.org/>
- Grantmakers Without Borders (Gw/oB),
<http://www.internationaldonors.org/advicegs/>
- Council on Foundations,
<http://www.cof.org/>
- Independent Sector (IS),
<http://www.independentsector.org/>
- National Council of Nonprofit Associations,
<http://www.ncna.org>

⁵⁷ For a complete listing of documents related to the Panel on the Nonprofit Sector, see Independent Sector's webpage at <http://www.independentsector.org/panel/main.htm>.

⁵⁸ Organizations represented on the Panel include: American Red Cross, American Cancer Society, American Heart Association, The California Wellness Foundation, Center on Budget and Policy Priorities, Council on Foundations, Council on Michigan Foundations, Evangelical Council for Financial Accountability, Ford Foundation, William and Flora Hewlett Foundation, Independent Sector, W.K. Kellogg Foundation, Leadership Conference on Civil Rights, The Meadows Foundation, Michigan Nonprofit Association, Minnesota Council of Nonprofits, National Council of La Raza, New York Community Trust, The Pittsburgh Foundation, Rockefeller Brothers Fund, Surdna Foundation, United Nations Foundation, United Way of America, and YMCA of the USA.

⁵⁹ The March 2005 interim report is available at <http://www.nonprofitpanel.org/interim/>.

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