

DESIGNING & DOCUMENTING CHARITABLE GIFTS

**American Bar Association
Section of Taxation
&
Real Property Probate & Trust Section
Joint Fall Meeting
San Francisco, California
September 16, 2005**

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Table of Contents

I.	Introduction	1
II.	Conditions and Restrictions.....	1
III.	Benefiting Individuals	2
IV.	Charitable Split-Interest Gifts.....	3
V.	Artwork.....	4
VI.	Naming Opportunities	5
VII.	Investment Management	5
VIII.	Valuation	6
IX.	Standing to Enforce.....	6
X.	Gift Agreements.....	7
XI.	Gift Acceptance Policies	8
XII.	Prevention	9
XIII.	Professional Ethics	9
XIV.	Conclusion	10

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I. Introduction

Many of today's donors desire to designate their charitable contributions for specific purposes or to impose other conditions on these gifts. These conditions and restrictions are usually well-intended efforts to ensure that a donor's wishes are carried out by the charitable beneficiary, but careful thought and planning is required to ensure these limitations do not endanger the deductibility of the contribution by the donor while ensuring proper use of the gift by the charity.

II. Conditions and Restrictions

A contribution is deductible only if it is made "to or for the use of" a charitable organization.¹ A donor may earmark a contribution to charity for a particular use without jeopardizing the charitable deduction, provided the restriction does not prevent the charity from freely using the transferred assets, or, at a minimum, the income therefrom, in furtherance of its charitable purposes.² The Regulations provide examples of permissible restrictions, including the contribution of land to a city to be used as a public park, where the city intends to use the land for such purpose at the time of the gift; the creation of an endowment fund for a particular university department; and the donation of funds for the construction of a building sought to be built by an exempt organization.³

However, if the gift is designated or earmarked for a non-charitable purpose, or even a charitable purpose that is outside of the donee organization's mission, the gift is not deductible. To ensure deductibility, the donor should utilize a gift agreement that specifically recognizes that the conditions placed upon the gift are in furtherance of, and consistent with, the donee's exempt purpose. For substantial gifts, a board resolution from the donee organization containing a similar acknowledgment might be considered.

When designing conditional gifts, reverter clauses are sometimes used. For example, if the city described in the Regulations ceased to use the donated property as a public park, the gift agreement or deed of gift could provide that ownership of the land would revert back to the donor's family. Such reversionary provisions must be used with caution since they will cause the charitable transfer to be nondeductible unless the reversion is "so remote as to be negligible".⁴ In *Briggs v. Commissioner*, 72 TC 646 (1979), the Tax Court defined "so remote as to be negligible" as a "chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction" and "so highly improbable and remote as to be lacking in reason and substance."

In Rev. Rul. 2003-28, 2003-11 IRB 594, the donor transferred a patent to a university on the condition that a designated faculty member remain on the faculty during the patent's fifteen-year remaining life. The IRS determined that the possibility that the faculty member might not remain on the faculty was not so remote as to be negligible and

¹ §170(a)

² Treas. Reg. §1.507-2(a)(a)(i); *Phinney v. Dougherty*, 307F.2d 357 (1962)

³ Treas. Reg. §1.170A-1(e)

⁴ Reg. 20.2055-2(b)(a)

no charitable deduction allowed. On the other hand, the city park example above illustrates that where the circumstances at the time of the gift indicate a strong likelihood that there will be no reversion, the charitable deduction will be permitted.

A charitable deduction will also be disallowed if a transfer is dependent upon the performance of some act or the happening of an event before the transfer becomes effective, unless the possibility that the event will not occur meets the “so remote as to be negligible test”.

In Rev. Rul. 79-249, 1979-2 CB 104, a gift to a public board of education to build a school contained a reversionary provision if sufficient funds were not raised to complete the project. The IRS ruled that until it was certain there were adequate funds to construct the building, the possibility the donation would be returned to the donor was not so remote as to be negligible. Therefore, the deduction had to be deferred by the donor until it was clear that the building would be constructed.

An alternative to reversions and conditions is to provide in a written gift agreement that if the primary purpose of the gift cannot be fulfilled, the gift will be used by the charity for an alternate purpose or transferred to another charitable organization.

If any restrictions or conditions are placed upon a gift, it must be done prior to making the gift. Otherwise, the retained right to place conditions on the property after the gift could render the gift incomplete. However, a donor can retain the right to make nonbinding recommendations regarding the distribution of previously contributed property. This is why contributions to donor-advised funds that allow post-gift recommendations are fully deductible.

Some commentators are also concerned that if the donor places too many restrictions on a gift, the IRS will not treat the gift as a contribution to the charity, but rather as the establishment of a separate charitable trust, subject to the private foundation rules. This would create tax headaches for both the donor and donee, due to the deduction limitations, as well as for the ongoing operation of the fund, which would then be subject to the strict restrictions imposed on private foundations.

III. Benefiting Individuals

To be deductible, a donation must be “to or for the use of” a charitable organization, not a designated individual – no matter how deserving the individual may be. A taxpayer cannot avoid this result by earmarking a gift for a particular individual and flowing it through a charitable organization.

The IRS uses two tests to determine if a gift is earmarked and therefore non-deductible:

1. Does the donee organization have discretion and control over the contribution notwithstanding the donor’s desire to benefit a specific individual? If the charity has the option to apply the donated funds to other purposes, this supports deductibility of the contribution.

2. Does the donor intend to benefit the charitable organization or the designated individual? A written agreement between the donor and donee provides the clearest evidence of how each side understands its rights and responsibilities. In addition to a gift agreement or correspondence between the donor and the donee organization, the donee organization's fundraising literature and the donor's receipt for the gift will be considered by the IRS in determining whether an earmarked gift is made.

There are a number of cases and rulings involving family members who desire to provide funds for a relative's living expenses while doing missionary work. If the gift is earmarked, the charitable deduction is denied. Facts that have supported a deductible gift include statements in the missionary organization's fundraising material that the organization retains full discretion over the donated funds and will assess all of its current needs before distributing any funds.

To ensure deductibility, the IRS suggests the following language in the donor's receipt: "this contribution is made with the understanding that the donee organization has complete control and administration over the use of the donated funds."⁵ Donors should consider including such language in their gift transmittal letter and donee organizations' fundraising materials and gift receipts ought to contain similar language.

In a particularly egregious case, Tim Mosley, a San Rafael, California insurance agent, created a donor-advised fund with a national charitable gift fund. Over a five-year period, Mosley sent contributions to his donor-advised fund, advised his tax preparer that these were charitable contributions, and claimed significant tax deductions on his income tax returns. Mosley recommended distributions from his fund to a religious organization and instructed the organization to use the funds to pay his children's tuition at the organization's school which they attended. Not only did the IRS deny Mosley's deduction for his "gifts" to the charitable gift fund, it also charged Mosely with five counts of tax evasion. Mosley was sentenced to five months in prison and forced to pay the Department of Treasury \$275,000, including \$165,000 of penalties and interest.⁶ It is unclear whether the IRS brought any action against the religious organization or its church school, although both must have knowingly participated in the scheme.

IV. Charitable Split-Interest Gifts

When the donor of a charitable remainder trust ("CRT") desires to exercise continued control over the ultimate distribution of the trust assets, a provision allowing the addition or removal of the charitable remainder beneficiary is frequently included in the trust instrument. Such a power was specifically authorized in Rev. Rul. 76-8, 1976-1 CB 179, which provided that the donor of an inter vivos CRT can retain the right to substitute charities or to add additional charitable remainder beneficiaries without jeopardizing the donor's income tax charitable deduction.

⁵ Shoemaker et al., "Donor Control," Exempt Organizations Continuing Professional Education Technical Institute for FY 1999 (1998), Topic O.

⁶ U.S. Department of Justice Press Release (June 30, 2003).

However, the donor should not retain the power to change the charitable remainder beneficiary if someone other than the donor (or, in most cases, their spouse) is the income beneficiary of the inter vivos CRT. To do so would cause the CRT's assets to be included in the donor's estate at death. An increase in the estate tax is likely if the assets have appreciated since the original gift because the donor's estate is not entitled to a full charitable deduction where someone other than the donor (or their spouse) is entitled to a continuing income stream from the CRT.

For similar reasons, the donor of an inter vivos charitable lead trust should not retain the right to designate or alter the charitable beneficiaries. If the donor dies during the lead term, the trust property will be included in their estate and the transfer tax benefits of the trust lost.⁷ The donor can avoid this result by granting to an independent trustee or advisory committee designated in the trust instrument the power to select an alternate charitable beneficiary.

V. Artwork

In a series of 2002 Private Letter Rulings, the IRS highlighted the special issues that must be considered when placing restrictions on gifts of art and other collectibles. In these rulings, the donor bequeathed paintings to a museum, subject to conditions, including their continuous display and the requirement that the proceeds from the sale of any of the works be used to purchase other works of art. The IRS allowed the charitable deduction since the only limitation on the museum's sale of the art was a requirement that it purchase other works of art with the proceeds.⁸

Restrictions on deaccessioning, including required holding periods before the sale of donated artwork, are more troublesome and can negatively impact the amount of the donor's charitable deduction. For example, collectors Samuel and Norma Silverman contributed 148 paintings to various exempt organizations with the restriction that the paintings could not be sold for three years. The Tax Court found that the Silvermans were entitled to an income tax charitable deduction, but the three-year restriction had an adverse impact on the value of the paintings and reduced the charitable deduction.⁹

In PLR 200418002, a husband and wife amassed an important art collection that was housed in a gallery attached to their home. The couple planned to bequeath their home, gallery and funds sufficient to maintain the facilities to a museum.

The couple entered into an agreement with the museum to transfer the collection to the museum at the last of their deaths, subject to certain conditions. The museum agreed to permanently display the collection at either the gallery or the museum. The agreement prevented the museum from selling, transferring or disposing of any of the works. In the event the museum did attempt to sell any pieces from the collection, ownership immediately and automatically vested in their private foundation.

⁷ PLR 200328030

⁸ PLRs 200202032, 200203013 and 200203014. For more information on these PLRs and gifts of artwork in general, see Fox, "Restrictions on Charitable Bequests of Art: Recent Ltr. Rul. Paints a Picture," *Estate Planning Journal* (September 2002).

⁹ Samuel S. Silverman, TC Memo 1968-216.

In this case, the IRS ruled that because the collection would not under any circumstances revert to the donors or inure to the benefit of any private individuals, the value of the charitable deduction would be equal to the collection's estate tax value included in the donors' gross estate for estate tax purposes.

VI. Naming Opportunities

Many donors desire to establish lasting memorials through the establishment of named scholarship funds, buildings or professorships. So long as these gifts further the organization's charitable mission, the deductibility of a gift conditioned on the naming opportunity should not be questioned. However, the recent corporate scandals serve as a reminder that exempt organizations must protect their integrity by establishing "un-naming" policies and procedures in their gift acceptance policies or gift agreements to address unexpected future developments.

It is unclear what will become of Seaton Hall University's Koslowski Hall, named after the dethroned CEO of Tyco International or the University of Missouri-Columbia's Kenneth Lay Professorship. Absent un-naming rights in the gift agreement or gift acceptance policy, the donee organization may not be able to remove the donor's name, or may be required to return the contribution if it does.

In 1987, Elroy Stock gave \$500,000 to Augsburg College to construct a building in his honor. After the acceptance of the gift, the school learned that Stock was a racist who had written numerous letters criticizing interracial marriage. The school refused to place Stock's name on its new building. Stock sued for return of his contribution, claiming that Augsburg had breached their gift agreement. After protracted litigation, a Minnesota court determined that the college could keep the contribution but was not required to place Stock's name on the building. In an ironic twist, after successfully resolving the naming issue, the college continued to receive criticism for accepting the gift. In the end, Augsburg created a minority scholarship fund with Stock's donation to end the controversy.

VII. Investment Management

In PLRs 200445023 and 200445024, the IRS ruled that a donor's retention of the right to manage the portfolio of publicly traded securities given to charity would not preclude the donor's income and gift tax charitable deductions. In these two rulings, the donors gave cash and marketable securities to a college, subject to an agreement that the gifted assets be placed in a brokerage account in the name of the charity for its exclusive benefit, with management authority retained by the donors. The account could be invested only in U.S. equities, mutual funds and fixed-income securities, offshore/onshore hedge funds, real estate investment trusts, and private placements and could not be invested in any company in which a donor held, directly or indirectly, more than five percent of the stock. The college could withdraw the assets from the accounts or terminate the management agreement at any time. If not earlier terminated, the management agreement would end in ten years.

The IRS determined that the donors retained no economic interest in or power to direct the beneficial enjoyment of the accounts and that their investment

management control, as limited in these facts, did not preclude an income or gift tax charitable deduction.

VIII. Valuation

Generally, the amount of an income or estate tax charitable deduction is equal to the contributed property's fair market value on the date of the gift or bequest. If a donor places a restriction on the marketability or use of the contributed property, the charitable deduction must be reduced to take the restriction into account.¹⁰

Rev. Ruling 2003-28, 2003-11 I.R.B. 594, discussed above, also addressed the deductibility of the contribution of a patent that the donee was prohibited from selling for three years. The IRS ruled that although the three-year sale prohibition could never cause the patent to revert to the donor, or otherwise benefit the donor, the restriction reduced the fair market value of the patent and the donor's corresponding charitable deduction.

In Rev. Rul. 85-99, 1985-2 CB 83, an agricultural college sought to acquire a parcel of land for research purposes. The landowner agreed to donate the property and did so by deed containing a restrictive covenant limiting the land's use to agricultural purposes. Although the highest and best use of the land was commercial development, the IRS ruled that the income tax deduction must be determined in light of the restriction, not based on highest and best use. A very similar conclusion was reached in PLR 8641017, where a donor restricted mining on property in the deed conveying it to an exempt organization. In both cases, the donor could have received a significantly greater deduction by first granting a conservation easement to restrict development or commercial activity on the land, then contributing the property, subject to the easement, to the exempt organization.

When evaluating gift restrictions, advisors must also consider the significantly different outcomes in inter vivos and testamentary gift situations. While a donor's income tax deduction will be reduced if a lifetime gift is deemed to have restrictions affecting valuation, a particularly bad result arises if the donor owns fee simple title to property at death, but places restrictions in the testamentary charitable gift of the property that reduces its fair market value. In that case, the estate tax charitable deduction may be significantly below the property's value for estate tax purposes. Rather than jeopardizing the value of a charitable deduction, donors should consider whether precatory language expressing their wishes regarding the donated property will achieve the desired result.

IX. Standing to Enforce

Once a gift is complete, courts have historically held that the donor no longer had standing to enforce the terms of the charitable gift. Instead, this right inures to the benefit of the public, usually enforceable by the state attorney general's office.

That began to change in 2001 when a New York State Appellate Court ruled that Adele Smithers-Fornaci, the personal representative of her late husband's estate, could sue St. Luke's-Roosevelt Hospital Center for failing to abide by the terms of her husband's

¹⁰ Conley, 33 TC 223; Rev. Rul. 85-99, 1985-2 CB83.

\$10 million, thirty-year old gift.¹¹ In Smithers, Mrs. Smithers-Fornaci alleged that St. Luke's had misappropriated \$5 million from her husband's endowment fund and planned to put the proceeds from the sale of a townhouse, also given by her husband, into its general operating funds. The New York Court held that the donor's estate had standing to sue St. Luke's to enforce the terms of the gifts. Since Smithers, some courts have opened to the idea that donors, their estates or descendants have the right to rescind gifts or to take legal action if gift conditions are not honored.

In another case, Sybil Harrington, a wealthy Texas oil businesswoman, gave \$33 million to the Metropolitan Opera to support opera "in the traditional manner". The Met used part of her gift to televise an abstract Wagner production. In reliance upon Smithers, Harrington's estate sued the Met to recoup the funds expended on its television production and to obtain veto power over how the remaining funds are spent.

In 1996, Paul Glenn's Foundation for Medical Research donated \$1.6 million to the University of Southern California for the study of aging. Glenn later sued USC in 2001, alleging that it did not honor their oral and written contracts. This case received significant media attention and reaffirmed the post-Smithers trend of allowing private legal action when charitable gifts do not turn out as planned.

While these recent cases have begun to alter the traditional concept that the donor does not have standing to sue, these decisions are quite new and not the law in every jurisdiction. In Georgia, for example, the Court of Appeals has held that the Attorney General is not the exclusive entity authorized to sue for the enforcement of a charitable trust. An individual who can show a "special interest" in the trust can also bring an enforcement action. However, there is little guidance in Georgia on what rises to the level of a "special interest".¹² As such, donors may seek to create standing to enforce their gifts by including provisions in their gift agreement giving themselves, their estate, or some other identifiable party the power to enforce the gift.

X. Gift Agreements

- A. The donor's wishes must be clearly understood and articulated.
- B. Anticipate changes in circumstances:
 - Conflict between donor's desire for specificity and the donee's desire for flexibility
 - Mandatory alternative uses

"If due to changed circumstances it is impracticable to carry out the above purpose, the gift will be used for...:

- "(specific alternative use)"

¹¹ Smithers v. St. Luke's Roosevelt Hospital Center, 281 App. Div. 2d 127, 723 NYS2d 426 (N.Y. App. Div., 2001).

¹² Warren V. Board of Regents, 247 Ga App 758 (2001).

- “purposes as nearly as possible akin to the original purpose as possible”
 - Precatory direction from Donor (“It is my wish...”)
 - Try not to make gifts perpetual:
 - Buildings do not last forever
 - Permit board to allow alternate use after fixed period of time
- C. Deferred Gifts:
- Enforceable pledge
 - Specific payment schedule
 - Withhold naming until gift completion
 - Remove name if gift not completed
 - Project cost overruns
- D. Confidentiality:
- Clarify Donor’s wishes
 - State sunshine laws
- E. UMIFA/Historic Dollar Value:
- If an endowment, clarify what portion charity can access
- F. General Contract Provisions:
- Governing law
 - Amendment only in writing
 - Entire agreement

XI. Gift Acceptance Policies

Many exempt organizations are updating their gift acceptance policies to establish criteria for all naming opportunities and for the removal of names from endowment funds, buildings, etc.

- What rights does charity have if donor goes to jail or defaults on their pledge?

- What happens thirty years from now if the building is demolished or completely renovated?

XII. Prevention:

- Follow-up verbal conversations with letters
- Use realistic projections and illustrations
- Say “no” when necessary
- Communication is the key to avoiding problems – before and after the gift
- Don’t ignore mistakes or disgruntled donors – usually easier to address problems when they first arise
- Don’t allow donors to be overly dependant on gift plan – donor should retain sufficient assets outside of the gift

XIII. Professional Ethics.

Attorneys who render charitable planning advice must be ever mindful that charitable gift planning is governed by the same rules of professional conduct as other areas of law practice.

Oregon Formal Ethics Opinion No. 1991-16 involved a very typical fact pattern. The attorney was a long-serving member of the charitable organization’s Board of Directors and had provided legal advice to the organization on a continuing basis. An individual donor, likely a fellow board member, asked the attorney to represent the donor and their spouse in two estate planning projects: an inter vivos charitable remainder trust where the charitable organization will be the remainder beneficiary, and in the preparation of last will and testaments under which the charity was also one of the beneficiaries.

The Oregon Ethics Opinion specifically addressed three questions:

1. May the attorney represent both the donors and the charity in the charitable remainder trust transaction?

No. Because of the potential differing interests or positions between the charity and the donors concerning the terms of the transaction, representation of both the charity and donors in this CRT transaction would constitute a conflict of interest.

2. May the attorney represent only the donor in the CRT transaction?

Yes. With full disclosure and the consent of both the charity and the donors.

3. May the attorney prepare the donors' last will and testaments?

Yes. With full disclosure to and consent from the donors. The consent of the charity was not required in this situation since its interests were deemed not to be adverse under this document, unlike the charitable remainder trust transaction.

In Maryland Ethics Docket 2003-08, the Committee on Ethics of the Maryland State Bar Association ruled that a lawyer who encourages parishioners of his church to leave bequests to the church in their wills may not also prepare their wills due to Rule 1.7 of the Maryland Rules of Professional Conduct governing conflicts of interests. This Rule (which is similar to Rule 1.7 of the ABA Model Rules of Professional Conduct) prohibits a lawyer from representing a client if that representation will be directly adverse to another client or may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interest.

In this situation, the lawyer chaired the church's Development Committee and offered to prepare estate planning documents on a pro bono basis for church members interested in leaving bequests to the church. The Maryland Committee on Ethics ruled that the lawyer's interest in helping his church's planned giving efforts compromised his independent professional judgment. The lawyer could not represent both the interest of the client and the Development Committee at the same time.

Attorneys, and other professional advisors, with ties to charitable organizations must carefully evaluate their relationship with the organization to determine whether it creates a conflict of interest or concerns about undue influence with a prospective client who is considering gifts or other transactions with the charitable organization. Full disclosure of the advisor's relationship with the charitable organization, in writing, is well advised. They might also consider obtaining a written acknowledgement and waiver of any potential conflicts.

XIV. Conclusion

Exempt organizations and planned giving advisors must be sensitive to the new breed of donors and their desire to control or restrict their charitable gifts. Many of these desires can be addressed in a well-drafted charitable gift agreement. However, failure to properly design and restrict donor control and gift restrictions can cause practical and tax implications that both the donor and the charitable recipient would like to avoid.