Sustainable Philanthropy

Advising and Representing *Exempt Organizations* and *Donors*

Giving with Strings Attached
Earmarked & Conduit Contributions

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Sustainable Philanthropy – Donor Care, Earmarked Donations

Setting the Scene:

Compassionate or dedicated Donor-Philanthropists sometimes want to donate to specific individuals, or to support specific individuals and their social-humanitarian efforts.

Sophisticated donors realize that **"*Contributions*" made directly to an individual are "*Gifts*" that create no income tax *Charitable Deduction*.** If the gift is large enough,[1] it triggers donor gift-tax return obligations – and, possibly, gift-tax liability.

That is not quite what most donors intend.

Faced with that realization, some donors resort to "restricted donations" made through a qualified charitable organization. That is, they make a charitable donation to a recognized charity but restrict who can receive the benefit of it.

- Gift letters like "This check is to be used to pay Martha's medical expenses," and
- Instructions or understandings like "Use this to support Father Tony's Overseas mission,"

often accompany these donations.

M**aking an "Earmarked Gift" through a qualified charity does not earn the donor an itemized Charitable Deduction.** This holds regardless of how well intended the donor's contribution or how clear the need may be.

Absent the deduction, the donor is left with only the rosy-glow-of-virtue in return for their generosity and consciousness. Maimonides[2] considered that the penultimate reward for charity – but a good healthy tax deduction ices the cake![3]

To understand why the deduction for an earmarked contribution is denied, we take a closer look at why the charitable deduction is allowed in the first place.

Internal Revenue Code §170: Detached or Disinterested Generosity

As used in the Internal Revenue Code (IRC), the term "*Charitable Contribution*" refers to a voluntarily *Gift*[4] made to a *Qualified Charity* with **no expectation of commensurate financial benefit in return for the transfer.**[5]

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[1] For 2022, the annual exempt gift limit is $16,000 per donee per *Donor*. The lifetime exempt gift tax exemption is $12.06 million per *Donor*. Pending legislation may alter both these limits and how they are calculated.
[2] Moses ben Maimon (1138–1204), also known as Maimonides, was a medieval Sephardic philosopher who wrote extensively on Jewish law and ethics, and the nature of charity (tzedakah).
[3] In a 2022 BNY Mellon Wealth Management / Brown Yardley Research survey, respondents ranked tax issues seventh in their list of charitable donation motivators – well below Personal satisfaction, Special causes, Impact, Legacy, Community relations, and Religious convictions and above only Family traditions and Social recognition.
[4] *Channing v. U.S., 4 F. Supp. 33(D. Mass. 1933), aff'd per curiam, 67 F.2d 986(1st Cir. 1933)* – in this context, gift and contribution are synonyms, though we use contribution throughout this piece.
[5] Treas. Reg. §1.170A-1(c)(5), H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A44 (1954); S. Rep. No. 1622, 83rd Cong., 2nd Sess. 196 (1954).

It follows, that donors get a contribution deduction only if the payment or property transfer is made as **an act of *Detached or Disinterested Generosity*** and not for an anticipated benefit to the payor.[6] If the donor receives or expects to receive a substantial financial or economic benefit (a "quid pro quo"), the charitable deduction is precluded.[7]

When donors give an organization an earmarked contribution, **the quid pro quo is the charitable deduction[8] for a payment that would not be deductible if made directly to the beneficiary or their cause.** Based on this logic alone, the Service could justifiably disallow earmarked contribution deductions.

Internal Revenue Code §170(a) & (c): "To or for the use of"

> "Charity begins where certainty in beneficiaries ends, for it is the uncertainty of the objects and not the mode of relieving them which forms the essential element of charity." [9]

The Service reasons (and Courts concur) that a contribution is not made "to" a charitable organization if the facts and circumstances show that the charity is merely a conduit to a particular person.[10]

In a somewhat more nuanced variant of the same argument,[11] the Service maintains that a contribution "to or for the use of" the charitable organization demands that:

- the organization have full control over the use of the donated funds and
- the contributor intends to benefit the charitable organization itself, not the individual recipient.

Discretion and Control: If the donee organization cannot exercise discretion and control over the contribution, there is a strong argument the transferred assets are not deductible charitable contributions.

In contrast, the fact that the Donee Organization may apply the donated funds to purposes other than those preferred by the donor supports deductibility.

Thus, the phrase "to or for the use of" implies the organization acquires a "right of exclusive appropriation or enjoyment of the thing donated," rather than control over its purpose or mode of use.[12] In Service opinion, "for the use of" conveys a meaning similar to "in trust for."

Donor Intent: Facts that imply the donor intends to benefit the organization, support deductibility.

Donative Intent may be indicated by the terms of a written gift letter, or the content of the donee organization's fundraising literature.[13]

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[6] *Commissioner v. Duberstein, 363 U.S. 278 (1960)*
[7] Singer v. U.S., 449 F.2d 413 (Ct.Cl. 1971)
[8] Technically, the quid pro quo is the "tax savings" from converting the donation to a charitable deduction. In the post-Tax Cuts and Jobs Act era this savings is often difficult to compute.
[9] *Russell v. Allen, 107 U.S. 163*
[10] *Rev. Rul. 62-113, 1962-1 C.B. 10*,
[11] *Rev. Rul. 68-484, 1968-2 C.B. 105*
[12] *S.E. Thomason v. Commissioner, 2 T.C. 441 (1943)*
[13] The Service suggests that the phrase; "This contribution is made with the understanding that the donee organization has complete control and administration over the use of the donated funds." inserted into donee literature clarifies the *Donor*'s charitable intent.

Charitable Classes

Charitable Classes stand at the core of the Service's determination process, the private benefit discussion, the purpose and operations tests, and, ultimately, the treatment of earmarked deductions. The gist of the policy is:

> **Organizations can obtain and maintain their exemption and Donors can deduct their contributions only if the activities or contributions benefit an identifiable charitable class.**

Considering the pivotal role that *Charitable Classes* play – It is it is rather amazing how stunningly poorly they are defined in the IRS canon, the Code, and the Regulations.[14] To comprehend the policy, it is necessary to review the Service's pronouncements (Revenue Rulings and Private Letter Rulings), and caselaw - on a case-by-case basis. Even then, a definition remains elusive. The most "comprehensive" general definition of the concept is found on the IRS website[15] and, in slightly different (more specific) form, in IRS Publication 3833.[16]

IRS Publication 3833 states:

> The group of individuals that may properly receive assistance from a tax-exempt charitable organization is called a "charitable class."
>
> A charitable class must be large enough or sufficiently indefinite that the community as a whole, rather than a pre-selected group of people, benefits when a charity provides assistance. For example, a charitable class could consist of all the individuals in a city, county or state. This charitable class is large enough that the potential beneficiaries cannot be individually identified and providing benefits to this group would benefit the entire community.
>
> If the group of eligible beneficiaries is limited to a smaller group, such as the employees of a particular employer, the group of persons eligible for assistance must be indefinite. To be considered to benefit an indefinite class, the proposed relief program must be open-ended and include employees affected by the current disaster and those who may be affected by a future disaster. Accordingly, if a charity follows a policy of assisting employees who are victims of all disasters, present or future, it would be providing assistance to an indefinite charitable class. If the facts and circumstances indicate that a newly established disaster relief program is intended to benefit only victims of a current disaster without any intention to provide for victims of future disasters, the organization would not be considered to be benefiting a charitable class.
>
> Because of the requirement that exempt organizations must serve a charitable class, a tax- exempt disaster relief or emergency hardship organization cannot target and limit its assistance to specific individuals, such as a few persons injured in a particular fire. Similarly, donors cannot earmark contributions to a charitable organization for a particular individual or family.

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[14] In fact, we could find nothing in either Code or Regs that even uses the term "charitable class." If you find one, let us know!
[15] IRS Website: What is meant by charitable class?
[16] IRS Publication 3833, *Disaster Relief*

Quickly summarizing, 1) There is something called a *Charitable Class*, 2) It's big and nebulous, 3) you have to serve one, 4.1) make it too small, you lose, 4.2) Ditto if you make it too brief, 5) We think it's important, but 6) that's all we're giving you to work with.[17]

If you are looking for more illumination, you are out of luck: neither of the Service's documents points you to, e.g., a precedential source for the doctrine.[18]

Interestingly, most of the literature on the subject adopts the same approach – usually by directly quoting the Publication and citing a small number of litigated cases, revenue rulings, or Private Letter Rulings that shed equally little light on the subject. We have to wonder if, like us, they found themselves obsessively searching their database at 2:40 AM, after six hours of search time – and simply gave up.

Restriction vs. Earmark

Donors may dedicate their contribution to a particular use if the restriction does not prevent the charity from freely using the transferred assets or, at a minimum, the income from the asset to further its charitable purposes.[19]

The Regulations provide examples of permissible restrictions, including the creation of an endowment fund and donation of funds for the construction of a building.[20]

Restrictions or conditions placed on a gift must be made before making the grant. Retained rights to place conditions after the gift render the gift incomplete. Donors may, however, retain the right to make nonbinding recommendations regarding property.[21]

The authors advise caution or restraint when placing restrictions on a contribution. If too many restrictions are placed, the Service may treat the contribution as a separate charitable trust, subject to the private foundation rules. This creates tax headaches for both the donor and donee: it imposes the more restrictive private foundation deduction limits and operating restrictions.

Deductible Contribution vs. Tuition, Rev. Rul. 83-104

Rev. Rul. 83-104[22] develops six fact situations that illustrate the distinction between qualified charitable contributions and tuition payments. The analysis and its conclusions provide a framework for determining deductibility of earmarked contributions as well.

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[17] OK, not entirely accurate. There are minimal references to the definition in several IRS pronouncements – most notably (but equally unhelpful), Chapter 9 of *Exempt Organizations Determinations CPE-2012*

[18] Neither the website nor the Publication may be cited as precedent.

[19] Treas. Reg. §1.507-2(a)(8); *Phinney v. Dougherty, 307 F.2d 357 (1962*

[20] Treas. Reg. §1.170A-1(e)

[21] This forms the basis for permitting immediate tax deductions for contributions to *Donor* Advised Funds.

[22] *Rev. Rul. 83-104, 1983-2 C.B. 46*

The Revenue Ruling identifies several factors, the presence of which support the presumption that payments to an organization are not charitable contributions: (Quoting, verbatim, hideous sentence structure, and all)

- The existence of a contract under which a taxpayer agrees to make a "contribution" and which contains provisions ensuring the admission of the taxpayer's child.
- A plan allowing taxpayers to either pay tuition or tomake "contributions" in exchange for schooling.
- The earmarking of a contribution for the direct benefit ofa particular individual.
- The otherwise unexplained denial of admission or readmission to a school of children of taxpayers who arefinancially able, but who do not contribute.

The Revenue Ruling posits other factors that may indicate a payment is not a charitable contribution.If those factors are present, economic or non-economic factors must be reevaluated.

- The absence of a significant tuition charge.
- Substantial or unusual pressure to contribute applied to parents of children attending the school.
- Contribution appeals made as a part of the admissions or enrollment process.
- The absence of significant potential sources of revenue for operating the school other than contributions by parents of children attending the school.
- Other factors that suggest that a contribution policy has been crafted as a means of avoiding the characterization of payments as tuition.

"Tuition" Cases

S.E. Thomason v. Commissioner, 2 T.C. 441 (1943): The plaintiff paid an educational institution the tuition and maintenance of a particular individual, who was the ward of a public charity. The court held that the taxpayer was not entitled to the deduction because the contributions were for the benefit of a particular individual.

Tripp v. Commissioner, 337 F.2d 432 (7th Cir. 1964): Payments made to an educational institution and earmarked for the educational expenses of a particular individual were not deductible. They were neither made to the college for use as it saw fit nor made for the benefit of an indefinite number of persons, as, for example, a scholarship fund.

Graves v. Commissioner, T.C.M. 1994-16: No portion of payments made by plaintiffs to a private foundation that solicited funds from parents of children in private schools to pay their tuition were charitable contributions.

Graves v. Commissioner is a classic example of "laundering" money through a convenient "fiscal agent" or intermediary organization. The organization, The Owl Foundation's primary activity was to act as a conduit of funds to pay for tuition. The Tax Court held that no portion of payments made by a married couple to The Owl

Foundation qualified for a charitable deduction. See the extensive discussion of Graves in the Service's EO Topic 96.[23]

Deductible Contribution v. Other "Good Causes"

Like the "tuition" cases, donations to funds set up to help designated individuals or families (benevolence funds, e.g., to pay for an organ transplant or to rebuild a home destroyed by a tornado), and religiously motivated programs to support designated missionaries are generally not deductible.

Missionary Support

The Service has held[24] that contributions to a religious ministry are not deductible if they are earmarked for a specific student or missionary and the church did not have full control of the donated funds.

In what the Service probably views as a subtle distinction, the Service allows a deduction for deputation offerings[25] if the funds raised by the offerings are accountable and under the church's control. Even though the money is given to the missionary, the church controls it throughout the donation-deputation. The donor receives no personal benefit.

Both the TAM and the Service's, seemingly inconsistent, deputation position arose from disputes[26] over what were then called "donor-directed funds" (the precursors to Donor Advised Funds). It is interesting to note that many of the arguments regarding "control" over Donor Advised Funds – particularly those regarding timing of disbursements and "siphoning off contributions from legitimate charities"[27] – sound a bit like déjà vu viewed through the lens of the earlier cases.

Missionary cases:

Davis v. United States, 495 U.S. 472 (1990): In what is probably the most famous of the missionary cases, the Supreme Court held that funds transferred by the plaintiffs to their two sons while they served as full-time, unpaid missionaries of the Church of Jesus Christ of Latter-day Saints (Church) did not qualify as a charitable contribution made "for the use of" the Church in the absence of evidence that the funds were transferred "in trust for" the Church. The Supreme Court affirmed the lower courts and concluded that because the taxpayers did not donate the funds "in trust for" the Church, or in a similarly enforceable legal arrangement for the benefit of the Church, the funds were not donated "for the use of" the Church.

To reach its decision, the Court noted that the Church:

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[23] EO Topic 96;

[24] TAM 94-05-003, November 12, 1992

[25] In a deputation offering: A missionary (for example) visits the Church to talk about their work. At the end of the presentation, an offering for the work of the mission is collected. The proceeds of the offering are given to the missionary.

[26] Notably *National Foundation, Inc. v. United States*, 13 Cl. Ct. 486 (1987) and *The Fund for Anonymous Gifts v. Internal Revenue Service*, 97-2 U.S.T.C.50,710 (1997)

[27] Compare, in this regard, Wall Street Journal, February 12, 1998 and the rhetoric that surrounds the ACE Act (S.1981 — 117th Congress (2021-2022)

- had a well-established missionary program,
- selected the missionaries and determined where they would serve,
- supervised the program closely,[28] and
- made suggestions for changes in amounts of support needed when appropriate.

In contrast, however, the Church:

- did not receive the funds,
- gave only advice regarding the wise use of funds,
- expected the parents of the missionaries to support their children's living expenses,
- did not commingle the funds with those of other missionaries,
- did not disburse funds based on need, and
- did not control the amount or timing of the parent's support for the missionary.

The Service and the Court agreed that the latter facts overcame the former. Contribution denied.

Peace v. Commissioner, 43 T.C. 1 (1964), acq., 1965-2 C.B. 6: The Court found that amounts paid directly to Sudan Interior Mission were contributions "to and for the use of" the Mission, not personal gifts to four designated missionaries.

- contributions were placed in a common pool,
- were disbursed based on each missionary's needs, and
- the Mission had exclusive control, under its own policy, of both administration and distribution of the funds

The court concluded that "the totality of the facts and evidence … clearly demonstrate(s) that the taxpayers knew and intended that their funds would go into a common pool to be distributed only as the Mission itself determined."

The Mission's policy was clearly stated in a pamphlet entitled "Missionary Maintenance:"

> Contributions designated by the donor to a specific department of the work or to an individual are applied as designated. The general fund, from which the general administrative expenses are met, receives most undesignated and sundry contributions. It is the aim of the Mission that each missionary going forth have his full support promised. The money thus received is divided equally for Personal Allowance and Service Support. The Personal Allowance Fund is divided equally each month among all the missionaries and fluctuates in proportion to the amount available. This is the equivalent of the missionaries' "salary" and is for his personal use. The actual sum received varies slightly on different fields but the fund is shared in such a manner as to enable each one to enjoy as nearly as possible the same purchasing power. From the half that goes into Service Support, appropriate sums are set aside for passage and general maintenance requirements. At the end of each month, any balance in the general fund is

[28] The Church, through a Missionary President, controlled the missionary's schedule, activities, behavior, dress, and expenses, among other things.

> transferred to the Allowance Fund and augments the amounts available for the missionaries' monthly allowances. By sharing funds this way, with each member contributing his support funds to the general family welfare, the Mission is happily following the example of the early church. There are missionaries accepted by the Mission who are waiting to sail but who need financial support. Perhaps God would have you share the burden by undertaking partial or full support of one of these, to be your personal gospel representative in Africa. The Mission's policy is that each of the missionaries acquire pledges from donors in the amount of his or her annual support. Contributors measure their contributions in terms of the support of individual missionaries. Contributions are placed in a common pool used for missionary support and are disbursed in accordance with the policy of the Mission as set out in the "Missionary Maintenance" pamphlet. The taxpayers in the case measured their contributions in terms of partially meeting the support for four named missionaries.

Our discussion of the missionary cases would not be complete without mentioning two cases[29] in which separate appellate courts sanctioned parents' deductions for payments to their missionary sons. In the Court's view the expenses qualified as out-of-pocket expenditures incidental to volunteer services[30] even though the parents, themselves, supplied no services. In both cases, the Appellate courts ignored obvious assignment of income/attribution of deduction issues (low-income child – high-income parent) to treat entire families as a single taxpayer unit. To which we are tempted to reply: "Oh well! It's all in a good cause."

Church's response to Davis and Peace:

In the wake of *Davis* and *Peace*, the Mormon church altered their missionary funding procedure, adopting an Equalized Funding Program (EFP). Contributions to the program are now fully deductible under IRC 170(c).

Prior to selecting missionaries, the organization determines the cost of operation of its missionary program and the cost of maintaining its missionaries in different parts of the world. It then determines an average cost for all its missionaries. The funds collected go to a commingled general fund. The organization distributes the funds to each mission to be used as needed.

Using this system, parents and relatives may donate more or less than their missionary's actual expenses. They donate the average cost of supporting a missionary worldwide, not the actual cost of supporting the missionary. Thus, conduit or earmarking issues are effectively diluted. Parents, friends, and relatives donate directly to the organization with the understanding that the organization distributes funds as needed at the mission site. Missionaries whose parents are unable or unwilling to provide support, are supported by the Church.

[29] *White v. United States*, 725 F.2d 1269 (10th Cir. 1984); *Brinley v. Comm'r*, 782 F.2d 1326 (5th Cir. 1986)
[30] Charitable deductions for contributed services are not permitted. However unreimbursed out-of-pocket expenditures made in connection with gratuitous services for a charitable organization may be deductible (Regs. Sec. 1.170A-1(g)). The expenses must be nonpersonal, directly connected with, and solely attributable to the services (Rev. Rul. 69-473). Expenditures that confer substantial *Donor* benefits are not deductible. (*Saltzman*, 54 T.C. 722 (1970)). Out of pocket expenses are deemed direct payments to the charity [as opposed to "for the use of" the organization (Rev. Rul. 84-61)]. They, thus qualify for the 50% AGI limitation (30% if made to other than a 50% charity).

Sustainable Philanthropy – Donor Care, Earmarked Donations

Estate of Otis C. Hubert, T.C. Memo 1993-482: In Hubert, the Tax Court allowed a charitable deduction for bequests that supported missionary work conducted by two missionaries. Despite the Donor's apparent intention that the gift provide support for the life of the two missionaries, the bequest was not a life estate for the missionaries' benefit:

- the church received and controlled thefunds,
- the funds were held in a trust against which the church could legally enforce its rights, and
- the decedent had no relationship with the missionaries except through the church.

The court distinguished Estate of Hubert from Thomason[31] and Davis: "under Davis and Thomason the test is not whether the charitable organization has full control of the funds, but rather whether the charitable organization has a legally enforceable right to the funds. In neither Davis nor Thomason did the charitable organization actually receive the funds either directly or in trust."

Benevolent Funds and Projects:

Churches (among other organizations) sometime form or maintain benevolence programs to assist their members and others in the community during times of emergency or financial crisis. The programs may also arise spontaneously: One or several members face a significant financial emergency. Others at the church wish to help.

The IRS has stated:[32]

> "If contributions to the fund are earmarked by the donor for a particular individual, they are treated, in effect, as being gifts to the designated individual and are not deductible. However, a deduction will be allowable where it is established that a gift is intended by a donor for the use of the organization and not as a gift to an individual.
>
> The test in each case is whether the organization has full control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out its functions and purposes."

The Service's position suggests that churches or other Exempt Organizations can facilitate deductibility by adopting some "Best Practices:"[33]

- Create and implement a written policy.
- Define what types of contributions will be allowed. To be tax-deductible, contributions must be made to the program, not to a specific individual or family.
- Appoint a committee or personnel to review and approve requests. Avoid giving one person control over fund distribution without adequate oversight and accountability measures.

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[31] Op. cit. *S.E. Thomason v. Commissioner, 2 T.C. 441 (1943): a "tuition case" cited above.*
[32] Rev. Rul. 62-113, 1962-2 C.B. 10
[33] Adapted from *Important Considerations for Church Benevolence Programs*, CapinCrouse: CapinCrous' full article goes into deeper detail on each of the bullet items.

- Decide what types of need will receive support. Typically, assistance is allowed for basic needs such as shelter, food, clothing, and medical.
- Develop criteria for determining individual need.
- Document the need and obtain (and document) external verification before disbursing larger amounts.
- Include reasonable limits per person during a specified time period. The tax law does not require limits, but larger amounts and longer-term assistance require more investigation and consideration than can be addressed in a policy for routine assistance.
- Make disbursements from a general fund or a benevolence fund, rather than from the collection plate or other sources.
- Pay assistance (rent, mortgage, utilities, etc.) directly to the service provider, rather than to the individual.
- Keep a written record of all funds disbursed. [and the reason(s) they were disbursed]

Compensation and Scholarship Funds

Similar to Missionary Support and Benevolence Funds, control is often the deciding factor when Donor's make contributions to facilitate the Exempt Organization's hiring, retention, or scholarship of an Artist, Administrator, Academician, or Student. The donor's intent - to benefit a specific individual or the charitable organization – achieves greater prominence in this arena than in those we discussed earlier. The scenario often evolves along lines similar to: e.g.,

> As reported by the New York Times, when Dutch Conductor Jaap Van Zweden left the Dallas Symphony to join the New York Philharmonic his compensation package included a sizable "Signing Bonus." The Bonus was funded by a restricted gift from one individual. The gift terms restricted The Phil's use of funds to hire anyone other than Van Zweden.

We don't know if the Donor's issue has been examined (and it is too soon for it to have reached the courts), but after reading the Tuition, Missionary, and Benevolent Funds materials, our inner Revenue Agent is screaming "Earmarked Contribution" right about now.

But wait! Rulings in this arena often hinge on what the Donor intended, as well as the formal procedures surrounding the transaction.

In Tripp[34] the Seventh Circuit ruled that even equivocal language like "it would be constructive" for a particular person to be granted a scholarship tipped the scale toward non-deductibility – even though the individual would have been an appropriate scholarship recipient.

In sharp contrast to Tripp, the Service allowed a corporate charitable deduction for scholarship grants to colleges from which the corporation recruited many of its employees.[35] Since neither the Donor nor the scholars made or received an employment commitment, the Service ruled that the corporation intended to benefit the charitable organization, not the individual recipients. The Service reached a similar conclusion for a scholarship

[34] *Tripp v. Commissioner, 337 F.2d 432 (7th Cir. 1964):*
[35] Rev. Rul. 68-484

fund that provided "potential benefits" to the Donor's family.[36] There was no express understanding between the parties that the Donor's relatives would be given preference in the selection of scholarship recipients.

Returning to the employment question we posed earlier, the Service has made it clear that donating funds to support a position (e.g., artist, dean, endowed chair, president) does not taint the donation if:

- the Donor has no say in the decision regarding who to hire,[37] and/or
- the Organization's acknowledgement states that there could be no assurance that their contribution would be used to support the donor's chosen candidate.[38]

The safe harbor apparently persists even if the Organization later commissions a work by the Donor's preferred recipient and underwrites the work's performance. (Note, however, in this instance the Organization retained rights to future exploitation of the work.)

The second condition indicates that the Organization may play an active role in assuring the Donor's deduction simply by refusing to provide assurance that the Donor's wishes will be accommodated, or specifically denying their intention. As we note below, the Organization's acknowledgement must (usually) be accompanied by a course of dealings that suggest it is not merely posturing.

Private Foundations

General Rule, Grants to Individuals

Many Foundation administrators and advisors believe (or maintain) that Private Foundation cannot make grants to individuals. In light of that, they maintain, the organization should never encounter a situation that implicates earmarking. While the logic of this is impeccable, the basic premise is faulty: Private Foundations CAN make direct grants to individuals – but there are rules.

A private foundation can make grants to individuals, provided the Foundation

- obtains IRS pre-approval,[39]
- adopts policies and procedures to prohibit self-dealing,

and the payments

- serve a charitable purpose (preferably a purpose consistent with the organization's exempt purposes),
- are permitted by the foundation's governing documents, and
- do not trigger a self-dealing or private benefit rule (by providing a direct or indirect benefit to the foundation's disqualified persons).

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[36] PLR 9338014 (June 23, 1993)
[37] PLR 9322017 (March 8, 1993),
[38] PLR 200250029 (Sept. 9. 2002)
[39] *See* *Advance Approval of Grant-Making Procedures*

With this as preface,[40] what consequences ensue if a Private Foundation accepts and executes an earmarked contribution?

Earmark Rule

Private Foundations may make grants only for purposes described in IRC 170(c)(2)(B).[41] Grants for unpermitted purposes are *Taxable Expenditures*. Grants to individuals (including loans made for charitable purposes, and program-related investments) are expressly designated *Taxable Expenditures* unless:

> The grant is awarded on an objective and nondiscriminatory basis under a procedure approved in advance by the Service, and …[42]

> The grant process is considered "objective and nondiscriminatory" only if:

> The group from which the grantees are selected must be reasonably related to the purposes of the grant, and the group must be large enough to constitute a charitable class (unless, taking into account the purposes of the grant, only a few individuals are qualified to be grantees - as in the case of scientific research),

> The criteria used in selecting grant recipients from the potential grantees should be related to the purpose of the grant. For example, proper criteria for selecting scholarship recipients might include (but are not limited to) the following: past academic performance, performance on tests designed to measure ability and aptitude for college work, recommendations from instructors, financial need and the conclusions the selection committee might draw from personal interviews, and

> The person or persons who select recipients of grants should not be in a position to receive a private benefit, directly or indirectly, if certain potential grantees are selected over others.

Following this arc, we conclude that a *Private Foundation* may neither give nor receive earmarked contributions without excise tax exposure. Doing so exposes the Foundation (at a bare minimum) to the IRC §4945 excise tax on *Taxable Expenditures* and may also incur the IRC §4941 *Self-Dealing* excise.

The IRC §4945 excise tax may be levied against both the Private Foundation and its managers:[43]

- 20% excise assessed on the foundation[44]

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[40] IRS Publication 3833 *Disaster Relief, Providing Assistance Through Charitable Organizations*, describes how members of the public can use charitable organizations to provide assistance to victims of disasters or other emergency hardship situations.

[41] religious, charitable, scientific, literary or educational, fostering national or international amateur sports competition (but only if no part of the activities involve providing athletic facilities or equipment), and preventing cruelty to children or animals

[42] IRC §4945(d)-(d)(5)

[43] IRC § 4946(b)-(b)(2): "foundation manager" means, with respect to any private foundation—"(1) an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), and (2) with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act)."

[44] IRC § 4945(a)(1)

- 5% (up to $10,000) on managers who "knowingly" approve a taxable expenditure [45] [46]
- If not corrected within the tax period, an additional excise of 100% of taxable expenditure on the foundation and a 50% excise on the manager (up to $20,000)[47]

For additional (and more detailed) information on the IRC §4945 excise tax, see the recently (March 2022) published IRS guidance[48] and Attorney Cory Halliburton's excellent discussion of it on Freeman Law's website.[49]

Gift Tax Implications

Donations given directly to an individual or earmarked for an individual and passed-through an exempt entity are treated as gifts to the designated individual and are NOT income tax deductible charitable contributions.

And then, there is worse news: As a deemed gift, the transfer may be subject to Gift Tax, as well. IRC §2511(a) makes it clear that the Gift Tax rules apply to both direct and indirect transfers:

> Subject to the limitations contained in this chapter, the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible

Fortunately, there is both transactional and cumulative relief from Gift Tax liability.

Transactional Relief: IRC §2503(b)(1-2) provides an annual "get out of gift tax free" card to each Donor for the first (inflation adjusted) $10,000 gifts of present interests to each donee, each year. For 2022, this permits every Donor to exclude $16,000 per Donee from Gift Tax exposure, without even suffering the inconvenience of filing a gift tax return.

If both spouses consent to do so, a married couple may "split" the gifts they make during the year,[50] each one excluding half of all gifts the couple made to each donee during the year. For 2022, this permits every Family Unit Donor to exclude $32,000 per Family Donee from Gift Tax exposure. The downside of gift splitting: both spouses must file a Gift Tax Return.

The IRC §2503 annual exclusion is extendible: Each Donor can (in 2022) gift $16,000 to each Donee. Simply stated, more donees – more exclusion. For example, if a married couple gives the maximum exclusion amount

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[45] IRC § 4945(a)(2)

[46] Treas. Reg. § 53.4945-1(a)(2)(iii)(a)-(c): A manager has "knowingly approved" the Taxable Expenditure if (a) the person has actual knowledge of sufficient facts so that, based solely upon such facts, such expenditure would be a taxable expenditure, (b) the person is aware that such an expenditure under these circumstances may violate the provisions of federal tax law governing taxable expenditures, and (c) the person negligently fails to make reasonable attempts to ascertain whether the expenditure is a taxable expenditure, or the person is in fact aware that it is such an expenditure. Treas. Reg. § 53.4945-1(a)(2)(iii)(c) and *Thorne v. Comm'r*, 99 T.C. 67, 104-105 (T.C. 1992): the term "knowing" does not mean "having reason to know."

[47] IRC § 4945(b)

[48] *Exempt Organizations Technical Guide TG 62 Excise Taxes on Taxable Expenditures*

[49] *Private Foundations, Taxable Expenditures, and Excise Taxes: IRS Issues Guidance on Taxable Expenditure Rules for Private Foundations*

[50] IRC §2513(a)(1)

to six people (Offspring, Inlaw, and their four children?) they can give away up to $32,000 x 6 = $216,000. Each year – again suffering only the inconvenience of filing two Gift Tax Returns.

Done systematically for thirty years, each Donor would eliminate a present value of $246,000[51] from their estate – completely consequence free to either the Donor or the Donee. In our extended scenario, the couple could shield a present value of $2,952,000 if they file annual Gift Tax Returns.

If the Donor wants to give more than $16,000 (in 2022) they will not face Gift Tax liability until their cumulative Lifetime Taxable Gifts exceed their lifetime gift tax exemption – $12,060,000 in 2022.[52] Which brings us to:

Cumulative Relief: IRC §§2010 and 2505 provide everyone with a "Unified Estate and Gift Tax Credit" that exempts all but the largest estates from Estate and Gift Tax liability. Though the IRC encodes the exclusion as a credit, most taxpayers, journalists, and tax practitioners think of it in terms of the credit's equivalent non-taxable estate. For 2022, that equivalent estate is $12,060,000. Viewed simplistically, everyone is entitled to give away or bequeath a total of (at least) $12,060,000 before they pay any estate or gift tax.[53]

The equivalent estate roughly corresponds to:

- The Total of all Gifts given during a Lifetime, plus
- The Fair Market Value of all assets owned at the time of death, minus
- Lifetime Gifts excluded under IRC 2503, Debts owed at the time of death, and Other statutory exclusions.

A married couple[54] is entitled to two unified credits – one for each spouse. Furthermore, the spouses' credits are "portable:" If the first-deceased spouse does not use their credit, the surviving spouse may elect to use it.[55] When the Unified credits are applied, a married couple is able to give away or bequeath (at least) $24,120,000 plus the total of their excludable lifetime gifts before they incur any Gift/Estate tax liability.

Returning to our thesis – Donors are very unlikely to incur Gift-Estate tax obligations if their charitable donations fail to be income tax deductible because of the earmarking rules. For some of us, it would be very hard to sympathize even if they did.

Fiscal Sponsorship

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[51] =PV(5%, 30 Years, 16000/year)

[52] The exemption reverts to its pre-2012, 2017 Tax Act level ($5,000,000) in 2025. Whether the revised (higher) exemption will be continued beyond 2025 probably depends on who controls the House, Senate, and White House after 2024.

[53] See our note, immediately above. We use the parenthetic "(at least)" advisedly. A well-structured, conscientious, gift and estate plan can shelter considerably more than that figure.

[54] If both of them are U.S. citizens, permanent residents, or tax residents.

[55] IRC §§2010, 2501, and Treas. Regs. §20.2010-2. The mechanics of portability dictate that the first-deceased spouse's representative make the election to transfer the remaining credit to the surviving spouse. The result of that is the same as if the surviving spouse made the election – but the procedure is critical. Note that, once made, the portability election is irrevocable.

General Observations

Fiscal Sponsorship describes a contractual arrangement under which:

- a *Qualified Organization* receives funds from a donor,
- on behalf of a non-exempt entity or individual, and
- makes those funds available to the non-exempt entity or its designees to meet the legitimate expenses of a specified charitable project.

Fiscal Sponsorship is useful for achieving charitable goals without the multiple burdens of forming, administering, and assuring compliance for new *Exempt Organizations*. At the same time, *Fiscal Sponsorship* encourages private and public efficiencies and reduces the number of nonprofits that require fiduciary and regulatory oversight. *Fiscal Sponsorship* is most appropriate for:

- Projects that are time sensitive – or must be implemented immediately (e.g., emergency response scenarios),
- Projects pursued by newly formed organizations whose application for exemption is pending,[56]
- Long- or short-term projects that will not (or should/cannot) expand their scope or lead to activity levels that merit formation of an exempt entity or structure,
- Administrative oversight of independent project teams that lack the experience or capacity to administer an *Exempt Organization*, and
- Insulating the sponsoring *Exempt Organization* from extraordinary liability concerns associated with the project [often accomplished by forming a Single Member LLC (SMLLC) to pursue the project].

Fiscal Sponsorship also multiplies opportunities for abuse – particularly by providing a seemingly-legitimate conduit for earmarked contributions.

The Service has long been aware of *Fiscal Sponsorship*'s abuse potential – but accepts the arrangements provided the sponsoring organization does not serve as a "mere conduit" for an otherwise non-charitable transfer or activity.

The literature on charitable conduits in the *Fiscal Sponsorship* context is surprisingly thin.[57] The literature recapitulates the arguments and precedents the Service or Donors advanced in the tuition, missionary, and compensation/scholarship cases – usually without significant alteration or elaboration. To the extent it develops any prescriptive argument, it usually focuses on something akin to the argument in Rev. Rul. 62-113:

[56] While technically unnecessary, Grantors often insist on oversight. Advisors had high hopes that the revised form 1023EZ and electronic exemption application processing would reduce the need for *Fiscal Sponsorship* for the first two of these purposes. Unfortunately, a pandemic and the Service's habitual institutional inertia, control issues, and paranoia seem to have put paid to those hopes.

[57] *Principal* sources include, Rev. Rul. 62-113 1962-1 C.B. 10 and *IRS EO Topic 96*, neither of which develops a particularly satisfactory definition of, or solution for, the conduit issue.

> the test in each case is whether the organization has full control of the donated funds, and discretion as to their use, so as to ensure that they will be used to carry out its functions and purposes.

Thus, literature and precedent provide little guidance for Advisors or Organizations that seek to avoid conduit conflicts. For that, we look to other sources.

Protective Measures

We begin by noting that the term "*Fiscal Sponsorship*" has no specific legal definition other than that it is a contract (or several contracts) between the Donor, the Sponsor, and the Project Principal or beneficiaries.

Since *Fiscal Sponsorship* is a contract – it behooves the parties to treat it like one. That is,

The Donor and the Project Principal should perform appropriate Due Diligence; vetting each other and the Sponsor. The due diligence follows the Donor and Principal's usual procedures[58] but emphasizes the parties' (particularly the Sponsor's) legal capacity and resources to absorb and administer the funds and to scale their operations if necessary. At a bare minimum, Donor and Principal due diligence must:

- Verify that the other parties (particularly the Sponsor) are duly formed, validly existing, and in good standing.
- Verify the Sponsor's (and if applicable, the Principal's) Exempt Organization Status.
- Review the Sponsor's financial status. Pay particular attention to the Sponsor's liquidity, solvency, cash management, and budgetary practices.
- Assess the Sponsor's and the Principal's management to ensure their ability and willingness successfully carry out the terms of the grant.

Site visits and management-staff interviews are often helpful, if feasible.

The ***Sponsor*** should apply enhanced versions of their usual due diligence, Gift Review, and acceptance protocols (including Board approvals) for Restricted Grants.[59] Enhancements to the Sponsor's due diligence include:

- Examine the relationships, if any, between the Donor and the Project Principal.
- Assess the Project Principal's ability to execute the required functions.
- Assess the impact of grant restrictions and activities on other Organization priorities, projects and operations.
- Verify (if applicable) that the other parties are duly formed, validly existing, and in good standing.
- Verify (if applicable) the other parties' Exempt Organization Status.
- Review the Donor's financial status and giving capacity (if the project is long term and based on periodic funding).

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[58] See our *Donor* Care document: *Vetting Donee Exempt Organizations and Projects*

[59] See, for example, our Organization Care document: *Vetting Donors and Projects (Gift Acceptance Policies)*

Sustainable Philanthropy – Donor Care, Earmarked Donations

If the Sponsor intends to make a habit of *Fiscal Sponsorship*, embrace written procedures, and incorporate protections in your program promotions and literature. Consider adding "discretion and control" language, similar to that employed by Sudan Interior Mission,[60] into all solicitations.

Oral agreements may be enforceable[61] but ***written fiscal sponsorship agreements*** that set forth the terms of the sponsorship, the purposes of the grants, and the relationships among the parties are preferable.

The Sponsorship Agreements should fulfill the usual contractual requirements [capacity, mutual assent (offer, acceptance), consideration, performance, and lawful purpose.], should be routed through the parties' usual vetting approval process, and specifically address:

(1) the project activities – delineating the activity, the parties' responsibilities, controls and their exercise, performance criteria, and reporting obligations.
(2) the purposes for which the grant may be used and the limitations on those uses within requirements imposed or implied by IRC §501(c)(3)
(3) the creation of a restricted fund to exercise custody over contributions received to benefit the project
(4) the sponsor's retention of the overriding right to determine the use of such funds (variance power), including the sponsor's right to withhold distributions it deems inappropriate
(5) the sponsor's sponsorship policies and fees
(6) Termination and exit provisions

If the arrangement between the parties conforms to the "Pre-Approved Grant Model (Model C, below) a clause stating that the sponsored project is a separate entity, and the sponsor has no responsibility or liability for the program work, fundraising, contracts, insurance, or other day-to-day activities of the sponsored project may be appropriate.

Key drafting points: avoid terms that

- Allow donated funds to be disbursed to a non-exempt group without Sponsor discretion,
- Impose excessive restrictions that impair the Project Principal's efficiency.

Include terms that recognize variations in the amount of financial and operational freedom the Sponsor grants to the Project Principal. The three most common variations include:

Comprehensive Model (Model A):[62] The Sponsor assumes all operational and functional responsibilities. No separate legal entity exists or is formed to conduct the project. The sponsor takes comprehensive responsibility for the project, assuming liability for and paying the project's bills directly and including the project in its own financial reporting and compliance regimes.[63]

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[60] See Peace v. Commissioner, 43 T.C. 1 (1964), acq., 1965-2 C.B. 6, and our discussion, above.
[61] Or not, depending on how your jurisdiction interprets the Statute of Frauds or its local equivalent.
[62] These and several other models are derived from Gregory L. Colvin's *Fiscal Sponsorship: 6 Ways To Do It Right;* originally published in 1993, the third edition (with co-author Stephanie L Pettit) was released in 2019.
[63] Model A has become increasingly popular as *Fiscal Sponsorship* becomes more common and Exempt Organizations endure closer scrutiny. Under Model A, there is, effectively, no outside agency that the *Sponsor* is responsible to fund. Thus, it becomes a question of whether the project fits within the spectrum of the Organization's exempt purposes rather than qui bono.

Independent Contractor Model (Model B): The Sponsor retains and pays the Program Principal as an independent contractor[64] using donated funds. The sponsor reports the payments as functional expense (grants or contracted services, as appropriate). The Project Principal assumes liability for its operations, accounts for its income and pays project expenses. The Project Principal reports its activities and expenses on the project in both its own financial and compliance regime and the contractual regime included in its agreement with the Sponsor.

Pre-Approved Grant Model (Model C): The Sponsor and Program Principal form a grantor-grantee relationship. The Project Principal is a separate legal entity. The Sponsor receives Donor Funds and disburses them to the Program Principal. The principal is responsible for fulfilling the terms of the Donor's grant-agreement with the Sponsor as well as the terms of the Principal's agreement with the Sponsor. This relationship is common between non-yet-exempt Principals and Exempt Sponsors and is often a hard condition of the Donor.

The three most common models have different asset ownership outcomes that require some recognition in the agreements: In Models B and C, The *Principal* is the *Sponsor*'s contractor or grantee. The project's assets and liabilities belong to the grantee (the *Principal*), who is responsible for its own tax and filing obligations. In Model A, The *Sponsor* is the grantee. Asset ownership, therefore, resides with the *Sponsor*.

In each of these scenarios, individuals associated with the grantee serve as agents of the grantee when working on the project. Fundraising for the project, however, must be carried out by the fiscal *Sponsor* because the *Principal* – even if it is the grantee - lacks a tax status that permits *Donor*'s to deduct contributions (or characterize them as qualifying distributions, in the case of *Private Foundations*). When they fundraise, therefore, personnel act as agents of the fiscal Sponsor. Fundraisers must, therefore, be bound by the Sponsor's fundraising standards.

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[64] We use the term "independent contractor" in its broadest sense here: individuals or entities that perform services outside the *Sponsor*'s legal umbrella. That usage does not distinguish the *Principal*'s form – whether individual, partnership, corporation, or trust.