FEATURE:
PHILANTHROPY

By **Conrad Teitell, Heather J. Rhoades** & **Brianna L. Marquis**

No Thank You

Tax, legal and practical consequences of charitable gifts returned to donors

Keep a fable by short story writer Ambrose Bierce in mind when considering all analyses:[1]

> An Associate Justice of the Supreme Court was beside a river bank when a Traveler approached and said:
>
> "I wish to cross. Will it be lawful to use this boat?" "It will," was the reply; "it is my boat."
> The Traveler thanked him and, pushing the boat into the water, embarked and rowed away. But the boat sank and he was drowned.
> "Heartless man!" said an Indignant Spectator. "Why did you not tell him that your boat had a hole in it?"
> "The matter of the boat's condition," said the great jurist, "was not brought before me."

Matters to Consider

When a client wants to make a gift, her advisor may be faced with various matters to consider at different points in the process:

Matters staring the alert advisor in the face at the time of the gift. These include: the tax-exempt status of the donee charity (for example, public charity, private foundation (PF), donor-advised fund); the income, gift, estate and capital gains tax consequences for the donor; and, for large gifts, the donee's use of the gift. The keen advisor also considers how a large charitable gift fits in with the donor's overall estate plan.

Matters not before the advisor at the time of the gift—unless she looks beyond the factors just listed. These include: restrictions placed on the use of the gift; enforcement of naming rights; gifts that can be returned to the donor at her demand; and gifts returned to the donor by the charity because keeping the gift would damage the charity's reputation.

Recent issues generally not before advisors and charities. For example, what happens if a well-known donor turns out to be a criminal or publicly opposes the charity's core values? The charity should consider the potential damage to its reputation of keeping the gift, weighing the legal, ethical and financial ramifications of returning it. Although the funds have the potential to make a meaningful impact on the charity's mission, the negative publicity of a gift by a tainted donor could outweigh the positive. Returning the gift raises other issues.

Recent and Earlier Returned Gifts

The ongoing opioid crisis and protests in the United States and England triggered changes at the Solomon R. Guggenheim Museum in New York City and the Tate Modern and Britain's National Portrait Gallery in London. Contributions from the Sackler family will no longer be requested or accepted. The Sacklers, with a long history of making significant gifts to benefit the arts, own Purdue Pharma, the maker of OxyContin.

(From left to right) **Conrad Teitell** is chairman of the National Charitable Planning Group of Cummings & Lockwood LLC in Stamford, Conn., **Heather J. Rhoades** is a principal and **Brianna L. Marquis** is an associate, both in the West Hartford, Conn. office of Cummings & Lockwood LLC

The Sackler Trust, reacting to public pressure, ceased making donations in the United Kingdom.[2]

Gifts to Crimson Tide[3] football flow in, but huge gift to law school flows out. Last year, the University of Alabama (UA) returned a $21.5 million gift from H.F. Culverhouse Jr., a Florida real estate investor and lawyer. This gift was one of many generous donations from Culverhouse to UA; in fact, UA renamed its law school in his honor. UA's reason for returning the gift is unclear. Some believe it was because Culverhouse publicly called for students to boycott UA after the state of Alabama enacted a restrictive abortion ban. UA maintains the decision to return the gift was because of Culverhouse's attempted interference with the law school's affairs. Whatever the reason, the gift was ultimately returned, and Culverhouse's name was removed from the law school.[4]

Another Crimson. Harvard's student newspaper renamed itself *The Crimson* in 1875. Why? That's for another time. But now, let's talk about Harvard. Harvard's meager endowment is over $37 billion. Virtually all its donors have been and are on the up and up. But then, Jeffrey Epstein let Harvard down. Registered as a sex offender and facing federal sex trafficking charges, he made gifts to Harvard and other charities. Epstein's 2003 donation of $6.5 million funded a mathematical biologist at Harvard who later established its Program for Evolutionary Dynamics. When the news about Epstein's crimes came to light, Harvard explained that most of the funds had already been spent for their intended purposes. Any remaining funds were sent to organizations that support victims of human trafficking and sexual assault. After reviewing its donations, Harvard didn't receive any gifts from Epstein or his foundation made after his 2008 guilty plea and specifically rejected a gift following his conviction.[5]

Boola Boola, Moola Moola—Score: Bass $20 million, Yale $0. In 1995, Yale University returned a $20 million gift to alumnus, Lee M. Bass. The dispute arose over the gift's intended purpose. Bass requested that it be used to create a Western civilization curriculum. Professors and students argued that a multicultural curriculum focusing on women and minorities was a more appropriate use of the contribution. Four years after the gift was made, half the money had been spent, but the requested course hadn't yet been implemented. Bass then also requested involvement in faculty choices, but Yale refused. Negotiations broke down, and the gift was returned.[6]

Internal Revenue Service rulings and Tax Court cases provide some tax benefit guidance when gifts don't go according to plan.

Tax Implications of Return

Suppose Bass took an income tax deduction for his gift in 1991 (depending on the type of gift, up to 30% or 50% of his adjusted gross income—with a 5-year carryover for any "excess.") What are the tax implications on the return of his gift? The tax benefit rule requires inclusion in income of amounts that represent the return of items deducted in earlier years. So, if contributed property is returned to a donor, the donor must include it in income to the extent its deduction on a prior return reduced a tax liability for the year.[7]

The top individual income tax rate in 1991 was 31%; the top rate for 1995 was 39.6% (actually, a tad higher when you factor in the then "3% reduction of deductions" rule[8]). Bass' tax benefit income would have been taxed at the 39.6%-plus rate, while his deduction was taken at the lower 31% rate. So, this could have cost him in taxes. In any event, he could have paid it out of the $20 million. See below for a case in which a donor claimed he shouldn't have to be taxed at the higher rate.

Return of Appreciated Securities

A donor makes a charitable gift of appreciated securities. There's no capital gains to the donor on the transfer to the charity, nor when the charity sells the asset. The charity later returns the gift. But, it can't return the sold asset, so it gives cash to the donor. What are the capital gains implications for the donor?

Exhaustive research and discussions with tax experts yield no answer to this issue. If you have an answer, you can wake us in the middle of the night.

The AG is responsible for enforcing contracts that benefit the state's charities, but the potential for abuse is still present if the donor has no representative.

Even though we might be groggy, we'll ask if your answer also takes into account whether the donor gave assets he held long or short term.

Tax Benefit Guidance

Internal Revenue Service rulings and Tax Court cases provide some tax benefit guidance when gifts don't go according to plan:

Revenue Ruling 76-150. A donor made several gifts to a tax-exempt governmental entity that held the contributions in a separate trust fund. For each transfer, the donor claimed a charitable deduction. The donor later requested and received repayment of the money when he decided to donate it to the city to save a historic building from demolition. The IRS looked to the tax benefit rule and held the repaid money should be included in the donor's gross income to the extent of his tax benefit from the prior charitable deductions.[9]

Rosen v. Commissioner.[10] The Rosens made a gift of property to their city in 1972 and took a charitable deduction. The following year, after finding no use for the property, the city returned it. In a second attempt to donate the property, the Rosens gave it to a hospital and claimed another deduction. As the city before it, the hospital was unable to use the property and returned it to the donors a year later. In both instances, no consideration was given for the property's return, and neither the hospital nor the city had any obligation to return it. The IRS later determined deficiencies and argued that the Rosens should have included the fair market value (FMV) of the returned property in their income in each year the property was returned. The Rosens, conversely, claimed the transfers were actually gifts to them. The U.S. Court of Appeals for the First Circuit, in *Rosen v. Commissioner*, agreed with the IRS. The court explained there was no generosity involved with the returned property. It was given back with no consideration to negate the donor's gift. The Rosens had to include the FMV of the property at each time it was reconveyed to them. Interestingly, the value of the property had actually decreased, so the amounts included were smaller than the original deductions.[11]

Query. If the Rosens had been in a higher tax bracket when the property was returned, would the amount included in income be taxed at the lower year-of-donation rate or the higher year-of-reconveyance rate? The court in *Alice Phelan Sullivan Corp. v. United States* addressed the same question and determined that it should be taxed at the rate in the year of recovery.[12] That court held:

> Since taxpayer in this case did obtain full tax benefit from its earlier deductions, those deductions were properly classified as income upon recoupment and must be taxed as such. This can mean nothing less than the application of that tax rate which is in effect during the year in which the recovered item is recognized as a factor of income.[13]

The gifts of real property in *Alice Phelan Sullivan Corp.* were made in 1939 and 1940, but the property wasn't returned until 1957. The court, however, wasn't swayed by the taxpayers' equitable arguments. It determined the additional amount included in income should be taxed at the then-current rate.[14]

885 Inv. Co. v. Comm'r.[15] In 1979, a partnership

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contributed a parcel of land along an interstate highway in Sacramento, Calif. in an attempt to help the city create a scenic corridor. In 1981, the partnership donated another parcel for the same purpose. The city doubted its ability to secure funding for the plan so in each deed of gift, it provided that the land would be returned if not used for the corridor. In 1983, the project was abandoned, and the city returned the land. The partnership accepted the land and agreed to develop and maintain the scenic corridor. In the years of the initial gifts, however, the partnership had taken charitable deductions. The statute of limitations had already run on the 1979 deduction, but the IRS disallowed the deduction for the 1981 contribution. It also imposed overvaluation penalties and held that the partners realized income in 1983 when the property was returned. The Tax Court agreed with the IRS and disallowed the 1981 deduction, relying on the fact that the city required the special deed provisions. Because the disallowance was based on the possibility that the gift would fail and not a valuation overstatement, the court didn't impose the IRS' penalties and held that the tax benefit rule wouldn't apply to the 1981 deduction.

The 1979 deduction, however, was treated differently. In some instances, the Tax Court had held that the tax benefit rule wouldn't apply if an improper deduction is claimed in a tax year when the statute of limitations has run.[16] Some courts of appeal, however, (including the Ninth Circuit, where an appeal of *885 Inv. Co.* would have been heard, if taken) have disagreed.[17] As a result, the court was compelled to apply the tax benefit rule to the recovery of the 1979 parcel. The Tax Court held that the recovery should be limited to the FMV of the property. Referencing the price the city paid for a similar parcel in 1979, the court was able to set an amount for the partners to include in income.[18]

Private Letter Ruling 8430068. The donors created a foundation and contributed real property to it the following year. On discovering the allowed deduction was smaller than originally anticipated, they attempted to undo the conveyance and donate other property in later years instead. The IRS held that when the donors received the returned land, they should have included any tax benefit in income. However, if the original deduction didn't result in any tax savings, the returned property didn't have to be included in income.[19] This ruling, however, only focused on the income tax consequences of returning a gift. There may also be self-dealing issues to consider because the donors created the foundation themselves, and the transaction allowed the donors to maximize their deductions.

PLR 8518033. A subsequent PLR involved another taxpayer's attempt to rescind a gift. The taxpayer donated artwork from his collection to Museum A. In the year of the gift and the following year, he took an income tax charitable deduction. Museum A later discovered that it wouldn't be able to house the entire collection that the donor wished to contribute.

Most university policies are vague on "tainted" gifts.

Attempting to keep the collection intact, the taxpayer found Museum B, which had the capacity to hold the complete collection. Under its policies, Museum A rescinded the gift, and the artwork was delivered directly to Museum B. The IRS ruled the taxpayer was still required to include the artwork in income the year the gift was rescinded, even though he never recovered possession. However, the charitable transfer to Museum B was deductible.[20]

Not all gift rescissions will trigger the tax benefit rule. In PLR 8425018, a company donated land to the U.S. Department of Agriculture. Later, the company wanted to get the land back in exchange for other parcels of land it owned that were already surrounded by U.S. property. An appraisal showed that it was an even exchange, so the IRS determined that the previous charitable deduction shouldn't be disturbed.[21]

Approval by State AG

Sometimes the donor demands repayment, but the state's Attorney General (AG) may have to approve the gift's return or allow a donor to avoid fulfilling a pledge. In *Carl J. Herzog Foundation, Inc. v. University of Bridgeport*, for example, the donor agreed to make grants to the University to provide need-based merit

scholarships to disadvantaged students in a medical field.[22] The school agreed to match the contribution and provided scholarships to students in its nursing program. A few years later, the school closed its nursing program and redirected the funds into its general endowment. The donor sued, demanding that the school either reestablish the program or transfer the funds to a different charity willing to provide the scholarships. Ultimately, the court held that under Connecticut law, the donor didn't have standing to enforce the terms of the gift. Only the AG or a donor who expressly reserved a property interest in the gift can maintain suit.[23] Further, the Uniform Management of Institutional Funds Act specifically states that the donor of a completed gift wouldn't have standing to enforce the gift.[24]

Naming Rights

Some donors fight to enforce naming rights. In 1969, the Hofheinz family made a $1.5 million gift to the University of Houston (UH). UH then named a building, the Hofheinz Pavilion, in their honor. In 2016, UH planned to renovate the pavilion and sought donations. As part of the initiative, UH offered naming rights to large (in wealth, not girth) donors. The Hofheinz family sued to keep the name and enforce the original agreement. Ultimately, the family and UH compromised. The family agreed to allow the pavilion renaming in exchange for other name changes throughout the school. Although the family and UH were able to come to an agreement in this case, in other situations, there may not be any remaining family members to challenge the charity. The AG is responsible for enforcing contracts that benefit the state's charities, but the potential for abuse is still present if the donor has no representative.[25]

Are naming rights a quid pro quo that reduces the value of the contribution? The short answer is no. Donors who condition their gifts on naming rights for buildings or scholarships are still entitled to their full charitable deductions. The IRS hasn't ruled that receiving such benefits requires a reduction in the charitable deduction.[26] The IRS has also discussed the tax consequences to a charity of gifts that publicize donors. PLR 9431029 involved a PF that granted scholarships to high school students.[27] The PF planned to hold a luncheon and issue a press release honoring all of the awardees and wanted to include the name of the donor who funded the scholarships. However, the PF was concerned that mentioning the donor would be considered advertising and an act of self-dealing. The IRS ruled that even though the donor would benefit from having his name associated with the scholarships, that benefit was "incidental and tenuous." Acknowledging the donor's role wasn't self-dealing and wouldn't affect the PF's exempt status.[28]

As a practical matter, the charity must be certain to properly acknowledge such a gift. The receipt should include a description of the gift and a statement that the donor received no goods or services from the charity in exchange for the gift. It should also state that the building (or scholarship, etc.) was named after the donor.

In light of the recent scandals, charities should include procedures to return the gift and rescind naming rights or other similar obligations under specified circumstances.

Charity Guidelines

Larger charities often have guidelines on the types of gifts they'll accept. Lately, they've likely been taking a second look at from whom they'll accept gifts. A recent study examined policies from several public universities and found widely varied guidelines.[29] While every school had a policy on the books, no two were alike. Some, like the University of Florida Foundation, are specific and list particular restrictions that can't be placed on a gift. Others are less so. The University of North Carolina at Chapel Hill provides that if a gift could have an impact on the curriculum, the university will seek the faculty's input.[30]

Most university policies are vague on "tainted"

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gifts. They speak broadly about honoring university values, fulfilling university missions and maintaining university reputations. Most difficult for the universities is where to draw the line. If the donor is a violent criminal, it's a lot easier to say no to the gift. But, does the same hold true for donors like fossil-fuel companies? What if the donor insists on anonymity? No one answer fits every situation.[31]

The Ideal Solution

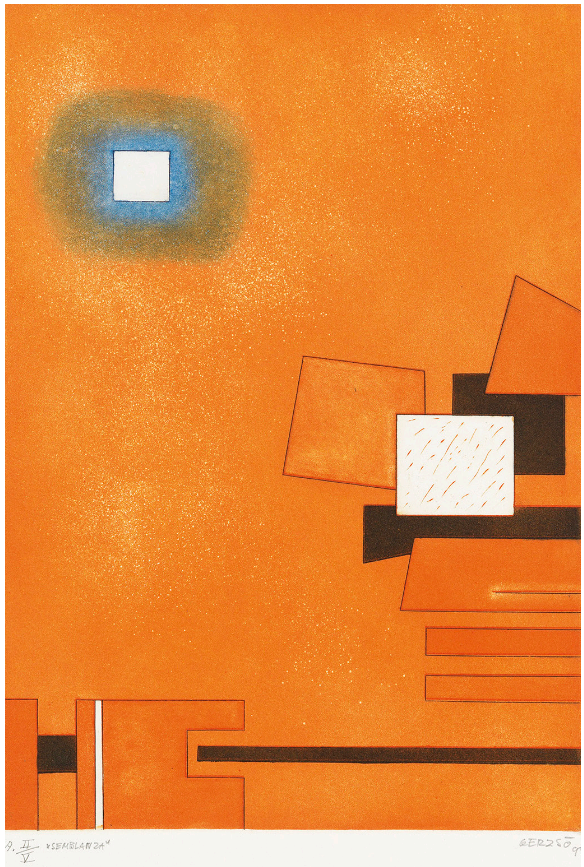
Donors and charities should come to terms before a gift is made. Gift agreements should be clear with restrictions and expectations. In light of the recent scandals, charities should include procedures to return the gift and rescind naming rights or other similar obligations under specified circumstances. While this is often easier said than done, the consequences of not doing so could be trouble down the road for all parties. Ultimately, when considering the return of a gift, the charities must decide what's best for their institutions and their other supporters. But, having all the facts about the donors, the tax consequences and the potential impact to reputations is critical in case the gift fails.

Apocryphal?

When the founder of an organization that helps the homeless, orphans and others in need was asked about the ethics of accepting charitable donations from questionable sources, he replied, "I'll tell you about tainted money; t'ain't enough of it!"

Endnotes

1. Ambrose Bierce, "Fantastic Fables," *The Collected Works of Ambrose Bierce* Vol. 6, at p. 294 (1911).
2. Sam Baker, "When Philanthropists' Reputations Become Problematic For Art Institutions," *Forbes* (April 1, 2019).
3. Alabama tied Auburn 6-6 in the 1907 Iron Bowl after a tough game in red-clay mud that stained Alabama's white jerseys crimson. Hugh Roberts, the former sports editor at the *Birmingham Age-Herald* coined the term.
4. Susan Svrluga, "After the University of Alabama returns more than $21 million, officials release internal emails saying decision was not about abortion but academic integrity," *The Washington Post* (June 10, 2019).
5. Susan Svrluga, "Epstein's donations to universities reveal a painful truth about philanthropy," *The Washington Post* (Sept. 8, 2019).
6. Elizabeth Mehren, "Yale to Return Bass' $20-Million Donation," *Los Angeles Times* (March 15, 1995).
7. Internal Revenue Code Section 111.
8. IRC Section 68.
9. Revenue Ruling 76-150.
10. *Rosen v. Commissioner*, 611 F.2d 942 (1st Cir. 1980).
11. *Ibid.*
12. *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 403 (Ct. Cl. 1967).
13. *Ibid.*
14. *Ibid.*, at pp. 401-403.
15. *885 Inv. Co. v. Comm'r*, 95 T.C. 156, 158 (1990). The court held that the



SPOT LIGHT

Orange You Glad?
Semblanza by Gunther Gerzso sold for $3,000 at Swann Auction Galleries Old Master Through Modern Prints Featuring Latin American Art sale on May 2, 2019 in New York City. Born in Mexico City, Gerzso spent time living with his wealthy uncle in Switzerland, where he was inspired by his uncle's collection of old master and modern paintings and the Swiss-born artist Paul Klee.

taxpayers weren't liable for the valuation overstatement penalty because the court disallowed the charitable deduction on the basis that the gift was subject to a condition. *Ibid.* The court relied on *Todd v. Comm'r*, 89 T.C. 912, 916 (1987) and *McCrary v. Comm'r*, 92 T.C. 827, 854 (1989), when it concluded that because the disallowance didn't result from a valuation overstatement, the penalty didn't apply. *Ibid.* Both of those cases, however, were overruled by *AHG Investments, LLC v. Comm'r*, 140 T.C. 73 (2013). That court held that "an underpayment of tax may be attributable to a valuation misstatement even when the Commissioner's determination of an underpayment of tax may also be sustained on a ground unrelated to basis or valuation." *Ibid.*, at p. 84. As a result, *RERI Holdings I, LLC v. Comm'r*, 149 T.C. 1, 22 (2017), *aff'd sub nom. Blau v. Comm'r*, 924 F.3d 1261 (D.C. Cir. 2019), recognized that *885 Inv. Co. v. Comm'r* was also overruled.

16. *S. Pac. Transportation Co. v. Comm'r*, 75 T.C. 497 (1980), *supplemented*, 82 T.C. 122 (1984).
17. *Unvert v. Comm'r*, 656 F.2d 483, 484 (9th Cir. 1981).
18. *885 Inv. Co.*, *supra* note 15, at p. 166.
19. Private Letter Ruling 8430068 (April 25, 1984).
20. PLR 8518033 (Feb. 1, 1985).
21. PLR 8425018 (March 14, 1984).
22. *Carl J. Herzog Found., Inc. v. Univ. of Bridgeport*, 699 A.2d 995, 996 (1997).
23. *Ibid.*, at pp. 997-999.
24. *Ibid.*, at p. 1002.
25. Frank Monti, "Whatever About the Rule of Law: Naming Rights and Sleeping Watchdogs," *Inside Philanthropy: Who's Funding What, and Why* (Sept. 21, 2016).
26. *See* PLR 7943084 (July 27, 1979); PLR 8137077 (June 17, 1981).
27. PLR 9431029 (Aug. 5, 1994).
28. *Ibid.*
29. Francie Diep, "Universities Are Facing Criticism for Taking Dirty Money. Do Their Donor Policies Protect Them?" *The Chronicle of Philanthropy* (Oct. 31, 2019).
30. *Ibid.*
31. *Ibid.*

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