CHAPTER 1

Charitable Giving Law: Basic Concepts

The purpose of this chapter is to provide basic information about the law concerning contributions (usually deductible ones) to charitable organizations. This information will serve as a basis for understanding much of the law summarized in the subsequent chapters. Specifically, this chapter will:

- Describe organizations that are considered *charitable* entities for these purposes
- Define the term *charitable contribution*
- Explore some unique aspects of charitable giving
- Provide an introduction to the charitable contribution deduction
- Explain the differences between *public charities* and *private foundations*
- Discuss the elements affecting the deductibility of charitable contributions
- Explain the *grantor trust* rules
- Summarize the law as to donor-advised funds
- Review certain subtleties in connection with charitable giving
- Discuss the matter of charitable pledges
- Examine the public policy doctrine

CHARITABLE ORGANIZATIONS

Organizations that attract deductible charitable gifts are termed *qualified donees*. Generically, these entities are known, for this purpose, as *charitable organizations*. More technically, qualified donees are charitable organizations (including educational, religious, and scientific entities), certain fraternal organizations, certain cemetery companies, and most veterans' organizations. Contributions to both private and public charities are deductible, but the law favors gifts to public charities.

Federal, state, and local governmental bodies are charitable donees. State or local law, however, may preclude a governmental entity from accepting charitable gifts. In most jurisdictions, a charitable organization can be established to solicit deductible contributions for and make grants to governmental bodies. This is a common technique for public schools, colleges, universities, and hospitals.

An otherwise nonqualifying organization may be allowed to receive a deductible charitable gift, where the gift property is used for charitable purposes or received by an agent for a charitable organization (see Chapter 8). An example of the former is a gift to a trade association that is earmarked for a charitable fund within the association. Examples of an agent for a charity is a title-holding company that holds a property for charitable purposes and a for-profit company that acquires and disposes of vehicles as part of a charity's used vehicle donation program.

CHARITABLE CONTRIBUTIONS

A fundamental requirement of the charitable contribution deduction law is that the cash or property transferred to a charitable organization must be transferred in the form of a *gift*. That is, before there can be a charitable gift, the underlying transaction must constitute a gift. Merely because money is paid or property is transferred to a charity does not necessarily mean that the payment or transfer is a gift. When a tax-exempt university's tuition, an exempt hospital's healthcare fee, or an exempt association's dues are paid, there is no gift, despite the fact that the recipient is charitable, and thus there is no charitable deduction for the payment.

The terms *contribution*, *gift*, and *donation* are essentially synonymous. Each term is used in the charitable giving context, although the larger the amount or value of the transfer, the lesser is the likelihood that the term *donation* is used. Thus, for example, a contribution to a charity of used clothing is likely to be termed a donation but not a gift to a charity of a large parcel of real estate, which is usually thought of as a contribution. The term *gift* is employed when the donee is not a charitable entity (most often, an individual) (see Chapter 5).

Basically, a gift has two elements: It involves a transfer that is *voluntary* and is motivated by something other than *consideration* (value received in return for a payment or transfer). Where payments are made to receive something in exchange (education, health care, etc.), the transaction is a *purchase*; there is no gift. (As discussed in Chapter 12, however, a transaction can be both a contribution and a purchase.)

The law places more emphasis on what is received by the payor than on the mere existence of a payment or transfer. The federal income tax regulations state that a transfer is not a contribution when it is made "with a reasonable expectation of financial return commensurate with the amount of the donation." Instead, this type of a payment is a purchase of a product or a service. Thus, the IRS stated that a contribution is a "voluntary transfer of money or property that is made with no expectation of procuring financial benefit commensurate with the amount of the transfer." When a single transaction is partially a gift and partially a purchase, and when a charity is the payee, only the gift portion is deductible.

The U.S. Supreme Court, in an oft-quoted pronouncement, observed that a gift is a transfer motivated by "detached or disinterested generosity." The Court also characterized a gift as a payment stimulated "out of affection, respect, admiration, charity, or like impulses." Thus, the focus in this area for the most part has been an objective analysis, comparing what the "donee" parted with and what (if anything) the "donor" received net in exchange.

Another factor, that of *donative intent*, is sometimes taken into consideration. The federal tax regulations state that, for any part of a payment made in the context of a charity auction (see Chapter 7) to be deductible as a charitable gift, the patron must have donative intent. More broadly, a congressional committee report contains the observation that the term *gift* is "generally interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent." This statement added that, if a taxpayer receives or expects to receive a quid pro quo in exchange for a transfer to charity, the taxpayer "may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return provided the excess payment is made with the intention of making a gift."

A federal court of appeals described the matter as to what is a gift this way: It is a "particularly confused issue of federal taxation." The statutory law on the subject, said this court, is "cryptic," and "neither Congress nor the courts have offered any very satisfactory definitions" of the terms *gift* and *contribution*.

INTRODUCTION TO CHARITABLE DEDUCTIONS

The basic concept of the federal income tax deduction for a charitable contribution is this: Corporations and individuals who itemize their deductions can deduct on their annual tax return, within certain limits, an amount equivalent to the amount contributed (money) or to the value of a contribution (property) to a qualified donee. A charitable contribution often gives rise to a deduction for state income tax purposes; a local tax deduction may also be available.

Deductions for charitable gifts are also allowed under the federal gift tax and estate tax laws (see Chapter 5). Donors and the charitable organizations they support commonly expect gifts to be in the form of outright transfers of money or property. For both parties (donor and donee), a gift is usually a unilateral transaction, in a financial sense: The donor parts with the contributed item; the charity acquires it.

The advantages to the donor, from the making of a charitable gift, generally are the resulting charitable deduction and the gratification derived from the giving. Planned giving (see Chapter 9) provides additional financial and tax advantages to the donor. Overall, these are the economic advantages that can result from a charitable gift:

- A federal, state, and/or local tax deduction
- Avoidance of capital gains taxation
- Creation of or an increase in cash flow
- Improved tax treatment of income
- Free professional tax and investment management services
- Opportunity to transfer property between the generations of a family
- Receipt of benefits from the charitable donee

PRIVATE FOUNDATIONS

Tax-exempt charitable organizations (charitable donees) are of two types: public charities and private foundations. The federal tax law does not (other than by implication) define the term *private foundation.* This is the case although a section of the Internal Revenue Code is captioned "Private Foundation Defined." This section should be titled "Public Charity Defined" because that is what it really does. That is, the section defines what a private foundation is not. Another perspective on the point is that, technically, a private foundation is any tax-exempt charitable entity that is not a public charity.

Nonetheless, a private foundation generally is an organization that has these four characteristics:

1. It is, as noted, a tax-exempt, charitable, educational, scientific, or like organization (and is thus subject to the rules applicable to charitable organizations generally).
2. It is funded (often on only one occasion) from a single source (such as an individual, a family, or a business).
3. Its ongoing revenue is income from investment assets (so that a foundation operates much like an endowment fund).
4. It does not have its own program but rather makes grants in furtherance of the charitable ends of other organizations (and sometimes individuals).

It is because of this second characteristic that an organization is considered to be *private.* (That term does not pertain to an organization's board, although a board can be private in the sense that it consists of representatives of a single corporation or a single family. Nonetheless, a public charity can likewise have a private board.)

Every tax-exempt, charitable organization is presumed to be a private foundation. A showing that the organization is a form of public charity rebuts this presumption.

PUBLIC CHARITIES

There are three fundamental types of public charities:

1. Institutions
2. Publicly supported charities
3. Supporting organizations (so classified because of their nexus to one or more other tax-exempt organizations)

Institutions

The *institutions* are not private foundations because of their functions. They are churches (including synagogues and mosques) and certain other religious organizations; colleges, universities, and schools; hospitals and other providers of health care; medical research organizations; and governmental units.

Publicly Supported Charities

A *publicly supported charity* is the antithesis of a private foundation. While, as noted, a private foundation is a charity that is privately funded, a publicly supported charity is a charitable organization that receives financial support on an ongoing basis from the public. Thus, this public charity status is dependent on the nature of the funding of the organizations. Most of the elements of the definition of the term *publicly supported charity* focus on the meaning, in the appropriate context, of the term *public*.

There are two types of publicly supported charities:

1. The *donative* type
2. The *service-provider* type

Donative Publicly Supported Charity

A donative publicly supported charity is an organization that *normally* receives a *substantial part* of its financial support from direct or indirect contributions from the *public* and/or from one or more governmental units in the form of grants. (The statute uses the term *general public,* but that is a redundancy.)

Most donative publicly supported charities must derive at least one-third of their financial support (the *support ratio*) from eligible governmental and/or public sources. Except for new entities, the normal time span for measuring the organization's support is its most recent four tax years (the *support computation period*).

Public support can come from individuals, corporations, trusts, other charitable organizations, or other legal entities. The total amount of contributions or grants from any one donor or grantor during the support computation period generally is not public support to the extent that the amount exceeds 2 percent of the organization's allowable total support received during that period. The 2 percent limitation, however, does not apply to support in the form of grants from other donative publicly supported organizations or from governmental units. All grant support from these two sources is public support.

Donors who have certain relationships with one another (such as spouses or individuals and controlled businesses) must share a single 2 percent limitation. Multiple contributions or grants from any one source are aggregated over the support computation period and treated as a single gift or grant.

In the computation of its support ratio, a donative publicly supported organization cannot include amounts received from the exercise or performance of its tax-exempt functions (*program service revenue*). An organization cannot, however, meet this *public support test* if it receives almost all of its support from its related activities and only an insignificant amount of support from the public and/or governmental units in the form of grants.

For example, charity X has been in existence several years. X reports for financial purposes on the calendar-year basis. X is and is striving to remain a donative-type publicly supported charity. Assessing X's status in 2007, during 2003 to 2006, X received $10 million in charitable contributions and grants. The 2 percent threshold thus is $200,000. The target minimum numerator of the public support fraction thus is $3,334,000. Over that four-year period, X received $3.5 million in public support. Its public support ratio, therefore, is 35 percent. Consequently, as of 2007, X is a donative-type publicly supported charity.

Service-Provider Publicly Supported Charity

A service-provider publicly supported charitable organization normally must receive more than one-third of its financial support in the form of gifts and grants, membership fees, and/or gross receipts in the form of program service revenue. Amounts that are eligible as public support are those derived from *permitted sources.* These sources are governmental agencies, the other types of institutions, donative publicly supported charities, and persons who are not *disqualified persons* with respect to the organization.

Like the law concerning donative publicly supported charitable organization, the service-provider organization rules take into account financial support received over the organization's most recent four tax years (the meaning of the word *normally*) and utilize a one-third support fraction.

Exempt function revenue can count as public support for the service-provider organization, but only to the extent that the revenue from any one source does not exceed the greater of $5,000 or 1 percent of the organization's support during the support computation period involved. Also, support of this nature, to constitute public support, cannot come from disqualified persons.

Thus, these rules place limits on qualifying gifts and grants to service-provider publicly supported charitable organizations. As noted, public support cannot come from *disqualified persons.* These persons are an organization's directors (or trustees), officers, members of their families, persons controlled by disqualified persons (such as businesses, trusts, and estates), and substantial contributors. A *substantial contributor* is a person who contributes or bequeaths an aggregate amount of more than $5,000 to a charitable organization, where that amount is more than 2 percent of the contributions and bequests received by the organization over the totality of its existence.

To qualify as a service-provider publicly supported charitable organization, the entity may not receive more than one-third of its financial support in the form of investment income.

For example, charity Y has been in existence several years. Y reports for financial purposes on the calendar-year basis. Y is striving to remain a service-provider publicly supported charity. Assessing Y's status in 2007, during 2003 to 2006, Y received $10 million in charitable contributions and grants. The target minimum numerator of the public support fraction thus is $3,334,000. Over that four-year period, Y received $3.5 million in contributions, grants, and exempt function income from sources other than disqualified persons (public support). Its public support ratio, therefore, is 35 percent. Consequently, as of 2007, Y is a service-provider publicly supported charity.

Supporting Organizations

The third category of charitable organization that is not a private foundation is the *supporting organization.* A supporting organization is an entity that is related, structurally or operationally, to one or more institutions and/or publicly supported organizations (or, in some instances, other organizations). A supporting organization must be organized, and at all times operated, in an active relationship with one or more eligible supported organizations.

This relationship must be one of three types, with the interaction between the organizations different for each type:

1. *Operated, supervised, or controlled by one or more eligible supported organization(s)*. This is a parent-subsidiary relationship, where the parent maintains a significant degree of direction over the policies, programs, and other activities of the supporting organization. This type of entity is informally known as a *Type I* supporting organization.
2. *Supervised or controlled in connection with one or more eligible supported organization(s)*. This is a brother-sister relationship, where there is common supervision or control by the persons heading both the supporting and supported organizations. This type of entity is informally known as a *Type II* supporting organization.
3. *Operated in connection with one or more eligible supported organization(s)*. This means that the supporting organization is responsive to and significantly involved in the operation of one or more supported organizations. This type of entity is informally known as a *Type III* supporting organization.

Most supported organizations are charitable, educational, religious, and like entities. Nonetheless, it is possible to structure a relationship where the supported organization is a tax-exempt social welfare, agricultural, horticultural, labor, or trade, business, or professional association. The basic requirement is that this type of supported organization must satisfy the public support test applicable to service-provider publicly supported organizations.

There is no limitation as to the number of organizations that can be supported by a supporting organization. Moreover, there is no limitation as to the number of supporting organizations a supported organization may have. Disqualified persons with respect to a supporting organization may not control, directly or indirectly, the supporting organization.

A supporting organization may be established by the organization or organizations that it is to support. Also, one or more donors may form a supporting organization. In this sense, a supporting organization is an alternative, from a prospective donor's viewpoint, to a private foundation. The fundamental difference between these choices is the control element: A donor to a private foundation can retain control over the foundation's resources; a donor to a supporting organization cannot.

WHAT DIFFERENCE DOES IT MAKE?

As noted, a tax-exempt charitable organization is either a public charity or a private foundation. From a law perspective, it is usually important for the organization to qualify as a public charity. That is, there is no law advantage to private foundation status.

Here are the disadvantages to classification as a private foundation:

- The need to comply with a battery of onerous rules, namely, prohibitions on self-dealing, insufficient grants for charitable purposes, excess business holdings, jeopardizing investments, and certain types of grants and other expenditures
- A tax on net investment income
- Extensive record-keeping and reporting responsibilities
- Narrow limitations on gift deductibility
- The reality that private foundations are highly unlikely to make grants to other private foundations

The biggest advantage to the use of a private foundation is that the donor or donors can retain control over the funds and property they have contributed (and taken a deduction for) to the organization.

TYPES OF DONORS

A *donor* is a person who makes a gift. A donor thus can be a person who makes a contribution to a charitable organization. A donor may or may not obtain a charitable contribution deduction as the result of a charitable gift. Many factors operate to determine this outcome, as will be described.

There are several types of donors, that is, several categories of persons who can make contributions to charitable organizations:

- Individuals
- C (or regular) corporations
- S (or small business) corporations
- Partnerships
- Limited liability companies
- Trusts
- Estates (where the gifts are termed *bequests* [in instances of transfers of money or personal property] or *devises* [in instances of transfers of real property]) (see Chapter 5)

Some of these organizations are classified for tax law purposes as *pass-through entities*, which means that they are not subject to federal income taxation. (Rather, the taxation is of the shareholders or members.) Pass-through entities are S corporations, partnerships, and limited liability companies. When a pass-through entity makes a charitable contribution, each shareholder or member takes into account his, her, or its distributive share of the resulting deduction (see Chapter 3).

FACTORS AFFECTING DEDUCTIBILITY OF CONTRIBUTIONS

Several factors affect the deductibility (or the extent of deductibility) of charitable contributions, including these:

- The transaction must, in fact, be a gift.
- The recipient of the gift must be an eligible charitable organization.
- The nature of the donor.
- The *acceptance* by the charitable organization of the money or property that was the subject of the ostensible gift.
- When the donor is an individual, whether the donor itemizes deductions.
- The year of the gift (see Chapter 3).
- The subject of the gift, whether money or property (see Chapter 2).
- If the gift is of property, the nature of the property that is contributed, such as:
    - Long-term capital gain property;
    - Short-term capital gain property;
    - Ordinary income property;
    - Inventory (see Chapter 6).
- If the gift is of property, the value of the property.
- The public charity/private foundation status of the charitable recipient.
- The nature of the gift recipient if it is an organization other than a public charity or private foundation.
- The use to which the contributed property is put, such as the unrelated use of tangible personal property (see Chapter 8).
- The nature of the interest in the money or property contributed, that is, whether the gift is of an outright interest or a partial interest (see Chapters 7 and 9).
- Compliance with record-keeping, reporting, appraisal, and other substantiation requirements (see Chapter 12).

GRANTOR TRUST RULES

The *grantor trust rules* apply with respect to grantors and others who are treated, for tax law purposes, as substantial owners of property held in a trust—that is, those persons who have retained substantial domination and control over a trust. These rules tax to the grantor the income of the grantor trust; technically, the income of the trust, along with appropriate tax deductions (including the charitable contribution deduction) and tax credits, is attributed to the grantor. A *grantor* is a person who transfers property to a trust.

There are five circumstances in which a grantor is regarded as an owner of some portion of a trust and thus is taxed on the income of the trust. A grantor is treated as the owner of any portion of a trust:

1. In which he or she has a reversionary interest in either the corpus of or the income from the trust if, as of the inception of that portion of the trust, the value of the interest exceeds 5 percent of the value of the portion
2. In respect of which the beneficial enjoyment of the corpus or the income from it is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party
3. When certain administrative powers over the trust exist and the grantor can or does benefit by reason of these powers
4. If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor
5. If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or his or her spouse

In some instances, a person other than a grantor is treated as a substantial owner of a portion of a trust. These rules also may apply with respect to foreign trusts having one or more U.S. beneficiaries.

DONOR-ADVISED FUNDS

An alternative to a private foundation or a supporting organization is the *donor-advised fund*. Although this term is not formally defined in the law, in this circumstance, a donor makes a gift to a public charity where the donee, instead of placing the gift property in its general treasury, deposits the gift item in a discrete fund (segregated account) within the charity (with the fund usually bearing the name of the donor). By contract, the donor is provided the opportunity to thereafter advise the charity as to dispositions from the fund, such as grants to other charitable organizations. The charitable deduction is likely to be defeated, however, where the arrangement amounts to a *donor-directed fund*, which provides a donor with the contractual right to direct (rather than merely advise as to) the subsequent distributions of the gifted money or property.

The IRS approved an arrangement where a donor made a gift of property to a charitable organization, yet retained the right to manage the investment of the property placed into a designated account. There were several conditions and restrictions attached to this right, with the charity empowered (by an agreement) to terminate the relationship at any time for any reason. This authority to manage investments usually terminates after a set number of years from the date of the gift.

Note: This ability to manage the investment of charitable assets appeals only to those individuals who enjoy financial management and/or who believe they can do a better job of investing than the charity. The governing board of a charitable organization, however, has certain fiduciary responsibilities. One of them is prudent stewardship of the organization's income and assets. It may be questioned whether turning asset management over to a person solely because that person is a donor to the entity comports with the requirements as to appropriate governance of a charitable organization.

The grantor trust rules (described earlier) can be invoked in this context. These rules can be used to evaluate whether a grantor (donor) retained rights with respect to property transferred to a charity that would cause the transaction to be regarded as less than an outright gift. The rules look to determine whether the grantor has, despite the transaction, retained significant ownership interests.

Donor-advised funds are controversial. Some contend that the maintenance of these funds is not a charitable activity. An extension of this assertion is that an organization that has maintenance of these funds as its primary or sole activity cannot qualify for tax exemption as a charitable organization. Critics argue that the process is akin to establishing and maintaining a commercial bank account holding deposits for the private benefit of a customer. (This is not the case; with a bank account, the customer can withdraw the deposited funds, while a transfer to a donor-advised fund is an irrevocable gift.) The courts are rejecting these arguments.

Another contention is that these transfers are not *gifts* in the first instance (and thus are not payments giving rise to a charitable deduction). The ostensible reason: The *donor* has not, by reason of the agreement with the charity, parted with all of his, her, or its right, title, and interest in and to the gift money or property. To assess this, the IRS applies a set of *material restrictions* rules that were promulgated in the private foundation setting to test whether a private foundation has properly terminated its status when granting its assets to one or more public charities.

Still another issue is whether the charitable organizations that maintain donor-advised funds are publicly supported charities. The gifts (assuming that is what they are) to the charity (assuming that is what it is) are forms of public support for purposes of both the donative publicly supported charity and the service-provider public charity. Almost always, however, these entities are the donative type. Then, when a grant is made from an account within a public charity to another charity, it can be public support for the grantee. Some in the IRS and elsewhere are uncomfortable with the view that a gift (or a portion of it) can constitute public support for two charities. That is, nonetheless, the case.

The ultimate criticism of donor-advised funds is that they constitute a way to avoid the private foundation restrictions. That is, as a matter of literal fact, true. They are, however, a *lawful* way to sidestep the private foundation rules. Congress is likely to legislate limitations and requirements regarding contributions to and operations of donor-advised funds.

CHARITABLE GIVING SUBTLETIES

There is far more to the law of charitable giving than a simple transfer of money or property from a donor to a donee. A sample of subtleties in charitable giving circumstances, some involving deductible gifts and some not, follows.

Incidental Benefit

As a general rule, a donor is entitled to a charitable deduction for a contribution of money or property to a charitable organization where the donor has given all of his, her, or its full title, rights, and interest in the property. That is, if the "donor" receives from the charity, in exchange, value approximately equal to the "gift" amount, there is, in fact, no gift-and thus no charitable deduction. (In some circumstances, there can be a charitable gift element when benefits are provided to the donor that have value less than that of the money or property transferred [see Chapter 12].)

When, however, a benefit provided to a donor by a donee is *incidental*, the charitable contribution deduction is not defeated. Token items provided in exchange for a charitable gift—such as address labels, key chains, and pins—are often lawfully disregarded when ascertaining a charitable deduction. Another illustration of an incidental benefit arising out of a charitable gift is the *naming opportunity*; a person can, for example, make a charitable gift and have a building or other facility (such as a stadium or room) named in honor of him or her and still receive a full charitable deduction. A donor can contribute land to a charitable organization and obtain a charitable deduction for its fair value, even though land owned by the donor that is adjacent to the gifted property is enhanced in value. In two of many IRS and court rulings on this point:

- An organization made a deductible contribution to a police department to assist the department in offering rewards for information leading to the conviction of individuals engaging in criminal activity in the community in which the donor organization was located.
- An individual made a deductible contribution to a charitable organization of a tract of land and retained the right during his lifetime to train his hunting dogs on the trails extending throughout the tract.

Absence of Value Transferred

A charitable contribution deduction can be denied because nothing of substance or value was transferred to a charitable organization. For example, a charitable deduction for the transfer by a corporation to a charitable entity of a "film library" was denied by a court on the ground that what was conveyed (negatives) had little value. (The donor claimed a deduction of more than $10 million.) Likewise, a corporation that believed it was making a gift of property to a state for use as a park had its claim for a charitable deduction rejected, with a court ruling that the state already owned the property by virtue of the doctrine of adverse possession. Another illustration of this rule is the *circular gift*, where persons contrive to pass money from one entity to another so as to generate a charitable deduction, when in fact the organizations are an "integrated whole" and therefore nothing of economic substance occurred.

Perhaps the best example of all of this point was provided in the case of two individuals who were granted a permit by the federal government to graze livestock on a parcel of government-owned land in a national forest adjacent to their ranch. The ranch was later sold; the grazing permit reverted to the government. These individuals nonetheless claimed a charitable contribution deduction for the alleged value of the permit. A court concluded that, because the federal government already held all right, title, and interest in the property, it did not receive any value when the permit was waived back to it. As this court sagely observed, "[o]ne cannot donate something one does not own or possess."

Anticipatory Income Assignments

A transaction may appear superficially to be a charitable gift of property but, in actuality, be an anticipatory assignment of the income from the property that would otherwise have flowed directly to the transferor. In other words, the "donor" is endeavoring to avoid paying income tax by trying to divert the income to another person (in these instances, a charity). An anticipatory assignment of income occurs in the charitable giving setting when a person has certain rights in the contributed property that have so matured that the person has the right to the proceeds from the property at the time the transfer is made. If the transaction is an assignment of income, there may not be a charitable contribution deduction for the fair market value of the property transferred; the transferor may be taxable on the proceeds diverted to the charitable organization and the charitable deduction (if any) may be determined as if the gift were of the after-tax income.

Note: This doctrine is similar to the step transaction doctrine (see Chapter 2).

The distinction between a gift of property and an assignment of the property's income is rarely easy to make. These rules are applied on a case-by-case basis. A major factor in the court cases is the extent of the "donor's" control over the timing of the generation of the income. One court applied the doctrine because the "realities and substance" rather than the "hypothetical possibilities" of the matter showed that the donor knew that the likelihood that property would not soon be yielding income (taxable to the "donor") was remote. By contrast, another court held that the donor did not know with "virtual certainty" that income returns were imminent; the donor merely had knowledge that the creation of the income was a "reasonable probability."

Mandatory Gifts

The concept of the *mandatory gift* has an oxymoronic ring to it, and for good reason: As mentioned, deductible charitable contributions are required to be *voluntary*. The Supreme Court ruled that a payment to a charitable organization proceeding from the "constraining force of a moral or legal duty" is not a charitable gift. There are transfers to charitable organizations that are mandated by statute, regulation, court order, contract, or even the charitable entity itself.

An individual was precluded, by a court, from deducting a sum paid to fill a gully in a city street, inasmuch as the payment was made in compliance with an order issued by the city. A national environmental organization was chastised, in 2005, by a congressional committee for selling parcels of land that became subject to conservation easements to private parties at a reduced price, then requiring the purchasers to make ostensible charitable contributions to the charity (often at closing), the amount of which just happened to be the difference between the discounted sales price and the fair value of the property. The IRS is ruling that so-called down payment assistance organizations are serving private purposes and are "encouraging the avoidance of federal income tax" when they require sellers of the homes to make "voluntary contributions" to the charity, the amount of which is determined by the financial assistance provided by the charity to the purchasers of the homes; the agency is ruling that the payments by the sellers are "fees received in exchange for the sale of a program-related service."

CHARITABLE PLEDGES

The making of a charitable pledge—a promise to make a charitable contribution—does not give rise to an income tax charitable contribution deduction. Any deduction that is occasioned by the pledge, such as it may be, is determined at the time the pledge is satisfied.

The enforceability of a charitable pledge is a matter of state law. Some states require the existence of consideration as a prerequisite to the existence of an enforceable pledge. Other states will enforce a charitable pledge on broader, social grounds, such as reliance. A typical circumstance concerning the latter approach arises where a person pledges a significant gift to a charity for a building and the charity commences construction of it in reliance on the forthcoming gift.

Usually, a pledge is made by a potential donor in the form of a written statement—a promise to the potential charitable donee of one or more contributions to be made sometime in the future. Pursuant to a *funding agreement*, a person may commit in writing to make multiple contributions to a charitable organization over a stated period for purposes such as general operations or endowment; the charitable contribution (and resulting deduction) arises in each year of actual payment. A variation on this approach is a pledge to charity of a stock option; the pledge produces an income tax charitable deduction in the year in which the charitable donee, having acquired the option, exercises it.

PUBLIC POLICY CONSIDERATIONS

A doctrine in the law of nonprofit organizations states that an entity cannot be tax-exempt as a charitable one if it engages in an activity that is contrary to public policy. For example, the U.S. Supreme Court held that it is contrary to federal public policy for a private school to engage in racially discriminatory practices as to its student body and faculty; this type of discrimination was found to bar tax exemption of the school as a charitable or educational organization. This doctrine is infrequently applied in the charitable giving setting.

In one case, an individual contributed certain Native American artifacts to a museum; a portion of the collection consisted of items covered by eagle and migratory bird protection laws. The IRS contended that there should not be any charitable deduction for these gifts, on the ground that acquisition of the items was contrary to public policy. Nonetheless, a court held that these donors had a sufficient ownership interest in these items to contribute them to the museum, even though the donors may have violated federal law when they acquired the items.

There are other aspects of the public policy doctrine; one concerns the efficacy of the imposition of certain conditions subsequent on the terms and conditions of a gift. In the principal case, an individual transferred certain property interests to a trust benefiting his children. The instrument making the gift provided that, should there be a final determination that any part of the transfer was subject to gift tax, all the parties agreed that the excess property decreed to be subject to the tax would automatically be deemed not included in the conveyance and be the sole property of the individual, free of trust.

The court held that this provision was a condition subsequent that was void because it was contrary to public policy. It wrote that "[w]e do not think that the gift tax can be avoided by any such device as this." A contrary holding, wrote the court, would mean that, "upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax." This holding would be made in the context of litigation to which the donees of the property were not parties, so the decision would not be binding on them and they would be able to enforce the gift notwithstanding the court's decision. Wrote the court: "It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained."

This condition subsequently was found to be contrary to public policy for three reasons. First, "it has a tendency to discourage the collection of the [gift] tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift."

Second, the "effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case." That is, if the condition "were valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax." The consequence would be that the donor "would thus secure the opinion of the court as to the taxability of the gift, when there would be before the court no controversy whatever with the taxing authorities which the court could decide, the only possible controversy being as to the validity of the gift and being between the donor and persons not before the court."

Third, the condition "is to the effect that the final judgment of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgment is rendered." The court noted that gift tax liability cannot be the subject of a federal court declaratory judgment. The condition thus "could not be given the effect of invalidating a judgment which had been rendered when the instrument containing the condition was before the court, since all matters are merged in the judgment." The court rephrased its distress with the voided condition: The condition "is not to become operative until there has been a judgment; but after the judgment has been rendered it cannot become operative because the matter involved is concluded by the judgment."

In a similar case, a husband and wife transferred shares of stock to their three children. At the time of the gifts, these individuals executed a gift adjustment agreement that was intended to ensure that the parents' gift tax liability for the stock transfers would not exceed the unified credit against tax to which they were entitled at the time. This agreement stated that, if it should be finally determined for federal gift tax purposes that the fair market value of the transferred stock either was less than or greater than $2,000 per share, an adjustment would be made to the number of shares conveyed, so that each donor would have transferred $50,000 worth of stock to each donee.

The court in this case declined to give effect to the gift adjustment agreement, inasmuch as honoring the agreement would run counter to public policy concerns. It wrote that a "condition that causes a part of a gift to lapse if it is determined for Federal gift tax purposes that the value of the gift exceeds a given amount, so as to avoid a gift tax deficiency," involves a "trifling with the judicial process." If valid, this type of condition would "compel" the court to "issue, in effect, a declaratory judgment as to the stock's value, while rendering the case moot as a consequence." Yet there was "no assurance that the [parents] will actually reclaim a portion of the stock previously conveyed to their sons, and our decision on the question of valuation in a gift tax suit is not binding upon the sons, who are not parties to this action." The sons, the court added, "may yet enforce the gifts."

There is another line of law, captured by this quotation: "The purpose of Congress in providing deductions for charitable gifts was to encourage gifts for charitable purposes; and in order to make such purposes effective, there must be a reasonable probability that the charity actually will receive the use and benefit of the gift, for which the deduction is claimed." A dissenting opinion in a court case stitched these aspects of the case law together in an attempt to defeat charitable contributions that the dissenter viewed as caused by an increase in value of property facilitated by the court majority. The dissent concluded that the "possibility of an increased charitable deduction serves to discourage [the IRS] from collecting tax on the transaction because any attempt to enforce the tax due on the transaction is of no advantage to the fisc." It argued that the charity involved would never be able to benefit from the gifts, and characterized the charitable deduction as "against public policy" and "plainly wrong."

In perhaps the best application of the public policy doctrine in the charitable giving setting occurred when the IRS issued regulations concerning charitable lead trusts (see Chapter 9) in an effort to stop the practice of using the lives of seriously ill individuals to measure the income interest period, so as to move income and assets away from charitable beneficiaries prematurely and to private beneficiaries instead. The IRS observed that, "similar to the vulture, the promoters of this form of charitable lead trust circle in on mortally ill people," thus giving rise to the term *vulture* or *ghoul* charitable lead trust. The agency stated: "Marketing schemes that exploit the misfortunes of some for the benefit of others are contrary to public policy."

SOME STATISTICS

Annual charitable giving in the United States is nearing $300 billion. (In 2005, the precise amount was $260.28 billion.) About 75 percent of this giving is from living individuals. Other gifts (or grants) are derived from business corporations, private foundations, and estates (bequests and devises). Approximately one-third of annual charitable giving is to religious entities. The other donees, in descending order of amounts received, are educational institutions, health care organizations, arts and humanities entities, public-society benefit organizations, environmental groups, and international organizations.

There are about 1 million charitable organizations registered with the Internal Revenue Service; that number continues to grow.

Hundreds of thousands of other charitable organizations exist. Overall, the U.S. nonprofit sector is edging close to accounting for about 10 percent of the nation's economy. The sector employs more people than any of these industries: agriculture, mining, construction, transportation, communications, other public utilities, finance, insurance, and real estate. The nonprofit component of the United States generates revenue that exceeds the gross domestic product of all but six foreign countries (China, France, Germany, Italy, Japan, and the United Kingdom).

SUMMARY

This chapter provided basic information about the laws that pertain to charitable giving. The discussion started with an analysis of the fundamentals, including the meaning of the terms *charitable organization* and *charitable contribution.* The chapter also offered an introduction to the charitable deduction, summarized the differences between the terms *public charity* and *private foundation,* identified the various types of donors, and inventoried the factors affecting the deductibility of gifts. It discussed some of today's subtle charitable gift situations and summarized the law concerning charitable pledges. The law as to grantor trusts and donor-advised funds was explained. The chapter concluded with a look at applicability of the public policy doctrine, and statistics pertaining to charitable giving and the charitable sector generally. These topics provide the reader with the fundamentals of the law of charitable giving. The balance of the book is devoted to an examination of specific law subjects and issues. This frame, coupled with the information provided in the remainder of the book, provide the nonlawyer with a usable understanding of charitable giving law.