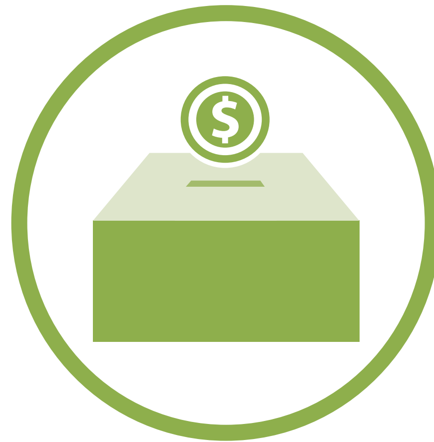
ChurchLaw&Tax

Best Practices for Receiving Charitable Contributions

By Richard R. Hammar



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Substantiating Cash Contributions

Charitable contributions must be properly substantiated in order to be deducted on the donor's tax return. Different substantiation rules apply to different kinds of contributions.

Contributions of Cash

Cash contributions include those paid by cash, check, credit card, or payroll deduction. They also include your out-of-pocket expenses incurred while donating services. For a contribution made in cash, the records a donor must maintain depend on whether the contribution is:

1. less than $250; or,

2. $250 or more.

In figuring whether a contribution is $250 or more, do not combine separate contributions. For example, if a member donates $25 to his church each week, his weekly payments do not have to be combined.

Contributions of Less than $250

For each cash contribution that is less than $250, the donor must keep one of the following.

1. A canceled check, or a legible and readable account statement that shows:

    - If payment was by check—the check number, amount, date posted, and to whom paid,

    - If payment was by electronic funds transfer—the amount, date posted, and to whom paid, or

    - If payment was charged to a credit card—the amount, transaction date, and to whom paid.

2. A receipt (or a letter or other written communication) from the church showing the name of the church, the date of the contribution, and the amount of the contribution.

3. Other reliable written records that include the information described in (2).

Records may be considered reliable if they were made at or near the time of the contribution, or were regularly kept by the donor.

Donors who claim expenses directly related to the use of their car in providing services to their church must keep reliable written records of expenses. Whether records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if made regularly and at or near the time of the expenses. Records must show the name of the church and the date each time the donor used the car for a charitable purpose. If the donor uses the standard mileage rate, his or her records must show the miles the car was driven for charitable purposes. If the donor deducts actual expenses, his or her records must show the costs of operating the car that are directly related to a charitable purpose.

Contributions of $250 or More

Donors can claim a deduction for a contribution of $250 or more only if they have a written acknowledgement of their contribution from the church. Donors who made more than one contribution of $250 must have either a separate acknowledgement for each or one acknowledgement that shows the total contributions. The acknowledgement must meet these tests.

1. It must be written.

2. It must include:

    - The amount of cash contributed,

    - Whether the church gave the donor any goods or services as a result of the contribution (other than certain token items or "intangible religious benefits"), and

    - A description and good faith estimate of the value of any goods or services. If the only benefit the donor received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction, the acknowledgement must say so and does not need to describe or estimate the value of the benefit.

3. The acknowledgment must be provided to the donor on or before the earlier of:

    - The date the donor files a tax return claiming the deduction, or

    - The due date, including extensions, for filing the return.

Out-of-pocket Expenses

Persons who render services to their church and have unreimbursed out-of-pocket expenses related to those services can satisfy the written acknowledgement requirement just discussed if:

1. They have adequate records to prove the amount of the expenses, and

2. By the required date, they get an acknowledgement from the church that contains:

    - A description of the services provided,

    - A statement of whether or not the church provided any goods or services to reimburse the donor for the expenses incurred,

    - A description and a good faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse the donor, and

    - A statement of any intangible religious benefits provided to the donor. ■

Handling Blank, Predated, and Postdated Checks

Churches occasionally receive blank checks, predated checks, and postdated checks. Should the church treat these checks as charitable contributions? If so, as of what date?

Blank Checks

A blank check is a check that is complete in all respects except for the designation of a payee. The person issuing the check specifies the date and an amount, and signs the check, but does not identify a payee. Occasionally a church will receive a blank check in the offering or in the mail. This can occur for a number of reasons. Some church members may simply forget to complete the check. Others may assume that the church will insert (or "stamp") its name as payee, so why bother? Can church members claim a charitable contribution deduction for a blank check? Possibly not. Consider the following example.

> ***Example.*** *A husband and wife claimed a charitable contribution deduction on their tax return for contributions they made by check to their church. The IRS audited the couple's tax returns, and questioned the contributions. The couple attempted to substantiate their deductions with canceled checks and carbon copies of checks from their two personal checking accounts on which they left the payee lines blank. The Tax Court ruled that "because these canceled blank checks fail to list [the church] as the donee, these checks do not establish" that the couple made tax-deductible charitable contributions to the church.*

Canceled checks may be used to substantiate charitable contributions of less than $250. This case suggests that persons who make contributions of blank checks to their church may not be entitled to a charitable contribution deduction—unless the church immediately prints or stamps its name on the payee line of each check.

Predated Checks

Can a member who contributes a personal check to a church during the first worship service in January claim a contribution deduction for the prior year by simply "predating" the check as December 31 of the prior year? Many churches advise their congregations during the first one or two worship services in January that checks can be credited to the previous year if they are dated December 31 of the previous year. This advice is wrong and should not be given. The income tax regulations specify that "ordinarily, a contribution is made at the time delivery is effected. The unconditional delivery or mailing of a check which subsequently clears in due course will constitute an effective contribution on the date of delivery or mailing."

According to this language, a check dated "December 31" of one year but physically delivered in January of the following year is deductible only on the donor's federal tax return for the current year (the year the check was delivered). This is so whether a donor "predated" a check to read "December 31" or in fact completed and dated the check on December 31 of the previous year but deposited

it in a church offering in January of the following year.

The only exception to this rule is a check that is dated, mailed, *and postmarked* in December of the previous year. The fact that the church does not receive the check until January of the current year does not prevent the donor from deducting it on his or her federal tax return for the previous year.

Postdated Checks

Churches occasionally receive a postdated check. A postdated check is a check that bears a future date. For example, Frank writes a check for $100 on March 1 that he dates April 15. Such checks often are received at the end of the year when some donors decide they will be better off for tax purposes if they delay their contribution until the following year. Other donors make gifts of postdated checks before leaving on an extended vacation or business trip.

A postdated check is treated like a promissory note. It is nothing more than a promise to pay a stated sum on or after a future date. It is not an enforceable obligation prior to the date specified. Since a postdated check is no different than a promissory note, it should be treated the same way. If someone issues a note to a church, promising to pay $1,000 over the next year, no charitable contribution is made when the note is signed (assuming the donor is a "cash basis" taxpayer). Rather, a contribution is made when the note is paid. Until then, there is only a promise to pay. Like a promissory note, a church ordinarily should simply retain a postdated check until the date on the check occurs. There is no need to return it. A bank may be willing to accept such a check for deposit before the date on the check has occurred, with the understanding that the funds will not be available for withdrawal. ■

Substantiating Contributions of Property

Charitable contributions must be properly substantiated in order to be deducted on the donor's tax return. Different substantiation rules apply to different kinds of contributions. The substantiation requirements for contributions of noncash property (e.g., land, equipment, stock, books, art, and vehicles) are more stringent than for contributions of cash or checks. It is important to note that *more than one rule may apply* to a particular contribution.

Rule 1: Individual contributions of noncash property valued by the donor at less than $250

The income tax regulations specify that any taxpayer who makes a charitable contribution of property other than money must maintain for each contribution a receipt from the charity showing the following information: (1) the name of the charity; (2) the date and location of the contribution; and (3) a description of the property (the fair market value need not be specified). A letter or other written communication from a church acknowledging receipt of the contribution and containing the information in (1), (2), and (3) above will serve as a receipt.

In addition to the receipt provided by the church, donors themselves must keep reliable written records for each item of donated property. These records must include the following information.

1. The name and address of the organization to which the donor contributed.
2. The date and location of the contribution.
3. A description of the property in detail reasonable under the circumstances. For a security, keep the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market.
4. The fair market value of the property at the time of the contribution and how the donor figured the fair market value. If it was determined by appraisal, the donor should also keep a signed copy of the appraisal.
5. The cost or other basis of the property if the donor must reduce its fair market value by depreciation. The donor's records should also include the amount of the reduction and how the donor figured it. If the donor chooses the 50 percent limit instead of the special 30 percent limit on certain capital gain property, the donor must keep a record showing the years for which the donor made the choice, contributions for the current year to which the choice applies, and carryovers from preceding years to which the choice applies.
6. The amount the donor claims as a deduction for the tax year as a result of the contribution, if the donor contributes less than the donor's entire interest in the property during the tax year. The

donor's records must include the amount the donor claimed as a deduction in any earlier years for contributions of other interests in this property. The donor must also include the name and address of each organization to which the donor contributed the other interests, the place where any such tangible property is located or kept, and the name of any person in possession of the property, other than the organization to which the donor contributed.

7. The terms of any agreement or understanding entered into by the donor which relates to the use, sale, or other disposition of the donated property, including for example, the terms of any agreement or understanding which: (1) restricts the church's right to use or dispose of the donated property; (2) confers upon anyone other than the church any right to the income from the donated property or to the possession of the property; or (3) earmarks donated property for a particular use.

Rule 2: Individual contributions of noncash property valued by the donor at $250 to $500

Donors who claim a deduction of $250 to $500 for a noncash charitable contribution must get and keep an acknowledgement of their contribution from the church. Donors who make more than one contribution valued at $250 to $500 must have either a separate acknowledgement for each contribution or one acknowledgement that shows the total contributions. The church's acknowledgement must be written, and it must include:

1. A description (but not necessarily the value) of the donated property,

2. Whether the church provided any goods or services as a result of the contribution (other than certain token items and membership benefits), and

3. A description and good faith estimate of the value of any goods or services described in (2). If the only benefit provided by the church was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgement must say so and does not need to describe or estimate the value of the benefit.

The donor must receive the church's written acknowledgment on or before the earlier of: (a) the date the donor files his or her tax return claiming the contribution, or (b) the due date, including extensions, for filing the return. The donor's written records must include all seven items of information listed in Rule 1.

Rule 3: Individual contributions of noncash property valued by the donor at more than $500 but not over $5,000

Donors who claim a deduction over $500 but not over $5,000 for a noncash charitable contribution must have the acknowledgement and written records described under Rule 2, and their records must also include: (1) A description of how the donor acquired the donated property, for example, by purchase, gift, bequest, inheritance, or exchange. (2) The approximate date the donor acquired the property. (3) The cost or other basis, and any adjustments to the basis, of property held less than 12 months and, if available, the cost or other basis of property held 12 months or more. This requirement, however, does not apply to publicly traded securities.

> ***Key point.*** *Donors whose total deduction for all noncash contributions for the year is over $500 must complete Section A of Form 8283, and attach it to their Form 1040. However,*

donors should not complete Section A for items reported on Section B (see Rule 9). The IRS can disallow a deduction for noncash charitable contributions if it is more than $500 and a donor does not submit a required Form 8283 with his or her tax return.

Rule 4: Individual Contributions of noncash property valued by the donor over $5,000

The requirements are triggered by a contribution of a single item of property valued by the donor at more than $5,000, but they also can be triggered by contributions of similar items within a calendar or fiscal year if the combined value claimed by the donor exceeds $5,000.

Publicly traded stock is not subject to these requirements since its value is readily ascertainable. Contributions of non-publicly traded stock (i.e., stock held by most small, family-owned corporations) are subject to these requirements but only if the value claimed by the donor exceeds $10,000.

The donor's obligations

Donors who contribute property valued at more than $5,000 to a church or other charity must satisfy each of the following three requirements in order to claim a charitable contribution deduction:

1. Obtain a qualified appraisal

A donor's first obligation is to obtain a *qualified appraisal*. The income tax regulations define a qualified appraisal as an appraisal made by a "qualified appraiser" no earlier than 60 days prior to the date of a contribution, and containing specified information, including an adequate description of the donated property; the physical condition of the property; the date (or expected date) of the contribution; the qualifications of the qualified appraiser who prepared and signed the qualified appraisal; a statement that the appraisal was prepared for income tax purposes; the date on which the property was valued; the appraised fair market value of the property on the date (or expected date) of the contribution; the method of valuation used to determine the fair market value; and a description of the fee arrangement between the donor and appraiser.

A qualified appraisal, as noted above, is one prepared by a qualified appraiser. The regulations define the term "qualified appraiser" as anyone meeting specified qualifications.

2. Prepare a qualified appraisal summary

A donor must complete an *appraisal summary* and enclose it with the tax return on which the charitable contribution deduction is claimed. The appraisal summary is a summary of the qualified appraisal, and is made on Section B (side 2) of IRS Form 8283. You can obtain copies of Form 8283 by contacting your nearest IRS office, by calling the toll-free IRS forms hotline at 1-800-829-3676, or by downloading them from the IRS website.

Section B of Form 8283 contains four parts. Part I is completed by the donor or appraiser, and sets forth information from the qualified appraisal regarding the donated property, including its appraised value. Part II is completed by the donor and identifies individual items in groups of similar items having an appraised value of not more than $500. Part III contains the appraiser's certification that he or she satisfies the definition of a qualified appraiser. Part IV is a donee acknowledgment, which must be *completed by the church*. The church simply indicates the date on which it received the contribution, and agrees to file an information return (Form 8282) with the IRS if it disposes of the donated property within two years.

If a donor fails to enclose a Form 8283 with a tax return on which a deduction is claimed for a charitable contribution of property valued at more than $5,000, the IRS may request that the

donor submit the appraisal summary within ninety days of the request. If such a request is made and the donor complies with the request within the ninety-day period, the deduction will not be disallowed for failure to comply with the appraisal summary requirement *if the donor's failure to enclose the summary was a good faith omission*.

3. Maintain records

The donor's third obligation is to maintain records containing the following information: the name and address of the church; the date and location of the contribution; a detailed description of the property; the fair market value of the property at the time of the contribution, including a description of how the value was determined; the cost or other basis of the property; if less than the donor's entire interest in the property was given, an explanation of the total amount claimed as a deduction in the current year; the terms of any agreement or understanding by or on behalf of the donor pertaining to the use or disposition of the property. Most of these items will be contained in the qualified appraisal, which should be retained by the donor.

The Church's Obligations

Churches receiving contributions of property valued by the donor at more than $5,000 have the following two obligations (assuming that the donor plans to claim a deduction for the contribution): (1) complete and sign Part IV of Section B of the donor's Form 8283 appraisal summary; and (2) file Form 8282 ("Donee Information Return") with the IRS if (1) a donor makes a contribution of non-cash property to the church that is valued at more than $5,000 (other than publicly traded securities); (2) the donor presented the church with a qualified appraisal summary (Form 8283, Section B, Part IV) for signature; and (3) the church sells, exchanges, consumes, or otherwise disposes of the donated property within two years of the date of contribution. The purpose of this reporting requirement is to ensure that donors do not claim inflated values for donated property. ■

Tangible Property Gift Receipt Cover Letter

Use this example for your church, or to create your own gift receipt.

SAMPLE

(Church Name)

123 Main Street
Anywhere, State 01234
Phone: (000) 123-4567
The Rev. John Doe, Pastor
Email: pastor@communitychurch.org

Date:
Name:
Address:
City/State/Zip:

Dear___________________________________:

Thank you so very much for your donation of property to support the ministry of First Community Church in the most recent tax year. We have attached a list of donated items and the date(s) on which they were received by the church. You will need to assign the value for the items you have donated.

To comply with the tax law, we are confirming that you did not receive any goods or services from First Community Church in connection with or in exchange for your gift, other than intangible religious benefits. You must follow the IRS's reporting rules to assure the legitimacy of your charitable deduction.

We have enclosed a copy of IRS Form 8283 (Noncash Charitable Contributions) and its instructions in the event this form is applicable to your gift. If your noncash gifts for the year total more than $500 by your valuation, you must include Form 8283 with your income tax return.

Again, we are grateful for your generous contribution to First Community Church and for your support for the extension of God's kingdom in our area.

Faithfully yours,

Jane Smith
Treasurer

Enclosure: Tangible Property Gift Receipt
IRS Form 8283

Church Contributions from IRAs

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to a charitable organization, including a church, that is made on or after the date the IRA owner attains age 70½.

- A distribution will be treated as a qualified charitable distribution only to the extent that it would be includible in taxable income without regard to this provision.
- This provision applies only if a charitable contribution deduction for the entire distribution would be allowable under present law, determined without regard to the generally applicable percentage limitations. For example, if the deductible amount is reduced because the donor receives a benefit in exchange for the contribution of some or all of his or her IRA account, or if a deduction is not allowable because the donor did not have sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.
- The maximum annual exclusion for QCDs is $100,000. Any QCD in excess of the $100,000 exclusion limit is included in income as any other distribution. For married couples who file a joint return, each spouse can make a QCD and exclude up to $100,000 out of his or her IRA.

What, if any, substantiation is a church required to provide to a donor who makes a QCD? The IRS states in Publication 590 that donors must have "the same type of acknowledgement" of their contribution that they would need "to claim a deduction for a charitable contribution." Publication 590 refers to the "Records to Keep" section in IRS Publication 526 (*Charitable Contributions*). This section summarizes the substantiation rules that apply to charitable contributions. To illustrate, for individual cash contributions of $250 or more, Publication 526 states that a donor must have an acknowledgment of the contribution from the charity that meets the following requirements:

1. It must be written.
2. It must list the amount of cash contributed; indicate if the charity provided any goods or services as a result of the contribution (other than certain token items) and, if so, a description and good faith estimate of the value of those goods or services; and, a statement that the only benefit received by the donor was an intangible religious benefit, if that was the case. The acknowledgment does not need to describe or estimate the value of an intangible religious benefit. An intangible religious benefit is a benefit that generally is not sold in commercial transactions outside a "donative (gift) context." An example is admission to a religious ceremony.
3. The acknowledgement must be issued to the donor on or before the earlier of (a) the date the donor files a tax return for the year the contribution was made, or (b) the due date, including extensions, for filing the return.

According to IRS Publication 590, a church would need to issue a receipt to a donor that meets these substantiation requirements for any QCD of $250 or more, even though these contributions will come directly from the IRA trustee rather than the donor. ■

Gifts of Stock

It is common for churches to receive gifts of stock. Such gifts raise a number of important questions. For example, are there tax advantages to donating stock? Are there limits on the amount of stock that can be donated? What about substantiation requirements? How do donors transfer stock to a church? Is it better if donors sell their stock and then donate the proceeds to their church? What about stock that has declined in value?

With more than half of all Americans now owning stock, it is not surprising that many of them are donating shares of stock to their church. As a result, it is important for church leaders to be familiar with the tax rules that apply to stock donations. Unfamiliarity with these rules can result in additional taxes for donors.

Why should donors consider donating stock to their church?

Gifts of stock can provide donors with a double tax benefit. First, they may be able to claim a charitable contribution deduction in the amount of the current market value of the donated stock. That is, they can deduct not only the original cost they paid for the donated shares, but also the value of any increase in the value of those shares. Second, donors avoid paying taxes on the appreciated value of the donated stock.

> ***Example.*** *Bob purchased 100 shares of ABC stock at a cost of $1,000 in 1997, and donates these shares to his church this year when their value is $3,000. Subject to the limitations discussed later in this section, Bob would be able to deduct the full $3,000 market value, and he would not have to pay capital gains tax on the $2,000 "gain" in the value of the stock.*
>
> *Many church members own stock that has appreciated greatly in value. The greater the amount of appreciation, the more capital gains tax the shareholder will face if the stock is sold. But this tax can be avoided if the member donates the stock to his or her church. And remember, the church pays no capital gains tax when it sells the donated stock, so the entire amount of the gift furthers the church's mission.*

What about gifts of privately held stock?

Most stock is either publicly traded or privately held by the owners of a business that has not offered its shares for sale to the public. When donors make gifts of privately held stock, there are three special rules that must be understood by both donors and church leaders:

1. qualified appraisals

If privately held stock valued at more than $10,000 is donated, then a donor must obtain a qualified appraisal of the donated shares no earlier than 60 days prior to the date of the contribution. The cost of obtaining a qualified appraisal of privately held shares can be costly, and has caused some donors to reconsider making such a gift.

2. qualified appraisal summaries (Form 8283)

The donor must complete a qualified appraisal summary (IRS Form 8283) and enclose it with the Form 1040 on which the contribution deduction is claimed. Note that the church must sign this appraisal summary. Unfortunately, some donors have sent this

form to their church for signature only to have it discarded or misplaced. The failure of a donor to submit a properly executed appraisal summary will jeopardize the deductibility of the contribution.

3. if the donor "buys back" the donated shares

It is common for donors who donate privately held stock to a church to "buy back" those shares after the gift. After all, there usually is little if any "market" for shares in privately held companies, and so the church cannot easily sell the shares to anyone else. However, if there is an agreement at the time the shares are donated for the donor to buy back the shares, or for the church to sell them to the donor, then the charitable contribution may be disallowed by the IRS and any gain in the value of the shares may be taxed to the donor.

What limitations apply to gifts of stock?

There are three limitations that apply to a gift of stock that has appreciated in value:

1. the one-year rule

When contributing "capital gain property" such as stock to a church or other public charity, a donor generally is entitled to claim a deduction in the amount of the fair market value of the donated property on the date of the gift. Property is capital gain property if its sale at fair market value on the date of the contribution would have resulted in long-term capital gain. Capital gain property includes capital assets held more than one year.

Donated stock that was held by the donor for less than one year is not capital gain property. The IRS classifies it as "ordinary income property," since a sale of the stock would result in ordinary taxable income rather than capital gain on any appreciation in value. The amount a donor can deduct for a contribution of ordinary income property is its fair market value less the amount that would have been ordinary income or short-term capital gain if the donor had sold the property for its fair market value on the date of the gift. Generally, this rule limits the deduction to the donor's "basis" (cost) in the property.

> ***Example.*** *Barb donates stock that she held for five months to her church. The fair market value of the stock on the date of the donation was $1,000, but Barb paid only $800 (her "basis") for the stock. Because the $200 of appreciation would be short-term capital gain if she had sold the stock on the date of the contribution, her deduction is limited to $800 (fair market value less the appreciation).*

2. the 30 percent limit

Donors generally can deduct contributions to their church only up to 50 percent of their adjusted gross income (AGI), with any excess being "carried over" to the next year (up to five years in all, with the 50% limit applying to each year). However, gifts of capital gain property (including stock) to a church are deductible only up to 30 percent of a donor's AGI. The 30 percent limit does not apply to donors who elect to reduce the fair market value of donated property by the amount that would have been long-term capital gain had the property been sold on the date of the gift. In such cases the 50 percent limit applies.

> ***Key point.*** *Donors may elect a 50 percent limit for gifts of capital gain property instead of the 30 percent limit. Donors who make this election must reduce the fair market value of the donated property by the appreciation in value that would have been long-term capital gain if the property had been sold on the date of the gift. This choice applies to all capital gain property contributed to churches and other public charities during a tax year. Donors make the election on their tax return or on an amended return filed by the due date for filing the original return*

Example. *Bill has AGI of $50,000 this year and makes cash contributions of $5,000 to his church and in addition donates stock to his church that he purchased in 2000 for $20,000 that has a current market value of $25,000. Ordinarily, gifts of "capital gain property" are limited to 30 percent of the donor's AGI, or $15,000 in this case (30% x $50,000), with any excess being carried over to the next five years. In addition, Bill can deduct his cash contributions of $5,000, for a total contribution deduction of $20,000. However, Bill can elect to claim a deduction of up to 50 percent of his AGI (i.e., $25,000) if he reduces the market value of the donated stock by the appreciation in value that would have been long-term capital gain had the stock been sold. In such a case, the amount of his charitable contribution would be his basis of $20,000 (what he paid for the stock) plus the $5,000 in cash that he donated to his church, for a total deduction of $25,000 or 50 percent of his AGI. Bill would be better off electing the 50 percent limit since his charitable contribution deduction would be $5,000 greater. Donors are not always better off electing the 50 percent limit. In general, the more a donor's shares of stock have appreciated in value, the less advantageous the 50 percent election will be. On the other hand, if stock has not appreciated greatly in value, then the 50 percent election may result in a larger charitable contribution deduction.*

Donors can "carry over" their contributions that they could not deduct in the current year because they exceed the 30 percent of AGI limit. Donors can deduct the excess in each of the next five years until it is used up, but not beyond that time. Contributions that are carried over are subject to the same percentage limits in the year to which they are carried. For example, contributions subject to the 30 percent limit in the year in which they are made are subject to the same limit in the year to which they are carried. Donors deduct carryover contributions only after deducting all allowable contributions in that category for the current year.

3. itemized deductions

Donors claim charitable contribution deductions as itemized expenses on Schedule A of Form 1040. Donors who do not itemize their expenses cannot claim a charitable contribution deduction for a gift of stock.

What about stock that has declined in value?

Some donors give their church stock that has declined in value. In general, donors who contribute stock with a fair market value that is less than their "basis" (cost) are entitled to a deduction in the amount of the stock's fair market value. They cannot claim a deduction for the difference between the stock's basis and its fair market value (the decrease in value). Persons who have stock that has declined in value generally will pay less tax if they sell the stock, give the proceeds to charity, and then claim a loss on their income tax return.

What about selling the stock and donating the proceeds?

Some donors consider selling their stock and then donating the cash proceeds to their church. Is this a good idea? Not if the stock has increased in value. Let's illustrate this with an example. Assume that Bill buys stock for $6,000 in 2000 that is worth $10,000 now. Bill sells the stock for $10,000 and donates the proceeds to his church. By selling the stock, Bill realized capital gains on the appreciation, and he will have to pay taxes on this amount. However, if

Bill instead had donated the stock to his church, without selling it, he would have avoided capital gains tax on the appreciation and still could have claimed a charitable contribution. This example is summarized in a table.

	Gift of stock	Gift of sales proceeds
Charitable contribution	$10,000	$10,000
Bill's marginal tax rate	28%	28%
Tax benefit of gift	$2,800	$2,800
Tax on gain	$0	$1,120 ($4,000 gain x 28%)
Net benefit of gift (tax savings)	$2,800	$1,680

By giving the stock directly to the church, Bill avoids paying any tax on the $4,000 gain that he realized on his stock investment, and he gets a charitable contribution deduction for the full value of his shares (unless one of the limitations mentioned previously applies).

How does a donor value donated stock? As we have seen, donors who contribute publicly traded stock to a church or charity can claim a charitable contribution deduction in the amount of the fair market value of the donated shares, subject to the limitations discussed previously. The fair market value of donated stock is determined by (1) determining the "mean price" of the donated shares by adding the high and low quoted prices of the stock on the day of the gift, and dividing by two; and then (2) multiplying the mean price times the number of donated shares.

> ***Key point.*** *The date of a gift of stock is addressed in the income tax regulations as follows: "Ordinarily, a contribution is made at the time delivery is effected. The unconditional delivery or mailing of a check which subsequently clears in due course will constitute an effective contribution on the date of delivery or mailing. If a taxpayer unconditionally delivers or mails a properly endorsed stock certificate to a charitable donee or the donee's agent, the gift is completed on the date of delivery or, if such certificate is received in the ordinary course of the mails, on the date of mailing. If the donor delivers the stock certificate to his bank or broker as the donor's agent, or to the issuing corporation or its agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation."* Treas. Reg. 1.170A-1(b).

Caution. Donors often make gifts of stock at the end of the year by calling their stock broker and asking that the shares be transferred. Donors who expect a year-end charitable contribution deduction should make their desire clear when communicating with their broker. In some cases, brokers do not transfer donated shares until the beginning of the new year, resulting in the loss of any deduction for the previous year.

What are the mechanics for donating stock?

Donors can contribute shares of stock in a number of ways, including the following:

- By electronic transfer (if available).
- By physical transfer (personally or through the mail). For security purposes, donors usually transfer unsigned stock certificates, and separately execute a "stock power" form with a signature guaranteed by the donor's bank or broker. The stock power form should be sent on the same day as the stock certificate, but in a separate envelope. If donated stock is held

in the names of more than one person, all owners must sign the stock power form. If using the mail, donors should send all documents by registered mail.

- By a stock broker.

Caution. Donors who contribute stock to their church through a broker should be sure that the broker understands that they are donating the stock, not selling it. If the broker sells stock held by the donor for more than one year and transfers the proceeds to the donor's church, rather than giving the shares directly to the church, the donor will have to pay capital gains tax on any gain in the value of the stock.

What about gifts of mutual fund shares?

Donors generally determine the fair market value of donated mutual fund shares by multiplying the "net asset value" on the date of the gift times the number of donated shares.

How do donors substantiate gifts of stock?

Gifts of stock are subject to special substantiation rules. Note the following:

- A church is not an appraiser, and should never provide donors with a "value" for donated stock. Instead, provide a receipt that acknowledges the date of gift, the donor's name, the number of shares given, and the name of the company.

- A donor who gives publicly traded stock valued at more than $5,000 is not required to obtain a qualified appraisal or complete a qualified appraisal summary (Section B of Form 8283).

- A donor who gives publicly traded stock valued at more than $500 must complete Section A, Part 1, of Form 8283. This requirement applies even if the stock is valued at more than $5,000 (in which case the stock is exempt from the qualified appraisal requirement).

- A donor who gives "non-publicly traded stock" valued at $10,000 or less is not required to obtain a qualified appraisal and complete a qualified appraisal summary (Form 8283). However, donors who give non-publicly traded stock valued at more than $10,000 must obtain a qualified appraisal of the stock no earlier than 60 days prior to the date of the gift, and they must also complete a qualified appraisal summary (IRS Form 8283) that summarizes the qualified appraisal and is enclosed with the tax return on which the deduction is claimed. Failure to comply with these requirements can lead to a loss of any charitable contribution deduction.

Example. *A donor contributed "non-publicly traded stock" worth more than $10,000 to a church, but obtained no qualified appraisal and attached no qualified appraisal summary to the tax return on which the charitable contribution deduction was claimed. The Tax Court ruled that the donor was not entitled to a charitable contribution deduction even though there was no dispute as to the value of the donated stock.* Hewitt v. Commissioner, 109 T.C.12 (1997).

> ***Tip.*** *Do not assume that donors are familiar with the substantiation rules that apply to gifts of stock. Church treasurers should obtain several copies of Form 8283 each January to give to persons who donate stock to the church during the year. You can order multiple copies of Form 8283 by calling the IRS forms hotline at 1-800-TAX-FORM.* ■

When Gifts Come with Strings Attached

By Elaine L. Sommerville

Whether it is a car, jewelry, or real estate, every church has been faced with a gift that has the potential to cause more problems than its value. Some gifts come with restrictions, some gifts are only valuable in the eyes of the donor, and some come with continuing costs to maintain.

Churches many times would be better off without the gift, but donors always believe that their gift will benefit the church. Rejecting gifts may place church staff, committee members, or directors in uncomfortable positions and may even damage relationships with church members.

Churches can avoid many of the traps associated with these types of gifts by carefully crafting a gift acceptance policy. This policy provides staff members with the guidance necessary to navigate the sometimes-treacherous waters of unusual gifts.

Before Someone Gives

Prior to drafting a gift acceptance policy, the church should seriously consider several issues surrounding noncash and other unusual gifts. Churches should understand they are not obligated to receive all gifts offered to them. Churches that feel obligated to accept any gift offered by a donor risk a costly situation resulting not only in potential monetary loss but also a loss of relationship with the donor.

There are several broad issues to be resolved prior to the drafting of a gift acceptance policy.

- Can it be used by the church in its ministry? Does the church only desire to accept gifts that can be used in its immediate operations? For example, if the church operates an outreach to the homeless, it may be prudent to accept donations of used clothing. However, if the church cannot utilize used clothing directly in its operations, its policy may specifically state the church will not accept the donation of used clothing or household items.

- Can the gift immediately convert to cash? Does the church wish to accept gifts that can only be readily converted to cash? For example, is it willing to accept a stock donation, but not accept a piece of real estate, since the ability to sell the property for cash may take a long time?

- Can the church live with gifts that come with strings attached? Gifts with restrictions are fairly common—and sometimes costly. Donors often place unreasonable restrictions on a gift as it relates to the use of the property or the disposal of the property. Some restrictions result in a gift not being completely given to the church. For example:

  - A church accepts a gift of a house adjacent to its property. The donor restricts the gift by requiring the church to allow her to occupy the house until her death. Many years later, the donor could still occupy the house, delaying the church's expansion plans.

- A donor gives an office building to a church, but restricts the building's sale for at least three years. The donor has not made a completed gift to the church until the three-year restriction expires.

- Can we afford it? Many noncash gifts require an annual monetary commitment, such as insurance, storage, disposal costs, and taxes. For example, a church accepts the gift of an expensive car. The church believes that disposing the car would offend the donor, so it insures the car each year and pays to store it. Since the church is unwilling to sacrifice the relationship with the donor by disposing of the car, it bears unexpected annual costs it shouldn't pay.

The Benefits of a Policy

After some general discussions regarding the above factors, a church should adopt a formal gift acceptance policy. The benefits of a gift acceptance policy include:

- Clarity
- Guidance on acceptable gifts
- Procedures that must be followed
- Timing considerations to be managed
- Receipting policies
- The handling of restrictions
- Valuation considerations
- Disposal guidelines
- Special issues for specific types of gifts.

While this policy is helpful to donors, it is most helpful for staff to use to navigate the various aspects of unusual gifts received by the church.

Acceptable Gifts

The policy should list out the types of gifts that the church is willing to accept. The policy should specifically address gifts in the following areas:

- Personal property, such as clothing and household goods
- Transportation equipment
- Securities (Consideration should be given to receiving both publicly traded securities and closely held securities.)
- Real estate
- Remainder interest in property
- Jewelry
- Collectibles
- Life insurance beneficiary designations
- Charitable trusts
- Bequests

Procedural Issues

A good gift acceptance policy will set out clear guidelines to assist both staff and donors with answering the following:

- Who can approve the acceptance of the gift?
- What type or level of gift requires specific action by the finance committee or other appropriate authority?
- Who is authorized to sign the Form 8283, Noncash Charitable Contribution, for the donor? (The donor must file Form 8283 with his tax return to claim noncash contributions. For many gifts valued at more than $5,000, the form must be signed by the church acknowledging the receipt of the gift.)

- Who is authorized and responsible for keeping a copy of the Form 8283 for the church's files?

- Who is responsible for filing Form 8282 with the IRS? In the event the church sells donated property within three years of the date of the gift and the church had originally signed the donor's Form 8283, it is required to file Form 8282, Donee Information Return (Sales, Exchange or Other Disposition of Donated Property).

- Who is responsible for completing the Form 1098-C, Contributions of Motor Vehicles, Boats and Airplanes, for donations of modes of transportation?

Timing Issues

There are several areas of timing that may be addressed by the policy:

- Time to perform due diligence: Donors are infamous for attempting to complete noncash gift donations in a short period of time. This is normally due to the goal of completing the gift prior to the end of the tax year.

- While the due diligence to accept a gift of publicly traded stock is almost nonexistent, the due diligence to make a decision regarding accepting a piece of real estate is more time consuming. Time may be needed to determine if the donor has clear title to the property and to have an appraisal performed. Significant time also may be needed to determine if the property has environmental hazards. It is absolutely essential for churches to condition the acquisition of any land or buildings, whether by purchase or donation, on a full environmental analysis of the property by a competent professional and an opinion that the property contains no possibility of environmental contamination.
  Some properties are environmentally contaminated with lead, asbestos, or radon, by leaks from underground tanks, and so on. Churches that acquire such properties can face unexpected and significant costs in addressing and eliminating the source of contamination.

  Therefore, it's critical the policy address the timing of certain types of gifts, especially real estate. For example, it may state that no gift of real estate will be accepted later than November 30th of each year.

- Timing as to the date of the gift: The policy should state that a gift will not be considered completed until either a clear transfer of title can be completed and appropriate agreements are formally executed or all restrictions have been released.

- Time to dispose of the gift: If the gift cannot be used within the immediate operations of the church, the policy may wish to clearly state that the gift will be disposed of in the quickest manner available to the church. This puts the donor on notice that their gift might be disposed of in the near future.

Receipting Procedures

Donors are often confused by the standard receipting practices of churches for "other than cash" donations. The policy should state that receipts issued for noncash items will contain only a description of the gift and will not contain the value of the gift given.

Donor Restrictions

Churches should carefully consider donor restrictions. The gift acceptance policy should provide clarification by stating:

- Restrictions that violate either the church's exempt operational test as defined by the Internal Revenue Service or that violate the church's corporate charter will not be accepted.

- Gifts that are specifically designated or restricted for an individual will not be accepted.

- The church considers all restrictions as suggestions and that the ultimate decision as to the ultimate use of the gift is to be determined by the church's governing body.

- In cases where the church may have solicited funds for a specific purpose, such as a building fund, any excess funds are to be used at the discretion of the governing body.

- The endowment of funds requires a written agreement in order to provide clarity to all parties.

- A time restriction as to the disposal of a gift, outside of an endowed gift, may result in an incomplete gift.

- All restricted gifts are to be approved by the appropriate committee.

Valuation Considerations

A church has an obligation to value all of the items it receives. This includes noncash donations. The portion of the gift acceptance policy for internal use should direct the accounting staff to record all of the property received and account for any subsequent dispositions. These are two separate accounting transactions, but are often mistakenly treated as one transaction. For example, when a church receives a gift of stock, the stock must be recorded in the accounting records as a noncash gift and as an investment of the church. Then, when the stock is sold, the transaction is recorded as a sale of an investment. The church should not wait until a gift is sold and then account for the transaction at that time only.

Disposals of Gifts

As previously discussed, not all gifts are desired nor are all gifts useful to the church. However, disposing of these gifts must be handled delicately in order to not offend the donor. Some gifts are very personal to donors and the donor may place a greater value on the gift than can be reasonably obtained. Stating the church's policy on the disposal of noncash gifts will help match the donor's expectations to the actions taken by the church. Some special considerations include:

- ***Real estate:*** The church may want to sell real estate as quickly as possible if the real estate cannot be used in the operations of the church. This may mean a fire sale so that the church avoids the costs of continuing to own a property while holding out for a greater sales price.

- ***Jewelry:*** All gifts of jewelry to a church are a gift of something personal. Additionally, the gift is never worth what the donor believes it is worth. The church should consider disposing of these items through a dealer in another locality. It is not recommended that the items be sold locally or to other staff members or church members.

- ***Clothing and household items:*** The church should reserve the right to dispose of these items through their donation to another nonprofit that can benefit.

Due to the issues and complications of related party transactions, the church may also desire to have the policy prohibit the sale of any

donated asset to a staff member, committee member, board member, or any other person in a position of influence or control.

No policy can anticipate all of the special issues that might arise from a gift, and this is also true for gift acceptance policies. The object of the gift acceptance policy is to anticipate the more common scenarios and provide church staff members a preplanned program to address and resolve donor issues in this area.

It is much easier for a church to decline a donor's gift if the church has a policy stating that it doesn't accept certain gifts.

It also is much easier for staff members to know what the church is and is not willing to accept as a gift, and the internal procedures to follow. This provides assurance that all compliance issues surrounding unusual gifts will be followed, ensuring the church meets all regulatory requirements. ■

Designated Contributions—Benevolence Funds

Designated contributions are those that are made to a church with the stipulation that they be used for a specified purpose. If the purpose is an approved project or program of the church, the designation will not affect the deductibility of the contribution. However, if a donor stipulates that a contribution be spent on a designated individual, no deduction ordinarily is allowed unless the church exercises full administrative control over the donated funds to ensure that they are being spent in furtherance of the church's exempt purposes. Contributions to a church that designate an individual recipient can arise in several ways.

Many churches have established benevolence funds to assist needy persons. Typical beneficiaries of such funds include the unemployed, persons with a catastrophic illness, accident victims, and the aged. There is no question that churches may establish benevolence funds. This is both a religious and a charitable function. But, the tax consequences of such funds depend on the circumstances.

Contributions Made Directly to Individuals

Contributions made directly to individuals are not deductible, no matter how needy the recipient may be. For example, the courts have repeatedly denied deductions for contributions made directly to relatives, ministers, students, military personnel, and needy persons. The reason is that a charitable contribution must be "to or for the use of" a qualified charitable organization. Gifts to individuals, no matter how needy, are not deductible as charitable contributions.

Undesignated Contributions Made Directly to a Church Benevolence Fund

Contributions made directly to a church benevolence fund and that do not designate a recipient or beneficiary can be treated as charitable contributions by the church and donor. To illustrate, assume that a church establishes a benevolence fund, and that a church member contributes $250 to the fund but does not designate the intended recipient. Such a contribution ordinarily can be treated as a charitable contribution since it was made "to or for the use of" the church.

Contributions Designating a Specific Beneficiary

The most difficult kind of benevolence fund contribution to evaluate (but by far the most common) is a contribution that designates a desired recipient. The designation may be written on the face of the check, on an envelope accompanying the contribution, in a letter, or it may be oral. To illustrate, a member contributes a check in the amount of $500 to a church's benevolence fund, and inserts a note requesting that a designated individual receive the proceeds. Can such a contribution be treated as a charitable contribution by the church and donor? Ordinarily, such "designated contributions" to a benevolence fund are not deductible, since the intent of the donor is to make a transfer of funds directly to a particular individual rather than to a charitable organization. This does not make them "illegal"—it simply makes them non-

deductible by the donor. On the other hand, the recipient does not have to report the transfer as taxable income since it is excludable as a gift. Further, the church ordinarily would hold such funds as the trustee of an implied trust, and accordingly could not divert them to any other purpose or use.

The IRS has stated, "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."

This test suggests that in some cases it may be possible for a donor to deduct a designated contribution to a church benevolence fund if the circumstances clearly demonstrate that the donor's "designation" was a mere suggestion or recommendation and that the donor intended the contribution to be "to or for the use of" the church and subject to its control rather than to the designated individual. The IRS has occasionally ruled that mere "expressions of interest" accompanying an otherwise undesignated gift do not prevent it from being treated as a charitable contribution. On the other hand, if there is a "commitment or understanding" that the church will distribute a donation to a person designated by the donor, then the donation cannot be treated as a charitable contribution since the church lacks sufficient control over the funds.

In summary, there is support for the conclusion that contributions to a church benevolence fund can be deductible even if the donor mentions a beneficiary, if the facts demonstrate that:

- The donor's recommendation is advisory only,
- The church retains "full control of the donated funds, and discretion as to their use," and
- The donor understands that his or her recommendation is advisory only and that the church retains full control over the donated funds, including the authority to accept or reject the donor's recommendations.

How can these facts be established? One possible way would be for a church to adopt a "benevolence fund policy" making all distributions from a benevolence fund subject to the unrestricted control and discretion of the church board, and to communicate such a policy to all prospective donors. It can be argued that donors willing to make a designated contribution to a church benevolence fund under these conditions are manifesting an intent to make a contribution to the church rather than to the designated individual. Churches adopting such a policy should make copies available to any person wanting to make a designated contribution to the church benevolence fund. There is no guaranty that such a policy will render a designated contribution deductible. Obviously, a church can administer a program in such a way as to jeopardize the deductibility of contributions. For example, a church can adopt a benevolence fund policy but honor every "recommendation" made by donors. Clearly, if this practice were made known to the IRS, no contribution would be deductible since the church's alleged "control" over the donated funds does not in fact exist.

Special Appeals

There is one other possible exception to the general rule of non-deductibility of designated contributions to church benevolence funds. Many churches have made special appeals to raise funds for a particular benevolence need. For example, an offering is collected to assist a family with a child who has incurred substantial medical expenses. Are contributions made to such an offering tax-deductible? Unfortunately, neither the IRS nor any federal court has addressed this issue directly.

However, it is possible that such contributions would be tax-deductible if the following conditions are met: (1) the offering was preauthorized by the church board; (2) the recipient (or his or her family) is financially needy, and the uninsured medical expenses are substantial; (3) the offering is used exclusively to pay a portion of the medical expenses; (4) immediate family members are not the primary contributors; and (5) no more than one or two such offerings are collected for the same individual. Even if these conditions are satisfied, treating the donations as charitable contributions represents an aggressive position that is subject to challenge in an audit. ■

Designated Contributions—Missionaries

The tax code specifies that a charitable contribution must be made "to or for the use of" a qualified charitable organization such as a church. However, contributions made directly to a missionary may be deductible if it can be established that the contribution was "for the use of" a charitable organization (e.g., a church or denomination exercises control or supervision over the missionary). In 1962, the IRS clarified the application of this principle in a ruling upholding a donor's contribution to a church fund out of which missionaries, including his son, were compensated:

> 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.* In the present case, the son's receipt of reimbursements from the fund is alone insufficient to require holding that this test is not met. Accordingly, unless the taxpayer's contributions to the fund are distinctly marked by him so that they may be used only for his son or are received by the fund pursuant to a commitment or understanding that they will be so used, they may be deducted by the taxpayer in computing his taxable income.

This principle has been consistently applied by the courts in determining the deductibility of "designated" contributions to charitable organizations.

If a donor contributes funds to a church or missions board, designating a particular missionary, the contribution will be deductible so long as the missions board retains *full administrative and accounting control* over the funds. What does this mean? Neither the IRS nor any federal court has addressed this issue directly. Presumably, this test could be satisfied if a missions agency adopts the following procedures:

1. Require each missionary to complete a periodic "activity report" summarizing all missionary activities conducted for the previous period. This would include services conducted, teaching activities, and any other missionary activities. The summary should list the date and location of each activity.

2. Require the missionary to complete a periodic "accounting" of the donated funds received from the missions agency. The agency should prepare an appropriate form. The form should account for all dollars distributed by the agency. Written receipts should be required for any expense of more than $75. This report should indicate the date, amount, location, and missionary purpose of each expense. It can be patterned after the expense report that is used for business travel. Keep in mind that "religious purposes" includes not

only those expenses related directly to missionary activities, but also ordinary and necessary travel and living expenses while serving as a missionary.

3. The missions agency must approve each missionary's ministry as a legitimate activity in furtherance of the church's religious mission.

4. Prepare a letter of understanding that communicates these terms and conditions. The agency should specifically reserve the right to "audit" or otherwise verify the accuracy of any information provided to you. For example, you may on occasion wish to verify that the activity reports are accurate.

5. Reconcile the expense summaries with the activity summaries. That is, confirm that the expenses claimed on the expense reports correspond to the missionary activities described in the activity reports.

Such procedures can be burdensome for a church or missions agency. However, such procedures (or similar ones) will be essential in order to demonstrate that the agency maintains administrative and accounting control over contributions designating specific missionaries. ■

Love Offerings

Churches sometimes collect "love offerings" from the congregation for a particular pastor, intern, or other staff member in recognition of services rendered. Such offerings must be reported as taxable income. If the recipient is an employee, the love offering should be added to his or her W-2. If the recipient is not an employee, then the income should be reported on a 1099-MISC if $600 or more.

It is common for churches to collect "love offerings" from the congregation that are distributed to a pastor or other church worker. The distribution is sometimes called a "love gift." Consider the following examples.

> ***Example.*** *A church pays its senior pastor a "love offering" of $1,000 at Christmas.*
>
> ***Example.*** *A seminary student works full-time at a church for three months during the summer. At the end of the summer the church collects a "love offering" from the congregation for the benefit of the intern. The offering amounts to $2,000.*
>
> ***Example.*** *A church organist plays at all church services, weddings, and other special events, at no charge to the church. At the end of the year, the church collects a "love offering" for the organist, which amounts to $1,000.*

Some church leaders believe that by calling such payments "love offerings" they can somehow prevent them from being treated as taxable income. Nothing could be further from the truth.

The tax code imposes an income tax on "all income from whatever source derived," unless specifically excluded. The income tax regulations further explain that taxable income includes "compensation for services, including fees, commissions, fringe benefits, and similar items." This is a very broad definition of taxable income that unquestionably includes "love offerings" collected by a church and paid to an employee who has rendered services.

Much confusion has arisen because the tax code lists "gifts" among the items that are excluded from the income tax. Some ministers assume that love offerings collected for them, or for some other person who has rendered services on behalf of the church, can properly be classified as nontaxable gifts rather than as taxable compensation. After all, the motivation of the congregation is not to provide the recipient with taxable compensation, but rather to confer a gift. Further, the United States Supreme Court, in a case involving the taxability of a "gift" given to a church treasurer by his church, announced the following definition of a gift: "A gift proceeds from a detached and disinterested generosity out of affection, respect, admiration, charity, or like impulses. The most critical consideration is the transferor's intention." Don't love offerings collected by a church and distributed to an employee satisfy this definition? If you asked most congregation members why they contributed to a love offering for their pastor at Christmas they would tell you that it was out of "affection, respect, and admiration."

While it is true that the tax code exempts gifts from the definition of taxable income, this provides little if any support for those wanting to treat love offerings distributed to a pastor

or other staff member as nontaxable. This is so for two reasons:

1. The tax code specifies that the non-taxability of gifts does not apply to "any amount transferred by or for an employer to, or for the benefit of, an employee." This provision ensures that most love offerings collected from a congregation and distributed to an employee are taxable compensation and not tax-free gifts. There is one exception to this rule. Employers are allowed to make nontaxable gifts to their employees so long as the value of the gifts is insignificant. The IRS has said, for example, that traditional gifts given to employees at Christmas, such as fruitcakes or turkeys, will not represent taxable income and so the value of such items does not need to be added to the recipients' W-2 forms.

2. The courts have consistently ruled that distributions made by employers to their employees constitute taxable compensation rather than tax-free gifts. The United States Supreme Court, in a leading case, observed, "What controls is the intention with which payment, however voluntary, has been made. Has it been made with the intention that services rendered in the past shall be requited more completely, though full acquittance has been given? If so, it bears a tax." In other words, is the intention of the congregation to more fully compensate the pastor or other employee for services rendered and fully compensated in the past? If so, the distribution is taxable. This language describes most if not all "love offerings" that are collected by churches and distributed to an employee.

Some church members give their pastor, or other church employee, a personal gift on special occasions such as a $20 bill enclosed with a birthday card. These personal gifts may be treated as nontaxable gifts by the pastor because they were not distributed by the employing church. On the other hand, when a church collects a love offering, and informs the congregation that their contributions will be receipted by the church, this requires the individual offerings to be treated as a single distribution by the church. This triggers the rule requiring distributions by employers to their employees to be treated as taxable compensation. If a church collects a one-time offering on a special occasion for a pastor, informs the congregation that their offerings will not be receipted by the church and are not tax-deductible, and asks persons who give checks to make their checks payable directly to the pastor, it is possible that these individual offerings could be treated as nontaxable gifts to the pastor. This is an aggressive position, however, that probably would be challenged by the IRS if the pastor were audited. And, this position becomes even less likely if more than one love offering is collected during the year, the amount of the love offerings is substantial, or the church was directly involved in promoting the offering.

Love offerings that are distributed to persons who are not church employees are treated in the same way as offerings collected for employees. To illustrate, a church collects a $1,000 love offering for its "volunteer" organist at the end of the year. The church receipts donors for their contributions. The $1,000 distribution to the organist is taxable compensation and not a tax-free gift. If the organist is self-employed rather than an employee, the church would not have to withhold taxes from this payment. However, it would need to issue the recipient a 1099 form after the end of the year reporting the distribution (since it is more than the threshold filing amount of $600). As noted in the previous paragraph, if the church collects

a one-time offering for the organist, informs the congregation that their offerings will not be receipted by the church and are not tax-deductible, and asks persons who give checks to make their checks payable directly to the organist, it is possible that these individual offerings could be treated as nontaxable gifts to the organist. This position becomes less tenable if love offerings are collected every year for the organist. In such a case, it becomes almost certain that the distributions will be treated as taxable by the IRS in the event of an audit. ■

Liability for Ignoring Donors' Designations

Churches must honor designated contributions—or else risk refunding them.

It is common for church members to make "designated" charitable contributions to their church specifying that their contributions be used for a specified purpose. What happens if a church board applies such contributions to some other purpose? Are there legal consequences for either the church or the church board? Should churches ever return a contribution to a donor? This is a question that nearly every church leader faces eventually. The answer often will depend on whether the contribution was undesignated or designated. Both scenarios are summarized below.

Undesignated Contributions

Most charitable contributions are undesignated, meaning that the donor does not specify how the contribution is to be spent. An example would be a church member's weekly contributions to a church's general fund. Undesignated contributions are unconditional gifts. A church generally has no legal obligation to return undesignated contributions to donors. In fact, a number of problems are associated with the return of undesignated contributions to donors. These include:

1. inconsistency

A return of a donor's contributions would be completely inconsistent with the church's previous characterization of the transactions as charitable contributions. A charitable contribution is tax-deductible because it is an irrevocable gift to a charity. If a church complies with enough donors' requests to refund their contributions, this raises a serious question as to the deductibility of any contribution made to the church. Contributions under these circumstances might be viewed as no-interest "demand loans"—that is, temporary transfers of funds that are recallable by donors at will. As such, they would not be tax-deductible as charitable contributions.

2. amended tax returns

Donors who receive a "refund" of their contributions would need to be advised to file amended federal tax returns if they claimed a charitable contribution deduction for their "contributions" for any of the previous three tax years. This would mean that donors would have to file a Form 1040X with the IRS. In many states, donors also would have to file amended state income tax returns.

3. church liability

A church that returns a charitable contribution to a donor who does not file an amended tax return to remove a prior charitable contribution deduction faces potential liability for "aiding and abetting" in the substantial understatement of tax. *IRC 6701(b).*

4. inurement

One of the conditions for tax-exempt status under section 501(c)(3) of the tax code is that none of a church's assets inures to the benefit of a private individual. Since undesignated contributions are church assets, a church that voluntarily returns such contributions to do-

nors is distributing its resources to private individuals. It is possible that the return of such contributions would amount to prohibited inurement, thereby jeopardizing the church's tax-exempt status.

5. "refund department"
Compliance with a donor's demand for the return of a contribution would morally compel a church to honor the demands of anyone wanting a return of a contribution. This would establish an undesirable precedent.

> ***Key point.*** *Churches should resist appeals from donors to return their undesignated contributions. No legal basis exists for doing so, even in emergencies. Honoring such requests can create serious problems, as noted above. Churches should not honor such requests without the recommendation of an attorney.*

6. First Amendment issues
A few courts have concluded that the First Amendment's guarantees of the nonestablishment and free exercise of religion bar the civil courts from refunding charitable contributions to donors if doing so would implicate religious doctrine. The leading case is *Hawthorne v. Couch, 911 So.2d 907 (La. App. 2005).*

IRS response to a question submitted by a member of Congress.
In 2010 the IRS responded to questions submitted by Congresswoman Kay Granger on behalf of one of her constituents regarding the tax consequences associated with a charity's return of a charitable contribution. The IRS observed:

> We are pleased to provide you with the following general information about the federal income consequences to a donor who receives a repayment of a charitable gift plus interest on the repayment. . . .
> If a taxpayer receives the full tax benefit of a charitable contribution deduction when making a contribution to a qualified charity, and the charity repays the contribution to the taxpayer in a subsequent year, the "tax benefit rule" requires the taxpayer to include in gross income in that subsequence year the amount of the previously deducted contribution.
>
> A taxpayer who receives interest on a repaid contribution must also include that amount in income. An individual taxpayer generally includes interest in income when it is available to the taxpayer free of substantial limitations and restrictions. . . .
>
> If the taxpayer uses a repaid contribution to make a new charitable contribution to a different charitable organization, he or she may claim a charitable contribution deduction for the new contribution, subject to the usual restrictions and limitations on charitable contribution deductions.

The tax benefit rule referenced in the above-quoted IRS response is codified in section 111 of the tax code, which states: "Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter."

In several cases the IRS and the courts have ruled that section 111 requires donors who have received a refund of a charitable contribution made in a prior year should report the refund as taxable income in the year of the refund rather than file an amended return for the year of the contribution deleting that contribution. *See, e.g., Revenue Ruling 75-150.*

> ***Key point.*** *Note that Congresswoman Kay Granger's constituent made his designated contribution to charity "more than two*

decades ago." According to the IRS, this did not affect his obligation to report the refunded contribution as taxable income.

Designated Contributions—Project Not Abandoned

The cases summarized above with the Mississippi Supreme Court ruling, which represent all the leading cases to address the use of designated charitable contributions for other purposes, illustrate that donors who make designated contributions to their church may have a legal right to a refund of their contributions if the church fails to use the contributions for the designated purpose. This may occur because the church board simply ignores donors' designations and applies the funds to other uses. Or, it may occur because a church has failed to use the funds for the designated purpose within a reasonable amount of time.

But, so long as a specified project for which contributions are solicited has not been abandoned by a church, then according to the precedent summarized above, donors who made contributions designated for the specified project generally have no legal right to a refund of their contributions.

However, at some point, a church's delay in using designated funds for a specified purpose may be so substantial that it amounts to an abandonment of the project entitling donors to a refund of their designated contributions. As the Maine Supreme Court has noted: "Where no particular time is mentioned for the performance of a condition attached to a charitable grant, devise, or bequest, the law requires that it should be done in a reasonable time, to be determined from all the surrounding circumstances, and unreasonable delay may be considered as a refusal of the gift. . . . In light of . . . the fact that nearly 40 has passed . . . a reasonable amount of time has expired." *Estate of Champlin, 684 A.2d 798 (Me. 1996).*

Designated Contributions—Project Abandoned

What if a donor contributes money to a church's building fund and the church later abandons its plans to construct a new facility? Should the church refund contributions to donors who stipulated that their contributions were for the building fund? A number of possibilities exist, including the following:

Donors can be identified. If donors can be identified, they should be asked if they want their contributions to be returned or retained by the church and used for some other purpose. As the Mississippi Supreme Court noted in the St. Paul Church case cited below, "Where a religious society raises a fund by subscription for a particular purpose, it cannot divert the funds to another purpose, and, if it abandons such purpose, the donors may reclaim their contributions." *Schmidt v. Catholic Diocese, 18 So.3d 814 (Miss. 2009).*

A church should send a letter to donors who request a refund of a prior designated contribution informing them that (1) there may be tax consequences; (2) they may want to consider filing an amended tax return to remove any deduction claimed in previous years as a result of their designated contribution; and (3) they should discuss the options with their tax advisor.

Some churches have issued donors a Form 1099-MISC under these circumstances to reduce the church's risk of liability for aiding and abetting in the substantial understatement of tax. *IRC 6701(b).* But this approach presents two problems:

(1) It assumes that the donor claimed a charitable contribution deduction

for the designated gift and will not file an amended tax return. In fact, some donors did not get a tax deduction for their gifts because they could not itemize their deductions on Schedule A. Others received a "discounted" deduction because of the amount of their income (high-income taxpayers only get a partial deduction for their charitable contributions). A church treasurer would have to inspect the actual tax return of each donor who requests a return of his or her contribution. Most church leaders consider such precautions excessive and unnecessary, especially for smaller contributions.

(2) Form 1099-MISC is not designed to report this kind of income. It is designed for nonemployee compensation. In what sense have these donors performed services for the church for which they are being compensated?

In summary, the best approach is for the church to inform donors who request a refund of a designated contribution to address the tax consequences with their tax advisor. They can either do nothing, report the amount of the returned contribution as "other income" on line 21 of their Form 1040, or file an amended return for the year the designated contribution was made, which removes the contribution from Schedule A. Keep in mind that amended returns can be made for only one of the previous three years.

Example. *Bob gives $1,000 to his church building fund in 2010. In 2015 the church decides to abandon the building project. Bob asks the church to refund his contribution. While it is too late for Bob to file an amended return for 2010, he feels morally compelled to report the $1,000 as income on his 2015 tax return. Doing so, however, is problematic, since Bob may not have been able to claim a deduction in the year of the contribution, or the deduction was reduced. Even if a full deduction was claimed, this only reduced taxable income. A $1,000 contribution to the building fund was not, in other words, worth $1,000. It was worth considerably less, depending on Bob's income and tax bracket. If Bob was in the 15 percent tax bracket in 2010, then the value of the contribution to him was $150. His $1,000 donation reduced taxable income by $1,000, thereby saving him $150 in taxes. Further, if Bob had substantial income in the year of the gift, the value of his donation may have been even less (charitable contribution deductions were partially "phased out" for high-income taxpayers in 2010). So when Bob receives his $1,000 back several years later, it is not a simple matter of reporting $1,000 as taxable income. At best, this should be something for Bob to decide, not the church.*

Key point. *Often donors prefer to let the church retain their designated contributions rather than go through the inconvenience of filing an amended tax return.*

Donors cannot be identified. A church may not be able to identify all donors who contributed to the building fund. This is often true of donors who contributed small amounts, or donors who made anonymous cash offerings to the fund. In some cases designated contributions were made many years before the church abandoned its building plans, and there are no records that identify donors. Under these circumstances, the church has a variety of options.

One option is to address the matter in a membership meeting. Inform the membership of the amount of designated contributions in the church building fund that cannot be traced to specific donors, and ask the membership to adopt a resolution with regard to the disposition of the fund. Often the members will authorize the transfer of the funds to the general fund. Note that this procedure is appropriate only for that portion of the building fund that cannot be traced to specific donors. If donors can be identified, use the procedure described above.

Another option is to ask a court for authorization to transfer the building fund to another church fund. Most states have adopted the Uniform Prudent Management of Institutional Funds Act (UPMIFA), and this Act permits churches to ask a civil court for authorization to remove a restriction on charitable contributions to permanent endowment funds in some situations. UPMIFA is addressed below.

Other options are available. Churches should consult with an attorney when deciding how to dispose of designated funds if the specified purpose has been abandoned or is no longer feasible.

> ***Key point.*** *Some courts have ruled that a donor has no legal standing to enforce a designated gift to charity. While the donor may not be able to enforce such a trust, this does not mean that a church or charity can ignore it. Some courts have ruled that the state attorney general can enforce a trust created by a designated gift, and so can any other person with a "special interest" in the trust. While this does not ordinarily include donors, their families or heirs, or even beneficiaries of the gift or trust, it may include fiduciaries (such as a trustee of a written trust). The issue of a donor's standing to enforce a designated contribution is not addressed in this article, but it is addressed fully in chapter 8 of my annual* Church & Clergy Tax Guide *(*ChurchLawAndTaxStore.com*).*

Some donors can be identified, and some cannot. In most cases, some of the building fund can be traced to specific donors, but some of it cannot. Both of the procedures summarized above may apply.

Solicitation Materials Can Minimize or Avoid Problems

Churches that solicit funds for designated projects face difficult choices when they abandon the project and are left with the task of disposing of funds donated for that project. These problems can be avoided if the church simply includes a statement similar to the following when soliciting funds for a specific project: "By contributing to this project, donors acknowledge that the church has full authority to apply contributions designated for this project to other purposes in the event the project is canceled or oversubscribed." Such a statement should be printed on special offering envelopes used for the project, or on any other materials so long as they provide adequate notice to donors of the policy and reflect donors' consent to it.

The Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA)

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) has been adopted, with minor variations, in 47 states. It replaces the Uniform Management of Institutional Funds Act (UMIFA), which was adopted by most states since its inception in 1972. An introductory note to UPMIFA states that one of the reasons for the revision of UMIFA was an update to the provisions

"governing the release and modification of restrictions on charitable funds to permit more efficient management of these funds." In this regard, Section 6 of UPMIFA states:

> (a) If the donor consents in a record, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution.
>
> (b) The court, upon application of an institution, may modify a restriction contained in a gift instrument regarding the management or investment of an institutional fund if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund. The institution shall notify the [Attorney General] of the application, and the [Attorney General] must be given an opportunity to be heard. To the extent practicable, any modification must be made in accordance with the donor's probable intention.
>
> (c) If a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund becomes unlawful, impracticable, impossible to achieve, or wasteful, the court, upon application of an institution, may modify the purpose of the fund or the restriction on the use of the fund in a manner consistent with the charitable purposes expressed in the gift instrument. The institution shall notify the [Attorney General] of the application, and the [Attorney General] must be given an opportunity to be heard.
>
> (d) If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, [60 days] after notification to the [Attorney General], may release or modify the restriction, in whole or part, if:
>
> > (1) the institutional fund subject to the restriction has a total value of less than [$25,000];
> >
> > (2) more than [20] years have elapsed since the fund was established; and
> >
> > (3) the institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

UPMIFA defines an institutional fund as "a fund held by an institution exclusively for charitable purposes. The term does not include: (A) program-related assets; (B) a fund held for an institution by a trustee that is not an institution; or (C) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund." Charitable purposes are defined as "the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community." The Act defines a program-related asset as "an asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment." An "institution" means any entity organized and operated

exclusively for charitable purposes. This would include a church.

An official comment to section 6 (quoted above) states:

> Subsection (a) permits the release of a restriction if the donor consents. A release with donor consent cannot change the charitable beneficiary of the fund. Although the donor has the power to consent to a release of a restriction, this section does not create a power in the donor that will cause a federal tax problem for the donor. The gift to the institution is a completed gift for tax purposes, the property cannot be diverted from the charitable beneficiary, and the donor cannot redirect the property to another use by the charity. The donor has no retained interest in the fund.
>
> Subsection (b) applies the rule of equitable deviation. . . . Under the deviation doctrine, a court may modify restrictions on the way an institution manages or administers a fund in a manner that furthers the purposes of the fund. Deviation implements the donor's intent. A donor commonly has a predominating purpose for a gift and, secondarily, an intent that the purpose be carried out in a particular manner. Deviation does not alter the purpose but rather modifies the means in order to carry out the purpose.
>
> Sometimes deviation is needed on account of circumstances unanticipated when the donor created the restriction. In other situations the restriction may impair the management or investment of the fund. Modification of the restriction may permit the institution to carry out the donor's purposes in a more effective manner. A court applying deviation should attempt to follow the donor's probable intention in deciding how to modify the restriction. Consistent with the doctrine of equitable deviation in trust law, subsection (b) does not require an institution to notify donors of the proposed modification. Good practice dictates notifying any donors who are alive and can be located with a reasonable expenditure of time and money. Consistent with the doctrine of deviation under trust law, the institution must notify the attorney general who may choose to participate in the court proceeding. The attorney general protects donor intent as well as the public's interest in charitable assets. Attorney general is in brackets in the Act because in some states another official enforces the law of charities.

The cy pres rule

The cy pres doctrine (which has been adopted in most states) specifies that if property is given in trust to be applied to a particular charitable purpose, and it becomes impossible or impracticable to carry out that purpose, and if the donor manifested a more general intention to devote the property to charitable purposes, the trust will not fail but the court will direct the application of the property to some charitable purpose which falls within the general charitable intention of the donor.

An official comment to section 8 of UPMIFA confirms that

> subsection (c) applies the rule of cy pres from trust law, authorizing the court to modify the purpose of an institutional fund. The term modify encompasses the release of a restriction as well as an alteration of a restriction and also permits a court to order that the fund be paid to another institution. A court can apply the doctrine of cy pres only if the restriction in question has become

unlawful, impracticable, impossible to achieve, or wasteful. . . . Any change must be made in a manner consistent with the charitable purposes expressed in the gift instrument. Consistent with the doctrine of cy pres, subsection (c) does not require an institution seeking cy pres to notify donors. Good practice will be to notify donors whenever possible. As with deviation, the institution must notify the attorney general who must have the opportunity to be heard in the proceeding.

Case study. *An elderly man drafted a will in 1971 that left most of his estate in trust to his sisters, and upon the death of the surviving sister to a local Congregational church with the stipulation that the funds be used "solely for the building of a new church." The man died in 1981, and his surviving sister died in 1988. Since the Congregational church had no plans to build a new sanctuary, it asked a local court to interpret the will to permit the church to use the trust fund not only for construction of a new facility but also "for the remodeling, improvement, or expansion of the existing church facilities" and for the purchase of real estate that may be needed for future church construction. The church also asked the court for permission to use income from the trust fund for any purposes that the church board wanted. The state attorney general, pursuant to state law, reviewed the church's petition and asked the court to grant the church's requests.*

However, a number of heirs opposed the church's position, insisting that the decedent's will was clear and that the church was attempting to use the trust funds "for purposes other than building a new church." They asked the court to distribute the trust fund to the decedent's lawful heirs. The local court agreed with the church on the ground that "gifts to charitable uses and purposes are highly favored in law and will be most liberally construed to make effectual the intended purpose of the donor." The trial court's ruling was appealed by the heirs, and the state supreme court agreed with the trial court and ruled in favor of the church. The supreme court began its opinion by observing that "it is contrary to the public policy of this state to indulge in strained construction of the provisions of a will in order to seek out and discover a basis for avoiding the primary purpose of the [decedent] to bestow a charitable trust."

The court emphasized that the cy pres doctrine clearly required it to rule in favor of the church. Applying the cy pres rule, the court concluded: "The will gave the property in trust for a particular charitable purpose, the building of a new church. The evidence clearly indicated that it was impractical to carry out this particular purpose. Furthermore, the [decedent] did not provide that the trust should terminate if the purpose failed. A trust is not forfeited when it becomes impossible to carry out its specific purpose, and there is no forfeiture or reversion clause." The court concluded that the trial court's decision to permit the church to use the trust fund for the remodeling, improvement, or expansion of the existing church facilities "falls within the [decedent's] general charitable intention." Accordingly, the trial court's decision represented a proper application of the cy pres rule. Matter of Trust of Rothrock, 452 N.W.2d 403 (Iowa 1990). ■

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