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Gift Horses

The offer that can be refused

*by Anne M Carley**

For almost any charity, offers from potential donors are hard to reject. Sometimes, however, it may make more sense not to accept a proffered gift. What could go wrong?

A nonprofit considering whether to accept a charitable gift must weigh the costs and benefits every time. Some common problems involve requests for special treatment, either for the donor or for the gift. The new donor may want a seat (or the chair) on the Board of Directors in exchange for a cash contribution. There may also be trouble ahead if the donor wants to impose restrictive conditions on a gift, such as requiring that the car to be contributed to a museum of automotive history must be on exhibit for nine months out of every year, forever. The fact that such restrictions can sometimes diminish the donor's tax deduction will help dissuade some donors from insisting on them.

Particularly when the donor is a for-profit corporation, there may be an expectation of a quid pro quo in return for its gift. As a preventive measure, the Smithsonian Institute established a policy permitting corporate donors of

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$ 25,000 or more to entertain guests at one party at the museum per year. A donor expecting anything additional will be refused.

If the donor wants to exert control within the charity, the potential donee may want to examine closely its organizational tolerances. If there is no capacity to accommodate a new "player," perhaps an alternative can be arranged. The donor might create or participate in a separate charitable entity, with ties to the first one, such as a supporting organization, donor-advised fund, or split-interest trust.

Rather than gifts of money and financial instruments, sometimes a gift of tangible personal property is the best for all concerned. The donor can gain substantial tax advantages, as compared to selling the property, giving it to a friend or relative, or keeping it in her estate.

The care and feeding of contributed property can really add up, however, after the gift is made. Before accepting a high-maintenance gift — for example, a priceless ancient manuscript requiring meticulous climate control, special low lighting and strictly limited access, and for which insurance premiums are exorbitant — the nonprofit should consider if the gift is worth it.

Using the Gift

For the donor to get the largest tax deduction on a gift of tangible personal property, the nonprofit's use of the contributed property must be related to the

organization's charitable purposes. This "related-use" rule means, for instance, that a sculpture contributed to an art museum will benefit the donor more than that sculpture contributed to a charitable trust, if displaying art is within the museum's charitable purposes, but not the trust's.

Even after a gift is made, if the IRS determines the charity cannot put the gift to a related use, the donor's tax deduction will shrink substantially, from fair market value to cost alone.

Take the contribution of an important painting to a museum seeking a painting of just that period and style. Both parties benefit: the donor gets a fair market value income tax deduction (without regard to the donor's cost basis, which may be tiny), and the museum gets an appropriate gift for a related use.

On the other hand, if related use seems questionable, the transaction stands on shakier ground. If the IRS disallows the donor's fair market value deduction, it limits the donor's deduction to the cost of the painting. Because of the importance of the related-use rule, the nonprofit may be asked to document in advance its plans for the contributed property, giving the donor a paper trail should the contribution be challenged later. If the nonprofit cannot establish a related use, it may want to disclose that fact to the donor before the gift is finalized.

Sometimes a promise is just not enough. Consider a first-time donor to a museum, offering an undivided fractional gift of one-tenth of a one-million-

dollar painting per year for ten years, after which the entire work would belong to the museum.

In the first year, the donor would take a charitable income tax deduction for $ 100,000.00 (one-tenth of the value), and the institution could exhibit the work for 37 days (one-tenth of a year). The following year, the donor would deduct one-tenth of the next year's appraised value (which could have increased or decreased from $ 1 million) while the museum would have access to the work for 73 days (20 percent of a year).

Sometimes the previous owner's rights of ownership will prevail, even if both donor and nonprofit claim innocence of any knowledge of the work's history.

The donor, who promises to follow through in this manner for the full ten-year period, is elderly and infirm, yet refuses to sign any binding agreement on which the nonprofit can rely for ten years. It may not be prudent to accept such a gift, with the real possibility that the donor could die before the ten years are up, leaving behind disputes over shared ownership of a very valuable asset.

What if the relationship between donor and nonprofit sours over time? Learn from the $ 5 million lawsuit a Chicago museum brought against board

member/donors who changed their minds about their charitable pledge.

In addition to the obvious problems, a change in national accounting guidelines now requires charities to show pledges as current income, so that the failure to complete this pledged gift would result in a $ 5 million loss to the charity in that year's annual report. Such a loss, at first look, could deter other donors, by suggesting the charity's fiscal health was unsteady. For these reasons, the cautious nonprofit may want to examine the strength of commitment existing even in irrevocable obligations, even from friends of the charity.

Donors often delay until death gifts of what the IRS calls "ordinary income property." For example, artists owning many of their own works, or appliance dealers who still own a warehouse full of refrigerators they acquired as inventory, or collectors who received gifts of art from the artist can gain significant tax benefits by deferring charitable transfers until death. Nonprofits should know this, and work with potential donors accordingly.

What if the donor promises that painting to a museum in her will? This can be hugely attractive to the donor yet less so to the nonprofit: there is the wait, and the constant possibility that the will could be changed at any time before death.

To the donor, however, using her will to make charitable contributions of non-liquid assets can lower or even eliminate estate tax liability, and the related-use rule does not usually apply to contributions made by will. The nonprofit should confer with the donor to agree upon the plans in advance, perhaps to establish an

irrevocable trust arrangement.

Also, technical legal problems can interfere with a bequest, if the will's language is not sufficiently detailed, and the particular objects not clearly identified. On the other hand, sometimes those ambiguities could give a charity more than expected. A nonprofit may want to ask that the will include a fallback position whereby a non-charitable bequest (to family or friends, for example) that is renounced should go to the charity instead.

Sometimes the problem lies with the gift property itself. Consider the long-time donor offering a treasured painting to an appropriate museum. It could seem impolitic, if not insulting, to send experts to the donor's home, with their white gloves, magnifying lenses, and special tools, to authenticate the work. However, the painting may be a very good fake, about which the collector-donor was completely ignorant.

Similar problems can arise with gifts of real estate to charity, when the donated property is discovered to contain toxic wastes buried underground.

Recently disputes have arisen between a charity accepting a painting as a gift, and the descendants of a previous owner, from whom the Nazis appropriated the work.

Sometimes the previous owner's rights of ownership will prevail, even if both donor and nonprofit claim innocence of any knowledge of the work's history. For these reasons, it is prudent to investigate prior to accepting a gift. Direct

communication within the organization — for example, to avoid conflict between a charity's administration and development arms — and established standards of due diligence can help protect the charity from moving too quickly to accept a questionable gift.

As tempting as it may be sometimes, nonprofits should resist promising certain tax benefits to the donor of a particular gift. For example, a work of art given as a gift to a collector by the artist retains its character as ordinary income property, even in the hands of the collector. This means that regardless how much the object may have appreciated in value, the collector should only deduct the artist's cost basis, often less than $ 100, if she donates the work to an eligible charity during her lifetime.

A work by an important artist, can mean millions of dollars in fair market value, that the donor cannot deduct. Through ignorance or willful blindness, an eager development officer could injure any long-term relationship with this donor by providing too rosy a picture of the gift transaction's benefits. A donor may, of course, choose for other reasons to go ahead with a contribution, regardless whether the maximum tax benefit is available to her. On the other hand, her advisers may favor waiting to make bequests through her will.

While the nonprofit must refrain from assuring a donor of specific tax consequences, the nonprofit should understand the rules governing charitable gifts. A crucial aspect for most donors is the value of the gift and its tax impact, since substantial penalties exist for undervaluation of estate and gift tax and for

overvaluation of the income tax deduction.

For lifetime gifts, the valuation submitted with the donor's income tax return must be a "qualified appraisal" by a "qualified appraiser." The IRS definitions of those terms are important, since the entire charitable income tax deduction can be lost if the appraiser is determined later not to have been "qualified."

A very helpful tool is IRS Publication 561, "Determining the Value of Donated Property," which goes into detail on valuation rules and their meanings. For testamentary bequests, the estate tax return must include the claimed value of the contributed property, although the appraiser is not required to be "qualified."

In a perfect world, every offered gift will be completely welcome and appropriate to the nonprofit's purposes. In the perfect world, the donor will never ask for further attention from the nonprofit except to make additional unrestricted gifts, promised gifts will always arrive on time, the IRS will find no fault with tax documents submitted by any and all involved parties, and the administration and development offices of the nonprofit organization will be telepathically linked at all times.

Failing these conditions, a thoughtful examination of the potential drawbacks of a proffered gift can be a nonprofit's best friend.