FEATURE:
PHILANTHROPY

By **Conrad Teitell, Rachel B.G. Sherman** & **Katherine C. Gent**

Quid Pro Quo Isn't Just a Political Issue

Not following the charitable gift QPQ rules means trouble for charities and donors

Taxwell Smart, over age 70½, directs his individual retirement account's $100,000 required minimum distribution (RMD) for the year to be distributed to his college. That $100,000 isn't deductible as a charitable gift. But, it isn't taxable. That's the equivalent of a charitable deduction.[1] To qualify for this favorable tax treatment, the donor must be 70½ or older.[2]

Taxwell's entire distribution must be paid to the charity with no quid pro quo (QPQ). (See "Definition," this page.) Thus, if a donor receives (or is entitled to receive) a chicken dinner in connection with the transfer to the charity from her IRA, the exclusion isn't available for any part of the IRA distribution. So, don't "fowl up" an otherwise tax-free IRA distribution with a "quid pro crow."

For transfers other than gifts from IRAs, benefits given to donors reduce, but don't obliterate, the charitable deduction. A QPQ (except under de minimis rules discussed later) reduces the charitable deduction when the benefit to the donor is properly described on a timely gift receipt given to the donor.

Shady Situations

But, first, let's get well-publicized shady QPQ situations out of the way. Those transfers don't produce charitable deductions but can produce time in federal gated tax shelters.

Over 50 individuals were charged last year in a college admissions scandal.[3] Actresses Lori Loughlin and Felicity Huffman, many other wealthy individuals and several business executives made payments to Key Worldwide Foundation (KWF) (the "non-profit" organization at the scandal's center). Edge College and Career Network, LLC, also known as "the Key" (the for-profit college counseling and preparation business at the center of the admissions scandal) were also involved.[4]

So-called "donations" to KWF weren't made out of detached and disinterested generosity or out of affection, admiration, charity or like impulses, but rather made with the expectation of receiving something in return to benefit the donors' children—for example, falsified standardized test scores, recruitment by athletic coaches (irrespective of athletic prowess) and ultimately college admissions.

Some of the individuals indicted in the college

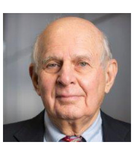
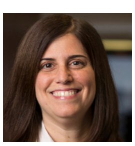
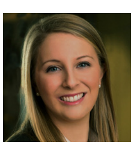
Definition

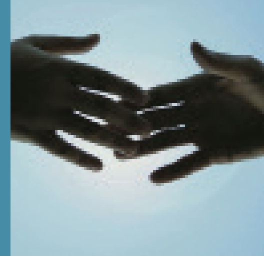
It must be avoided in charitable giving

Quid pro quo (kwid prh kwoh), n. [Latin "something for something"] An action or thing that is exchanged for another action or thing of more or less equal value; a substitute <the discount was given as a quid pro quo for the extra business>.

—Black's Law Dictionary *(3rd ed. 2006)*

(From left to right) **Conrad Teitell** is chairman of Cummings & Lockwood LLC's National Charitable Planning Group and **Rachel B.G. Sherman** is a principal in its Private Clients Group, both based in the Stamford, Conn. office. **Katherine C. Gent** is an associate in Cummings & Lockwood LLC's Private Clients Group and is based in the Greenwich, Conn. office.



admissions scheme claimed charitable deductions on their individual income tax returns for contributions to KWF and as deductions for business expenses for payments made to the Key.

The tax chutzpah award. Payments disguised as donations can't be deducted as charitable gifts or as business expenses. The most obvious reason: Funneling approximately $25 million dollars over the span of seven years through KWF charitable accounts and into the pockets of school administrators and coaches doesn't exactly qualify KWF as a charitable organization.[5] A transfer is a charitable gift only when the donor doesn't receive a substantial benefit in return for the gift. These benefits include school, college admission, zoning concessions and retirement housing. A charitable deduction is disallowed when the "donor" receives or merely expects to receive a significant QPQ.

QPQ Rules

Putting aside the gross abuse situations, here are the QPQ rules and the walking-around knowledge for advisors. The Internal Revenue Service has been concerned about QPQ gifts for years.

Let's go to the Internal Revenue Code. A QPQ gift is a payment made partly as a contribution and partly in consideration for goods or services provided to the donor by the charity.[6] A fundraising banquet is a common example, when a donor's payment to a charity exceeds the cost of the meal. If there's a QPQ, any excess of the value of the donor's transfer over what's received from the charity is a charitable gift. No reduction is required if what's received from the charity is a de minimis benefit. Of course, if the donor receives a benefit that equals or exceeds what she transfers to the charity, no gift is made and no charitable deduction is allowed.[7]

Substantiation and disclosure requirements. Most individuals who routinely give to charity are accustomed to getting an acknowledgment letter from the charity describing and thanking them for the gift. The acknowledgment's purpose isn't just good manners, but donors need those letters—receipts—as proof of their gifts to claim charitable deductions.

The rules. To be deductible, charitable contributions of $250 or more must be substantiated by a contemporaneous written acknowledgment.[8] The acknowledgment must include: (1) the amount of any cash contributions or, for non-cash contributions, a description of the property; and (2) a statement of whether the charity provided any goods or services to the donor in return for the gift. If goods or services are provided, the acknowledgment must contain a description and good faith estimate of their fair market value (FMV). If the gift is in cash, the donor must maintain records, for example, bank records or a written communication from the donee, to substantiate the gift.

If the gift is in cash, the donor must maintain records to substantiate the gift.

More rules. A charity receiving a QPQ gift over $75 must, as part of the solicitation or receipt of the gift, provide a written statement: (1) informing the donor that the gift deduction is limited to the excess of any money (and the value of any property other than money) contributed by the donor over the value of the goods or services provided by the charity; and (2) providing the donor with a good faith estimate of the value of the goods or services.[9] When the QPQ transfer is $250 or over, the donor needs a receipt to claim the deduction.

Penalties for noncompliance give weight to the QPQ disclosure requirements. The penalty is $10 for each contribution for which the charity fails to make the required disclosure.[10] The total penalty per fundraising event or mailing is capped at $5,000. But, a penalty isn't imposed if the charity's noncompliance is due to reasonable cause.

Rules overlap. Just to make it interesting, some

substantiation and disclosure rules overlap. For example, a donor who transfers over $75 to a charity but under $250 for a QPQ gift doesn't need a receipt as a condition of claiming the charitable deduction, but she may be called on to prove the gift if the IRS audits her income tax return. The charitable deduction is still limited to the excess of the amount contributed over the value of goods or services received. In both cases, the charity must give the donor a good faith estimate of the value of the benefits received by the donor. In determining whether the $75 threshold is reached, all payments made during the year for the same fundraising event are aggregated; payments for separate events aren't.

The rules needn't always be followed "religiously." A donor isn't deemed to have received a QPQ when she receives solely an intangible religious benefit, for example, admission to a religious ceremony.[11] But, if the charity gives the donor an intangible religious benefit and something else, the QPQ disclosure rules apply. If the only goods or services provided by the charity are intangible religious benefits, the receipt must so say, but it doesn't need to describe or value the benefits.

If the only goods or services provided by the charity are intangible religious benefits, the receipt must say so, but it doesn't need to describe or value the benefits.

Goods or services disregarded. Sometimes goods or services provided by a charity in exchange for a donor's payment needn't be reported on the charity's disclosure statement to the donor. These include: (1) small items or token benefits of insubstantial value; (2) some annual membership benefits given in exchange for an annual payment of not more than $75; and (3) goods or services provided to a donor's employees to the extent they meet the requirements of (1) and (2).[12]

Determining a QPQ's Value

The FMV of the benefit is the price at which an item would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of the relevant facts.[13] Generally, value will be at retail, not wholesale, and, except for token items, the charity may not use its cost. Often, the determination is easy. Tickets to a theater party are valued at what they sell for at the box office. Merchandise is valued at its retail price.

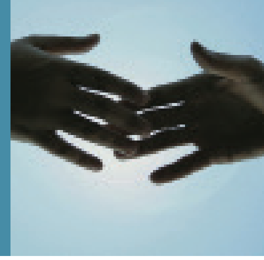
When the goods or services are generally available in a commercial transaction, the charity's good faith estimate of the FMV using a reasonable methodology meets the IRS' requirements. But, if that methodology isn't in good faith, the QPQ contribution disclosure requirements aren't met.[14]

For goods or services not generally available in a commercial transaction, a charity may make a good faith estimate of their value by reference to the FMV of similar or comparable goods or services. Goods or services may be comparable even though they don't have the unique qualities of the goods or services being valued.[15]

Example. A donor's $50,000 payment to a museum allows her to hold a private event in one of its rooms. No other events are permitted at the museum. In the museum's community, four hotels have ballrooms with the same capacity as the museum's room. Only two of the four hotels have ballrooms with amenities and atmosphere similar to the museum's room, but neither hotel has the unique art collection displayed in the museum's room. The ballrooms in those two hotels are, for valuation purposes, considered as comparable to the museum's room, even though the museum's room has a unique art collection. Using this analysis, the museum is said to make a good faith estimate of the benefits it provides as the cost of renting the ballroom in either of the two hotels with comparable ballrooms.[16]

Here's a tricky rule. In determining how much of a payment made for goods or services is deductible, the donor may rely on the charity's estimate of value. But, a donor may not use the charity's valuation when she knows, or has reason to know, that the charity's estimate of FMV is unreasonable.[17]

Example. A donor attends an auction held by a charity. Before the auction, she receives a catalog of items that will be available for bidding and the charity's good



faith estimate of their value. The donor successfully bids and pays $500 for a vase that the charity valued at $100. The donor has no reason to doubt the accuracy of that value. Her payment qualifies as a contribution. Before making the payment, she knew that the estimated value of the vase was less than her payment, and her payment exceeded the estimate. In determining the amount of her deduction, the donor may treat the vase's estimated $100 value as its FMV, and thus, she's deemed to have contributed $400.[18]

Ignorance is tax bliss. A knowing donor and an unknowing donor are deemed to have contributed different amounts.

Example. Donor A bids and pays $2,000 for a lithograph valued at $500 in good faith by the charity in its auction catalog. However, Donor A knows the lithograph is worth $1,600 because she's seen that same lithograph selling in a number of downtown art galleries for $1,600. She can only deduct $400 according to the regulations. Donor B doesn't know much about art, but knows what she likes. She doesn't have a clue as to what the lithograph is selling for. She can deduct $1,500 ($2,000 payment minus $500 value placed by the charity).

Expectation of a QPQ

Does the donor intend to make a charitable gift, or is the donor's expectation that she will receive something in return for her contribution? A charitable gift is the excess of the payment over the value of the QPQ if there's an intent to make a charitable gift. Intent is determined by—guess what—the facts and circumstances of each payment.

When a gift is made in response to an express promise of a benefit, the donor generally expects a QPQ. A donor may also expect a QPQ when the gift is made with the knowledge that the charity has given a benefit to other donors making similar gifts.

Example. When a charity traditionally sponsors a dinner for donors making large gifts, a donor making a substantial gift may expect to receive a dinner invitation. Further, a donor may expect a QPQ even though she's unaware of the exact nature of the QPQ—such as a gift to a charity that sponsors a donor-appreciation event of a different type each year. Thus, a charitable deduction isn't allowable when the facts and circumstances indicate that the donor expected at the time of the gift that there would be a QPQ even though one wasn't explicitly promised. When a donor receives, or expects to receive, a financial benefit that's commensurate with money or property transferred to a charity, she won't get a charitable deduction.[19]

Case in point. The U.S. Court of Claims held that a 45% discount by Singer on the sale of sewing machines to schools wasn't a charitable gift because the company figured that students who learned to sew on Singer machines would be likely to buy their product later on, and the company would thus receive a financial benefit.[20]

A similar result was reached in the *Ottawa Silica Co.* case, in which the donor gave property to a governmental unit for use as a school site. He figured his transfer would make the rest of his land more valuable when government roads were built to service the school.[21] There was no agreement or other requirement that the roads would be built or that the school would be built. Still, the court denied a charitable deduction because the donor expected to receive a substantial benefit.

Donors who anticipated zoning breaks have historically been denied charitable deductions for their land donations.

Similarly, donors who anticipated zoning breaks have historically been denied charitable deductions for their land donations.[22] Additionally, a donor who receives, or can expect to receive, more benefit than the general public from a transfer for charitable purposes won't get a charitable deduction.[23]

In Private Letter Ruling 9447028 (Nov. 25, 1994), the IRS ruled on a gift of land by a company to the state for highway construction. The company developed a community adjacent to the highway, but the only benefit it received was less congestion on existing roads. The IRS ruled that the gift qualified for an income tax charitable deduction—the donor received no substantial benefit

from the gift. Any benefit the company received was "incidental" compared to the public's benefit.

QPQ and Education

Disguised tuition payments. The IRS set its sights on eliminating charitable deductions for "contributions" to educational institutions that are disguised as tuition payments. Depending on the situation, the IRS may consider a parent's contribution to an organization operating a private school as a qualified charitable contribution. However, to be deductible, the voluntary gift must exceed the cost of the child's tuition.

Tuition paid for the education of children is a family expense, not a charitable contribution to the educating institution.

Exception. In Revenue Ruling 83-104, the IRS outlined its criteria for the deductibility of payments to private schools, adopting a facts-and-circumstances test. The IRS presumes a payment to a private school isn't deductible if: (1) there's a contract in which the donor agrees to make a contribution, and the school agrees to admit her child; (2) there's a plan allowing the donor either to pay tuition or to make contributions in exchange for schooling; (3) contributions are earmarked for the direct benefit of an individual student; or (4) there's an otherwise unexplained denial of admission or re-admission to children of parents who are financially able but don't contribute.[24]

Additional factors that may indicate that a payment isn't deductible include: (1) the absence of a significant tuition charge; (2) substantial or unusual pressure to contribute applied to parents of children attending the school; (3) contribution appeals made as part of the admissions or enrollment process; (4) the absence of significant potential sources of revenue for operating the school other than contributions by parents of children attending the school; and (5) other factors suggesting that a contribution policy has been created as a means of avoiding the characterization of payments as tuition.[25] If a combination of these factors isn't present, payments by a parent to a private school will typically constitute deductible contributions—even if the actual cost of educating the child exceeds the amount of any tuition charged for the child's education.[26]

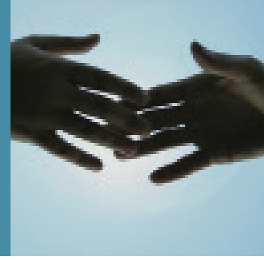
Donor's name in lights. Donors who condition their charitable gifts on having scholarships, chairs and even big buildings named for them have been entitled to charitable deductions with no reduction for the benefit of those payments. Although there's no published law on the subject, the IRS has never suggested that receiving those benefits results in a reduction of charitable deductions.

Tuition for parochial schools. Religious school tuition payments aren't deductible. Those payments to a parochial school generally aren't considered charitable contributions because taxpayers making the payments receive something in return—educational benefits.[27] Tuition paid for the education of children is a family expense, not a charitable contribution to the educating institution. But, payments exceeding the education's FMV are charitable contributions.

QPQ and Business Expenses

Proposed Treasury regulations issued earlier this year[28] cover (among other topics) payments to or for the use of an IRC Section 170 charity that bear a direct relationship to the taxpayer's trade or business and are made with a reasonable expectation of financial return commensurate with the amount of the payments. Those payments may constitute allowable trade or business expense deductions rather than charitable deductions under Section 170. Here are some examples from the proposed regs:

Example 1. An individual is a sole proprietor who manufactures musical instruments and sells them through a website. She makes a $1,000 payment to a local church (Section 170(c) charity) for a half-page advertisement in the church's concert program, which includes the URL for the website through which she sells instruments. She reasonably expects that the advertisement will attract new customers to her website and will help to sell more



musical instruments. Under IRC Section 162, she may treat the $1,000 payment as a trade or business expense.

Example 2. A partnership operates a chain of supermarkets, some located in State N. The partnership operates a promotional program in which it sets aside the proceeds from 1% of its sales each year, which it pays to one or more charities. The funds are earmarked for use in projects that improve conditions in State N. The partnership makes the final determination on which charities receive payments. The partnership advertises the program and reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thus increase its revenue. As part of the program, the partnership makes a $1,000 payment to a Section 170 charity. The partnership may treat the $1,000 payment as a trade or business expense under Section 162. This result is unchanged if, under State N's tax credit program, the partnership expects to receive a $1,000 income tax credit on account of its payment, and under State N law, the credit can be passed through to the partners.

Discourage Abuse

Why do generous clients who support charities have to jump through hoops to substantiate their charitable gifts? Some taxpayers abuse the system and claim charitable deductions for transfers that aren't charitable gifts, for example, disguised tuition payments; others don't reduce their deductions for benefits they've received.

As advisors, our job is to discourage the bad guys and help the good guys. And, keep in mind Justice Oliver Wendall Holmes, Jr.'s admonition, "Men [women too] must turn square corners when they deal with the Government."[29]

Next Up

Tune in next month, and you'll learn, among other things, how the QPQ rules apply to charitable fundraising and the IRS' concern about charities providing donors with misleading information on the deductibility of donations.

Navigating the IRS' rules is important so charities don't land in hot water—potentially paying penalties, or worse, losing their tax exemptions.

Endnotes

1. Advantages of individual retirement accounts/charitable distributions: over 9/10 of taxpayers who take the standard deduction—and thus can't deduct their charitable gifts—can get the equivalent of a deduction by making gifts directly from their IRAs to qualified charities; itemizers who bump into the adjusted gross income (AGI) ceilings on charitable gift deductibility can use distributions from IRAs to make additional gifts; because they won't be taxed on the distributions, they have the equivalent of additional charitable deductions; the carryover can be saved because deductible gifts made in a current year are taken into account before deducting a carryover from earlier years; making a gift from an IRA (as opposed to making a gift with other funds or assets) means that a carryover can be used in the current year. As AGI increases, the following benefits can be reduced or eliminated: Social Security; contributions to Roth IRAs; and passive activity losses and credits. If a donor's state income tax law doesn't allow charitable deductions (for example, Connecticut), making the gift from the donor's IRA to the charity can be the equivalent of a state income tax charitable deduction.
2. *See* Internal Revenue Code Section 408 for the other requirements.
3. *www.justice.gov/usao-ma/investigations-college-admissions-and-testing-bribery-scheme.*
4. *www.justice.gov/file/1142871/download.*
5. *Ibid.*
6. IRC Section 6115(b).
7. *See Signom v. Commissioner*, T.C.M. 2000-175 (2000).
8. IRC Section 170(f)(8).
9. Section 6115.
10. IRC Section 6714.
11. Section 6115(b).
12. Treasury Regulations Section 1.170A-13(f)(8)(i)(a).
13. Treas. Regs. Section 25.2512-1.
14. Treas. Regs. Section 1.6115-1(a)(I).
15. Treas. Regs. Section 1.6115-1(a)(2).
16. Treas. Regs. Section 1. 6115-1(a)(3), Example 1.17.Treas. Regs. Section 1.170A-I(h)(4)(I).
18. Treas. Regs. Section 1.170A-1(h)(5), Example 2.
19. *United States v. Transamerica Corp.*, 392 F.2d 522 (9th Cir. 1968) *aff'g* 254 F. Supp. 504 (D.C. Cal. 1966); *Seed*, 57 T.C. 265 (1972).
20. *Singer Company v. the United States*, 449 F.2d 413 (Ct. Cl. 1971).
21. *Ottawa Silica Co. v. United States*, 669 F.2d 1124 (Fed. Cir. 1983).
22. *Stubbs v. United States*, 428 F.2d 885 (9th Cir. 1970); *Sutton*, 57 T.C. 239 (1971).
23. Private Letter Ruling 9447028 (Nov. 25, 1994).
24. Revenue Ruling 83-104.
25. *Ibid.*
26. *Ibid.*
27. *Sklar v. Comm'r*, T.C.M. 2000-118 (2000).
28. REG-107431-19 (published Dec. 17, 2019).
29. *Rock Island Arkansas & Louisiana Railroad Company v. United States*, 254 U.S. 141 (1920).