DONOR RESTRICTIONS:
What Will They Think of Next?

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A. Common Gift Restrictions

1. Naming opportunity
2. Purpose
3. Endowment
4. Investment of gift assets
5. Administration issues

B. Donor Issues

1. Contribution of a Partial Interest

    a. Generally non-deductible, unless within one of the statutory exceptions.

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

    c. Gift of a remainder interest in property that is not a personal residence or farm/ranch is non-deductible (IRC sec. 170(f)(3)(B)(i)).

    d. What about retaining the right to direct the investment of the contributed funds? Properly structured, this may be only an "insubstantial" right, not significant enough to affect the deduction (PLRs 8152072 and 200445023-4) – but if the rights are too significant, the gift may be non-deductible (see, *Fund for Anonymous Donors*, 79 AFTR 2d 97-2520, rev'd 83 AFTR 2d 99-1976).

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

2. Incomplete Gift

    a. Purpose restrictions may be imposed at time of gift. However, if the donor retains continuing authority to change the purpose of the contribution, the gift may be incomplete due to his having retained the power to direct the disposition or enjoyment of the property (see *Pauley*, 459 F2d 624 (1972)).

    b. The federal gift tax regulations provide that a gift is complete "if the donor has so parted with dominion and control as to leave in him no power to change its disposition…", but is incomplete if the donor reserves any power over its disposition, whether to revest title in himself or to name

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new beneficiaries or change the interests of the beneficiaries (unless limited by an ascertainable standard) (Regulation sec. 25.2511-2(b) and (c)).

3. Contingencies

   a. If the gift can be "defeated" by some subsequent event (a "condition subsequent") which is not "so remote as to be negligible", no deduction is allowable (Regulation sec. 1.170A-1(e), 20.2055-2(b)).

   b. 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).

4. Valuation

   a. 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).

   b. The appraisal rules require that the appraiser describe any restrictions imposed on the gift, and consider if they impact valuation.

   c. 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.

5. Gifts For a Particular Person

   a. A gift to a charity which 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.

   b. 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).

   c. 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

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charity and donors agreed that the gift would be used at the discretion of the charity (PLR 200250029).

6. Return Benefits

a. A gift is not deductible as a charitable contribution if the donor expects to receive "substantial return benefits." See *Ottowa Silica v. US*, 699 F2d 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 F2d 413 (1971) (bargain sales of sewing machines to schools were done for purpose of increasing market for machines).

b. 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)).

C. Charity Issues

1. 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.

2. Fiduciary Duty Issues

a. 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.

b. 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 sec. 5240(c)).

3. Substantiation Issues

If a charity provides "return benefits" to a donor, it must under disclose any goods or services provided (IRC sec. 6115). Also, the charity must include a description

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and good faith estimate of the value of any goods and services provided to the donor on its receipt (IRC sec. 170(f)(8)).

4. Donor Relations – Public Perception Issues

   a. 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.

   b. Even mere naming opportunities carry risk – Seaton Hall University has a "Koslowski Hall", University of Missouri-Columbia has the "Kenneth Lay Professorship" and the University of Alabama-Birmingham has the "Richard Scrushy Building".

D. Spending Restrictions

1. What Is An Endowment?

   a. 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.

   b. To an accountant, it is a fund which is "permanently restricted".

   c. To a lawyer, it is an institutional fund not wholly expendable on a current basis under the terms of the gift instrument.

   d. 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.

2. What Is UMIFA?

   a. The Uniform Management of Institutional Funds Act (UMIFA) is a uniform law which provides rules regarding how much of an endowment a charity can spend, for what purpose, and how the charity should invest the endowment funds. UMIFA has been adopted by 47 states and Washington DC. California's version of UMIFA is contained in Probate Code sec. 18500 and following.

   b. UMIFA covers more than just endowments – it applies to all "institutional funds" (i.e., funds held by a charity for its exclusive use).

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3. Why Was UMIFA Adopted?

Charities and their lawyers were unsure how to define "income" in the context of an endowment. Many looked to trust law, which generally defines "income" as including interest, dividends and the like, but defines gains as "principal". Thus, charities invested endowments in bonds and high-dividend stocks, but passed by investments with favorable growth prospects if they had a low current yield. Consequently, long-term yield suffered. The drafters of UMIFA thought charities should be able to spend a prudent portion of the gains earned by an endowment.

4. How Much Of An Endowment Can A Charity Spend?

a. "The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, both realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent …."

b. Net appreciation includes realized gains and unrealized gains.

c. Historic dollar value is "the aggregate fair value in dollars of (1) an endowment fund at the time it became an endowment fund, (2) each subsequent donation to the endowment fund at the time it is made, and (3) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the endowment fund."

d. Although UMIFA does not explicitly so state, "income" (e.g., interest and dividends) may be spent as well.

D. Documentation

1. Gift Instrument

It is key to understand, and carefully document, all donor restrictions in a "gift instrument".

2. Gift Terms If There Is Not a Gift Instrument

a. Not surprisingly, it can be very difficult to determine the terms of a gift if there is no clear gift instrument.

b. 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)...."

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c. Gift terms may also be found in oral representations, development officer notes, etc., but the enforceability (and accuracy) of this "evidence" can be sketchy.

3. Key Gift Instrument Terms

a. An introductory section, describing the transaction, the donor's intent, and the donor's connection to the charity in general terms.

b. Charity's administration policies and procedures (spending, fees, etc.) should be referenced in gift instrument and available to donors.

c. Variance power

i. Under UMIFA, with written consent of the donor, a charity may release a restriction imposed by the donor on the use or investment of a gift.

ii. If the donor is not available, by reason of death, disability, etc., the charity may petition the Probate Court for release of a restriction; if the court finds that the restriction is *obsolete or impracticable*, it may release the restriction. Note that UMIFA provides that a court may not change an endowment fund to a fund that is not an endowment fund. This standard is not unlike that of *cy pres*.

iii. 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.

iv. As to naming rights, charities should consider a "naming right policy" which addresses a donor who becomes embroiled in a scandal, or a building which needs to be expanded/remodeled/etc.

4. Spending Rule

As "charity-friendly" as UMIFA is, some charities (or donors) want more flexibility. In particular, many charities wish to employ their "Spending Rule" (e.g., 5% of the fund's average market value) to all endowed funds, regardless of Historic Dollar Value. A charity or donor *can* expand the spending limitations by carefully crafting the terms of the endowment (UMIFA sets forth a "default" rule).

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5. 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.

6. Who Has Standing to Enforce?

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 gift. 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 A2d 995 (1997)). Other states have concluded that a donor does have standing (*LB Research and Education Foundation v. UCLA Foundation,* (June 15, 2005 decision of California Court of Appeals)*; Smithers v. St. Luke's Roosevelt Hospital Center*, 723 NYS2d 426 (2001)).

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