

# **DONOR RESTRICTIONS: What Will They Think of Next?**

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**Erik Dryburgh  
Adler & Colvin  
235 Montgomery Street, #1220  
San Francisco, CA 94104  
415-421-7555  
dryburgh@adlercolvin.com**

## **I. COMMON GIFT RESTRICTIONS**

- A. Purpose
- B. Endowment
- C. Naming opportunity
- D. Investment of gift assets
- E. Administration issues
- F. Restrictions on contributed asset

## **II. DONOR ISSUES**

### **A. Contribution of a Partial Interest**

1. **General Rule:** A gift of a partial interest in property is generally non-deductible, unless within one of the statutory exceptions (IRC section 170(f)). The donor must generally give his/her entire interest in the property.
2. **Exceptions:** Certain exceptions exist for remainder interests in CRTs and PIFs, income interests in CLTs, a remainder interest in a farm/ranch or personal residence, a conservation easement, and an undivided portion of the donor's entire interest.
3. **Examples:**

Gift of a patent, in which the donor retained the right to license the patent to others, is non-deductible (Rev. Rul. 2003-28).

Gift of a remainder interest in a beautiful forest and lake to a land conservation entity – non-deductible, as it is not a remainder interest in a farm/ranch or personal residence (IRC Section 170(f)(3)(B)).

Gift of shares of stock, where the donor kept the right to vote the shares is non-deductible (Rev. Rul. 81-282).

Gift of the rent-free use of space is non-deductible (Reg. Section 1.170A-7(a)(1)).

Gift of real property, where the donor retained the mineral rights, is non-deductible (Rev. Rul. 76-331), as is a gift of an overriding royalty or profits interest where the donor retains the underlying property or lease interest (Rev. Rul. 88-37).

4. Partial interest issues can impact gift tax as well as income tax deduction.

#### B. Incomplete Gift

1. Purpose restrictions may be imposed at time of gift. However, if the donor retains continuing authority to change the purpose or direct the use of the contribution, the gift may be incomplete due to his/her having retained the power to direct the disposition or enjoyment of the property (*Pauley*, 459 F.2d 624 (1972); *Fakiris v. Comm'r*, TC Memo 2017-126 (2017)).
2. Donor-advised funds, of course, only allow the donor-advisor to exercise “advisory privileges” with respect to grants or investments, but not control the use of the funds (IRC Section 4966(d)(2)). The Joint Committee on Taxation Technical Explanation states that “In cases where a donor retains control of an amount provided to a sponsoring organization, there may not be a completed gift for purposes of the charitable contribution deduction.”

#### C. Contingencies

1. If the gift can be defeated by some future event (a “condition subsequent”) that is not “so remote as to be negligible”, no deduction is allowable (Reg. Section 1.170A-1(e)).
2. For example, a gift of a patent subject to a condition that a particular faculty member remain on staff for 15 years, with a reversion back to the donor if he/she did not, is not deductible (Rev. Rul. 2003-28).

#### D. Valuation

1. Certain restrictions (especially those affecting the charity’s ability to sell the gift asset) can impact valuation. For example, a gift of a patent subject to a condition that the university could not sell the patent for three years is deductible – but the prohibition reduces the FMV of the gift (Rev. Rul. 2003-28). On the other hand, a gift of art to a museum, subject to restrictions regarding the continuous display of the works as a group and the re-investment of sales proceeds in other works of art, did not reduce the deduction amount. (PLRs 200202032, 200203013, 200203014).

2. Restrictions limiting a charity's use of an asset may be problematic as well. A donor who gives real estate to charity and requires that the charity only use the land for agricultural purposes, when there is a "higher and better" (i.e., more valuable) use may face a reduced deduction (Rev. Rul. 85-99).
3. The appraisal rules require that the appraiser describe any restrictions imposed on the gift, and consider if they impact valuation – in particular, the terms of any agreement that relate to the use or sale of the gift property, including restrictions on the charity's right to use or dispose of the property (Reg. Section 1.170A-13(c)(3)).
4. Exercise caution when placing restrictions on bequests – the estate will include the full value of the property, but the charitable deduction may be reduced if there are significant restrictions.

#### E. Gifts for a Particular Person

1. A gift to a charity that is "earmarked" for a particular person is treated as a gift to that person (*Thomason*, 2 TC 441 (1943)). The charity must exercise control and discretion over the use of the funds, and the donor must have intended to benefit the charity rather than the individual.
2. IRS has suggested the following language: "this contribution is made with the understanding that the donee organization has complete control and administration over the use of the donated funds" (CPE Text for 1999).
3. Donors were successful in deducting a gift after "expressing interest" that the charity support the composition of a work by a particular composer, because the charity did not commit to commission such a work, and charity and donors agreed that the gift would be used at the discretion of the charity (PLR 200250029).

#### F. Return Benefits

1. A gift is not deductible as a charitable contribution if the donor expects to receive "substantial return benefits". See *Ottawa Silica v. US*, 699 F.2d 699 (1983) (gift of land to school district would lead to construction of roads, increasing value of retained land); and *Singer Co. v. US*, 449 F.2d 413 (1971) (bargain sales of sewing machines to schools were done for purpose of increasing market for machines).
2. When the return benefit is nominal, a deduction is available because the payment has a dual character (part purchase, part gift). A dual character payment is deductible only to the extent the payment exceeds the benefits

received and only if the payor can demonstrate the he/she knowingly and purposefully paid more than the value of the benefit received (*United States v. American Bar Endowment*, 477 US 105 (1986)).

### III. CHARITY ISSUES

#### A. Administrative Issues

Donors often do not understand a charity's administrative policies and procedures, and can be suspicious of how policies and procedures are made. Donors also do not realize that perpetuity is a "very long time". It is important to educate donors on these issues.

#### B. Fiduciary Duty Issues

1. Is gift purpose consistent with charity's mission? Donors often want to make a gift or bequest to Charity X, with the understanding that it will transfer a portion of the funds to Charity Y.
2. Investment restrictions imposed by donor may create "fiduciary duty – prudent investment" issues for the charity's Board of Directors. In California, a board may be relieved of certain of its fiduciary duties if a donor authorizes (or requires) a certain investment (Cal. Corp. Code Section 5240(c), UPMIFA Probate Code Section 18503).

#### C. Substantiation Issues

The receipt issued by the charity must accurately describe the property received. If a charity provides "return benefits" to a donor, it must describe the goods or services provided, provide a good faith estimate of the value of the goods and services, and disclose that the deduction is limited to the value contributed over the value of the goods and services provided (IRC Sections 170(f)(8) and 6115).

#### D. Donor Relations – Public Perception Issues

1. Lee Bass made a \$20 million gift to Yale University to establish a program in Western civilization, and wanted to approve the people who would teach it. Ultimately, Yale returned the money.
2. Dr. Albert Barnes established the Barnes Foundation in 1922 to house his art collection. The collection was in a modest structure in a suburb of Philadelphia, and Dr. Barnes specified that it could not be moved or sold. The Foundation trustees filed suit to move the collection to Philadelphia, arguing it was not economical to continue the museum in its suburban

location. The court rejected various parties' attempts to contest, holding they had no standing, and said the public interest was to be protected exclusively by the Attorney General.

3. Even mere naming opportunities carry risk: University of Missouri-Columbia established the "Kenneth Lay Professorship" and the University of Alabama-Birmingham established the "Richard Scrushy Building". I have now started to see (and draft) more gift policies that contain an "un-naming" provision.

#### **IV. SPENDING RESTRICTIONS**

##### **A. What Is an Endowment?**

1. To a donor, an endowment is a sum of money given to a charity for charitable purposes, with only the "income" being spent and "principal" being preserved.
2. To an accountant, it is a fund that is "permanently restricted".
3. To a lawyer, it is an institutional fund not wholly expendable on a current basis under the terms of the gift instrument.
4. Thus, a "true" endowment is one established or created by the donor. A board-restricted endowment (or "quasi-endowment") is created when the board takes unrestricted funds and imposes a spending restriction.

##### **B. How Much of an Endowment Can a Charity Spend?**

The Uniform Prudent Management of Institutional Funds Act (UPMIFA), adopted in almost every state in the Union, makes a radical change from the old law of endowments and does away with the concept of "historic dollar value". UPMIFA allows a charity to appropriate for expenditure, or accumulate, so much of an endowment fund as the charity determines is prudent for the purposes for which the fund was established. In so doing, the charity must consider:

1. The duration and preservation of the endowment fund,
2. The purposes of the charity and the fund,
3. General economic conditions,
4. Effects of inflation and deflation,

5. Expected total return from income and appreciation,
6. The charity's other resources, and
7. The charity's investment policy.

California, like many other states, included the optional provision stating that an appropriation of greater than 7% of the average FMV of an endowment (averaged over the last three years) is be presumptively imprudent.

## **V. RELEASING RESTRICTIONS**

- A. UPMIFA allows a charity to release or modify a restriction regarding management, investment, or purpose of a fund if the donor consents in writing.
- B. If a purpose or use restriction becomes unlawful, impracticable, impossible to achieve, or wasteful, the court may modify the restriction in a manner consistent with the donor's intent. The Attorney General must be notified.
- C. The court can modify a management or investment restriction if it has become impracticable or wasteful, impairs the management or investment of the fund, or (if due to unforeseen circumstances) the release would further the purposes of the fund. The Attorney General must be notified.
- D. If a fund is less than \$25,000 (\$100,000 in California) in value and over 20 years old, and the charity determines that a restriction on the management, investment, or use of the fund is unlawful, impracticable, impossible to achieve, or wasteful, the charity can (after notice to the Attorney General) release or modify the restriction. It must thereafter use the funds in a manner consistent with the donor's charitable purposes.

## **VI. DOCUMENTATION**

- A. Gift Instrument
  1. It is key to understand, and carefully document, all donor restrictions in a "gift instrument". Not surprisingly, it can be very difficult to determine the terms of a gift if there is no clear gift instrument.
  2. Gift terms can be found in "a will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document (including the terms of any institutional solicitations from which an institutional fund resulted)...."

3. UPMIFA provides that the terms of a gift instrument, and thus any purpose or spending restrictions, must be set forth in a “written record”, which includes email but not “oral” representations.

#### B. Key Gift Instrument Terms

1. An introductory section, describing the transaction, the donor’s intent, and the donor’s connection to the charity in general terms.
2. Charity’s administration policies and procedures (spending, fees, etc.) should be referenced in gift instrument and available to donors.
3. The purpose to which the donor’s gift is dedicated needs to be expressed clearly. With an endowed gift, the funds will be put to this purpose in perpetuity – all parties need to recognize that the purpose must be flexible enough to be meaningful and workable in the future.
4. The gift instrument should contain a variance power. While a restriction can be released with the donor’s consent or a Probate Court order, petitions to modify gift terms are time-consuming and expensive. I strongly encourage charities (and donors) to add a variance power to their gift instruments. Variance powers should address who in the charity may exercise the power (e.g., the Board of Directors), and what standard they are to apply.
5. As to naming rights, charities should consider a “naming right policy” that addresses a donor who becomes embroiled in a scandal, or a building that needs to be expanded/remodeled/etc.

#### C. Spending Rule

An endowed gift should reference the charity’s endowment spending rule, which should track UPMIFA. A charity or donor *can* expand (or restrict) the spending limitations by carefully crafting the terms of the endowment (UPMIFA sets forth a “default” rule). I am generally not in favor of restricting the UPMIFA standard. On the other hand, I sometimes include an “Emergency Invasion” power, under which a charity can spend some of the endowment principal in times of financial need.

#### D. Consequences of a Default

Gift instruments should address what happens if the charity (or donor) “defaults” on their promise. Often, the remedy for a charity’s failure to follow a purpose restriction is to require a “gift over” to another charity.



E. Who Has Standing to Enforce?

1. Donors may wish to ensure they have “standing to sue” if the charity does not abide by the purpose or spending restrictions. Absent such language in the gift instrument, however, the donor may not be able to enforce the terms of his/her gift.
2. Some states have held that unless the donor reserves a right to enforce in the gift instrument, only the state Attorney General has legal standing (*Carl Herzog Foundation v. University of Bridgeport*, 699 A.2d 995 (1997)).
3. Other states have concluded that a donor does have standing (*LB Research and Education Foundation v. UCLA Foundation*, 29 Cal. Rptr. 3d 710 (2005); *Smithers v. St. Luke’s Roosevelt Hospital Center*, 723 NYS2d 426 (2001)).