Donor Incentives – A Double-Edged Sword

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It's crunch time again for development teams scrambling with solicitations and the production of donor events as we enter peak giving season.

It's also a good time to review recent IRS guidance and refresh a few tax provisions affecting gifts made through donor advised funds, individual retirement accounts, and private foundations that can have a most unwelcome and potentially chilling effect on donor relations. Donor incentives can produce marvelous giving results, but their fraught with peril for the unwary.

Background

The Pension Protection Act of 2006 added IRC Section 4967, imposing excise taxes on the value of prohibited benefits resulting from the use of the assets of a donor advised fund (DAF). A 125% tax may be imposed on a donor/advisor and certain related persons, and a 10% tax on any DAF manager who agrees to such a payment knowing that it confers a more than incidental benefit.

More recently, the Internal Revenue Service issued interim guidance in anticipation of proposed regulations that would, if implemented, apply The Section 4967 sanctions where a donor/advisor receives more than an incidental personal benefit such as meals, entertainment, prizes, and other donor amenities in connection with a fundraising event where any part of an admission is purchased by DAF distribution.

Illustration

Assume that a charity sells tickets to an event for $1,000 per ticket and notifies purchasers that the fair market value of each ticket is $100 as required under the "*quid pro quo*" rule of Section 6115. Assume further that the requirements for a charitable contribution are otherwise satisfied. An individual who purchases a ticket for $1,000 may therefore deduct up to $900 of the payment as a charitable contribution.

If the ticket is purchased by DAF distribution instead, most would take the position that the Donor/Advisor does not receive a more than incidental benefit if the $100 ticket value is paid by the donor and the DAF, on the advice of the Donor/Advisor, distributes $900 to the charity to pay the remaining cost of the ticket. It might be argued that the donor is in the same position as if the donor had paid the entire $1,000 individually.

However, the IRS stated in Notice 2017-73 that it does not agree that a distribution made by a DAF to a charity should be analyzed the same as a hypothetical direct contribution by the

Donor/Advisor to the charity. The Service added that a Donor/Advisor who wishes to receive goods or services (such as tickets to an event) offered by a charity in exchange for a contribution of a specified amount can make the contribution directly, without the involvement of a DAF. The Notice also states that this same conclusion should apply in the case of membership fees where a donor pays any non-deductible portion of such fees and the deductible portion is paid by a DAF.

The IRS takes the view that the relief of a Donor/Advisor's obligation to pay the full price of a ticket to a charity-sponsored event can be considered a direct benefit to the Donor/Advisor that is more than incidental, and that proposed regulations would provide that a distribution from a DAF that subsidizes the Donor/Advisor's attendance or participation in a charity-sponsored event confers a more than incidental benefit under § 4967.

Excess benefit transaction

A distribution that results in a more than incidental benefit under § 4967 may also be treated as an excess benefit under § 4958. The intermediate sanction rules of Section 4958 impose excise taxes on a disqualified person equal to 25% of the excess benefit (self-reported), with a second tax of 200% if the excess benefit is not timely corrected (i.e. before the IRS catches it). A 10% tax is also imposed on an organization manager who knowingly participates in an excess benefit transaction.

The IRS anticipates that any proposed regulations would address the application of excise taxes in the case of a distribution that is potentially subject to tax under both provisions.

Private foundation

Although Notice 2017-73 deals specifically with donor advised funds, the principles discussed are helpful in analyzing transactions involving other types of pre-tax assets used to fund charitable gifts that include donor benefits.

In the case of a private foundation, such transactions are prohibited under the self-dealing rules of Section 4941, which impose a separate set of excise taxes applicable to foundation managers and disqualified persons, including the transfer or use of the income or assets of a private foundation.

It would be prudent for such persons to remit any gift that results in the receipt of a personal benefit, including the full price of an admission or membership, from separate individual funds, and to make any additional event-related contributions separately from foundation assets.

Qualified charitable distribution

A qualified charitable contribution (QCD) is a direct gift to charity made from a traditional individual retirement account (IRA) by an individual who has attained age 70 1/2. If any

amount of personal benefit is received as part of a QCD, except for certain specified benefits that may be disregarded, the entire distribution is disqualified and fully includible in the donor's income. When this occurs, the remittance of funds by the IRA trustee to the charity is treated as a gift by the IRA owner to the charity under the rules for a charitable contribution from an individual with the accompanying limitations

No-cost events

Fundraising activities that provide goods or services to donors without a required admission charge or minimum contribution pose a related risk for donors under the *quid pro quo* rule of Section 6115. If a donor chooses to take part in such an activity with the knowledge that a personal benefit will be provided, the donor has an expectation of a benefit, regardless of whether this is a motivating factor in the donor's decision to participate, applying the analysis in *U.S. vs. American Bar Endowment,* the 1986 Supreme Court case that laid the groundwork for Section 6115. Application of the quid pro quo rule is based on facts and circumstances and situations must be analyzed individually.

Although the IRS has not provided specific guidance for this scenario to date, the Service might successfully argue, for example, that if a donor attends a fundraising event knowing that a personal benefit will be provided and that an ask will be made, and the donor makes a gift in connection with the event, in substance the outcome should be no different than if the donor had made a gift of the same amount in payment of an admission charge or in satisfaction of a minimum gift requirement. The alternative is to allow a charitable deduction for the value of personal benefits, contrary to the intent of Section 6115.

A gift made from a DAF under such circumstances could be considered to provide more than incidental personal benefit under the Section 4967 interim guidance if the IRS holds this as a *quid pro quo transaction*. And the outcome could be considerably worse if the excise tax under Section 4967 is assessed, where the initial tax on a donor/advisor is 125%, versus 25% if alternatively assessed under the excess benefit rules of Section 4958.

Charities that receive gifts or accept pledges in connection with such events to be remitted through a DAF distribution or a QCD should take heed.

Summary

Planned giving professionals, DAF managers, and tax advisors alike should proactively caution donors regarding the hazards of using the pre-tax assets of a DAF, IRA, or private foundation in connection with a gift to a charity that results in any form of personal benefit to the donor, other than those types of benefits specifically exempted by statute. Refer to IRS Publication 1771 for the types of incidental benefits that may be disregarded.

For any fundraising effort that provides goods or services without an admission charge or minimum contribution requirement, the pledge or remittance of DAF, IRA, or private foundation assets should not be solicited in connection with such an activity.

Although these situations can pose challenging donor management issues, the potential outcomes resulting from non-compliance, including draconian excise taxes, loss of charitable deductions, embarrassment, and resulting erosion of donor goodwill outweigh the time and discomfort of broaching such concerns with donors in advance of a gift.

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