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CHARITABLE SECTOR LETTER

VOL. XVI, NO. 1, 2008

IRS Proposes Regulations on Substantiation and Reporting of Charitable Contributions

By Jeffrey D. Davine

The IRS recently issued proposed Regulations regarding substantiation and reporting requirements for charitable contributions. The purpose of these proposed Regulations is to implement the changes made to the Internal Revenue Code by the American Jobs Creation Act of 2004 (the "AJCA") and the Pension Protection Act of 2006 (the "PPA"). The new rules that are ultimately adopted will apply to contributions made after the date that the proposed Regulations are published as final Regulations in the Federal Register. Until that time, the IRS has indicated that taxpayers should continue to comply with the recordkeeping and return requirements contained in §1.170A-13 of the existing Regulations (to the extent these provisions are not superseded by provisions of the AJCA or the PPA).

Specific Provisions of the Proposed Regulations.

Substantiation Requirements for Charitable Contribution of Cash, Check, or Other Monetary Gifts.

Proposed Regulations §1.170A-15 seeks to implement the requirements of Code Section 170(f)(17), added by the PPA, which provides that no deduction is allowed for a charitable contribution of a cash, check, or other monetary gift (such as a wire transfer) unless the donor maintains as a record of the contribution a bank record or written communication from the charity. The bank record or written communication must show the name of the charity, the date of the contribution, and the amount of the contribution.

We look forward to seeing our fellow gift planners at the National Conference on Planned Giving, October 22-25, 2008, in Denver. David Newman will be conducting an in-depth three-hour workshop on effective gift acceptance policies and procedures. Details at www.ncpg.org.

A question was raised as to how this requirement can be satisfied if a bank statement does not include the name of the charity. The IRS has indicated that in this situation a monthly bank statement, together with a photocopy or image obtained from the bank of the front of the check showing the name of the charity, will suffice.

The proposed Regulations contain two exceptions to this general rule. The first exception applies to a monetary contribution to a charitable remainder trust of less than $250. The second exception applies to unreimbursed expenses incurred by a donor who performs services for a charity where these expenses are less than $250. Even though the proposed Regulations exempt these two types of contributions from the substantiation requirements, it is important that a donor claiming a deduction for a monetary contribution to a charitable remainder trust or for out-of-pocket expenses incurred in rendering services to a charity maintain a record of the contributions or expenses.

Revised Noncash Substantiation Requirements.

As is true under current rules, the proposed Regulations provide that a donor who claims a deduction for a non-cash contribution of less than $250 must obtain a receipt from the charity or keep a reliable record that is satisfactory based on all of the facts and circumstances.

The proposed Regulations provide that a donor who makes a contribution of between $250 and $500 is required to obtain only a contemporaneous written acknowledgment, as provided under Code Section 170(f)(8) and Regulations §1.170A-13(f) and the donor is not required to obtain any other written record. No revisions to Regulations §1.170A-13(f) are proposed in the proposed Regulations.

For a claimed contribution of more than $500 but not more than $5,000, a donor must obtain a contemporaneous written acknowledgment from the charity and must file a completed Form 8283 (Section A) with the return on which the deduction is claimed.

For a contribution of an auto, boat, or airplane that is valued at more than $500 and that is sold by the charity without any significant intervening use or material improvement, the donor must attach a copy of the charity's acknowledgment to the Form 8283 for the return on which the deduction is claimed.

For a claimed contribution of more than $5,000, in addition to a contemporaneous written acknowledgment from the charity, a qualified appraisal is generally required, and either Section A or Section B of Form 8283 (depending on the type of property contributed) must be completed and filed with the return on which the deduction is claimed.

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For a claimed contribution of more than $500,000, the donor must obtain a contemporaneous written acknowledgment from the charity and a qualified appraisal (which must be attached to the return). The donor must also complete Form 8283 and file it with the return on which the deduction is claimed.

The proposed Regulations also provide that the requirements for substantiation that must be submitted with a return also apply to the return for any carryover year under Code Section 170(d).

Section 170(f)(11)(A)(ii)(II), added by the PPA, provides that the requirements of Code Sections 170(f)(11)(B), (C), and (D) (which contain the requirements that must be met by a donor who seeks to deduct a charitable contribution of property with a value of more than $500) do not apply if the donor shows that the failure to meet these requirements is due to reasonable cause and not due to willful neglect. Code Section 170(f)(11)(H) provides that the IRS may provide that some or all of the requirements of Code Section 170(f)(11) do not apply in appropriate cases. The proposed Regulations provide that, to satisfy the "reasonable cause" exception under Code Section 170(f)(11)(A)(ii)(II), a donor must submit with the return a detailed explanation of why the failure to comply was due to reasonable cause and not due to willful neglect, and must have timely obtained a contemporaneous written acknowledgment and a qualified appraisal, if applicable. The proposed Regulations supersede Regulations §1.170A-13(c)(4)(H), which provides that a donor who fails to file an appraisal summary (Form 8283) with the return is permitted to provide it within 90 days of a request from the IRS, and the deduction will be allowed if the donor's original failure to file the appraisal summary is a "good faith omission." Consistent with the Congressional purpose for enacting Code Section 170(f)(11) of reducing valuation abuses, the IRS anticipates that the "reasonable cause" exception will be strictly construed.

New Requirements for Qualified Appraisals and Qualified Appraisers.

New definitions of "qualified appraisal" and "qualified appraiser" are contained in proposed Regulations §1.170A-17. These new definitions take into account the PPA definitions of these terms in Code Section 170(f)(11)(E).

Qualified Appraisal.

Proposed Regulations §1.170A-17(a) provides that a qualified appraisal is an appraisal document that is prepared by a qualified appraiser in accordance with generally accepted appraisal standards. Generally accepted appraisal standards are defined in the proposed Regulations as the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation.

The proposed Regulations also clarify current rules. For example, the current Regulations require an appraisal to be made no earlier than 60 days before the contribution date. Under the proposed Regulations, the valuation effective date, which is the date to which the value opinion applies, generally must be the date of the contribution. In cases where the appraisal is prepared before the date of the contribution, the valuation effective date must be no earlier than 60 days before the date of the contribution and no later than the date of the contribution. The date the appraiser signs the appraisal report (i.e., the appraisal report date) must be no earlier than 60 days before the date of the contribution and no later than the due date (including extensions) of the return on which the deduction is claimed. As under current Regulations, if the deduction is claimed for the first time on an amended return, the appraisal report date must be no later than the date the amended return is filed.

Qualified Appraiser.

Proposed Regulations §1.170A-17(b) incorporates many of the requirements from the current Regulations, but also modifies certain other provisions. For example, the appraiser declarations required in the appraisal and on Form 8283 have been modified. In addition, the proposed Regulations contain several new terms implementing the PPA requirements of a qualified appraiser under Code Sections 170(f)(11)(E)(ii) and (iii). In general, under the proposed Regulations, a "qualified appraiser" must be an individual with verifiable education and experience in valuing the relevant type of property for which the appraisal is performed.

The PPA refers to two types of education and experience: (i) minimum education and experience to establish qualification as an appraiser generally and (ii) verifiable education and experience in valuing the type of property subject to the appraisal to establish qualification as an appraiser for a particular appraisal. The IRS has indicated that it is sufficient for an appraiser to satisfy the more stringent requirement of verifiable education and experience in valuing the type of property subject to the appraisal. Satisfaction of this more specific requirement will also satisfy the more general requirement. The proposed Regulations provide that an individual has verifiable education and experience if the individual has successfully completed professional or college-level coursework in valuing the relevant type of property and has two or more years experience in valuing that type of property.

In addition, because significant education and experience are required to obtain a designation from a recognized professional appraiser organization, under the proposed Regulations appraisers with these designations are deemed to have demonstrated sufficient verifiable education and experience.

The IRS has indicated that it has received comments that focus on education and experience. For example, several commentators have suggested that an appraiser's evidence of education and experience should be required to be verifiable as provided in Code Section 170(f)(11)(E)(iii)(I). The proposed Regulations incorporate this suggestion by requiring a statement in the appraisal of the appraiser's specified education and experience in valuing the relevant type of property. The proposed Regulations also require the appraiser to complete coursework in valuing the category of property that is customary in the appraisal field for an appraiser to value.

The IRS has also received comments requesting a definition of "types of property" for purposes of identifying the required education and experience. More education and experience may be necessary and available for some types of property than for others. Therefore, the proposed Regulations provide that the relevant type of property is determined by what is customary in the appraisal profession. The IRS has asked for suggestions for categorizing types of property that would be helpful in determining the qualification of appraisers, for purposes of both the education and experience requirements.

The IRS believes that the term "regularly performs appraisals for which the individual receives compensation" (which is one of the requirements that is set forth in the Internal Revenue Code for an appraiser to be considered to be a "qualified appraiser") is generally encompassed by the experience requirement of Code Section 170(f)(11)(E)(iii)(I) and does not need to be separately met.

Due to concerns about identity theft, the IRS has received comments urging elimination of the requirement that an appraiser supply his or her taxpayer identification number on Form 8283 and in the appraisal, as is required in current Regulations. The concern arises from appraisers whose taxpayer identification number is their social security number. The proposed Regulations continue to require this information because an appraiser may obtain an employer identification number even if the appraiser does not have employees. This number can be obtained by completing Form SS-4, "Application for Employer Identification Number." If an appraiser is employed by a firm, the firm's employer identification number should be used.

Clothing and Household Items.

Proposed Regulations §1.170A-18 implements Code Section 170(f)(16), which provides that no deduction is allowed for any contribution of clothing or a household item unless it is in good condition or better. According to the legislative history of the PPA, the purpose of this provision is to ensure that donated clothing and household items are "of meaningful use to charitable organizations." The IRS has indicated that it is aware that a number of charities publish donation guidelines listing items the charity will and will not accept and believes that the guidelines are helpful in ensuring that charities receive donations of items that are of meaningful use to the charity. To gather additional information regarding this issue, the IRS has requested comments regarding how donation guidelines published by charities may relate to the "good used condition" requirement in Code Section 170(f)(16).

The proposed Regulations provide that the "good used condition or better" requirement does not apply to a contribution of a single item of clothing or a household item for which a donor claims a deduction of more than $500 if the donor submits a qualified appraisal with the return on which the deduction is claimed.

Tax Tip.

The proposed Regulations are just that - proposed. Notwithstanding this fact, donors would be well advised to make every effort to satisfy the rules that have been proposed (in addition to the current rules). Donors generally get only one chance to satisfy their substantiation and reporting obligations. Missing a deadline or not submitting the proper document can often be fatal for purposes of the charitable contribution rules.

IRS Proposes Controversial Regulations That Would Negatively Affect Charitable Lead Trusts

By David Wheeler Newman

When drafting a charitable lead annuity trust or a charity lead unitrust, an attorney must grapple with the fact that, unlike its cousin, the charitable remainder trust, a CLT is not exempt from income tax. The trust is subject to tax on its net income, calculated after taking into account a charitable income tax deduction under Internal Revenue Code Section 642(c) for the annuity or unitrust interest distributed to charity. This dynamic has led draftspersons to include in CLT documents an income-ordering provision that instructs the trustee to first make the distribution to charity from ordinary income (which would otherwise be taxed to the CLT at the highest rate) that is not unrelated business income; then from long-term capital gains; then from UBTI (for which no charitable deduction is allowed under Code Section 681); then from tax-exempt income (also not eligible for a charitable income tax deduction pursuant to the current regulations under Code Section 642(c)); and, finally, from the corpus of the trust. Income-ordering provisions of this type are designed to ensure that the assets of a CLT will not be unnecessarily depleted by income taxes. This drafting technique has been employed by draftspersons over the last forty years that CLTs have been specifically recognized in the Code and is specifically authorized under the current regulations,.

This long-standing practice led to the surprise of many gift planners (and the frustration of more than a few) when, over the summer, the IRS proposed new regulations saying that a provision in the governing instrument of a CLT as to the source out of which payments are to be made must have economic effect independent of income tax consequences in order to be respected for federal tax purposes. In the proposed regulations and accompanying explanation, the IRS provides no guidance on what this "economic effect" would be, but the example in the proposed regulations seems to make it clear that, since the distribution from a CLT is calculated using either an annuity or unitrust formula, a CLT could never satisfy this requirement.

If the proposed regulations become final, they will negatively affect many CLTs, including those already in existence. If the income-ordering provision in the trust document is ignored, the distribution to charity will be deemed to be made proportionately from each category of income earned by the trust, with the result that tax liability to the trust will be increased and the size of trust principal will be decreased over time. This erosion of trust principal is exacerbated by the long term of many CLTs since the effect is cumulative. In the case of a charitable lead annuity trust, this erosion of trust principal increases the likelihood that trust corpus could be exhausted as a result of the distributions to charity, resulting in potential losses to the charity, not to mention the noncharitable remainder beneficiary of the trust. In the case of a unitrust, erosion of trust principal means that the unitrust amount (and therefore distributions to charity) will be lower, with this reduction magnified in the later years of the trust due to the cumulative effect of tax payments eroding the principal of the trust on which the unitrust amount is calculated.

The American Council on Gift Annuities (ACGA) and the National Committee on Plan Giving (NCPG) have submitted official comments opposing these regulations. The comments (prepared on behalf of ACGA and NCPG by Conrad Teitell) persuasively argue that income-ordering provisions in CLTs do indeed have economic effect since these provisions can directly affect amounts distributable to charity through preservation of trust principal. Moreover, the comments demonstrate that Code Section 642(c), under which the regulations were promulgated, allows an income-ordering provision and does not require that it have an economic effect independent of income tax consequences, meaning that the IRS lacks the authority to promulgate regulations inconsistent with the statute passed by Congress. The full text of the ACGA/NCPG comments on the proposed regulations may be viewed at www.ncpg.org.

Charitable Sector Letter Available Via E-mail

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The Book Shelf: *Charity on Trial* by Doug White

Unlike Doug White's previous book, *The Art of Planned Giving*, which was directed at fundraising professionals, donors are the audience for this interesting volume. In fact, professional fundraisers and the organizations that employ them may take issue with a number of the views expressed here, notwithstanding the compelling case that is made that organized charity performs an essential function in society and that donors are usually best served by working within the system to achieve their philanthropic objectives.

Doug White begins by laying before us a series of case studies of charities gone bad, including the National United Way of the late 1980s, exploited by its CEO William Aramony for his personal benefit, and Adelphi University, similarly misused by its president, Peter Diamandopoulos. Also chronicled is the Baptist Foundation of Arizona, whose reach in the 1990s greatly exceeded its grasp, and the Foundation For New Era Philanthropy, the classic philanthropic Ponzi scheme concocted by John Bennett in the early 1990s. The general theme of this part of the book is that serious misdeeds (or at the very least very poor judgment) on behalf of the leadership of a few large charities placed severe strain on the abiding trust that American donors have in the charitable sector.

Sometimes charities are put under severe strain through no fault of their own. This was the case with the Texas class action law suit revolving around charitable gift annuities that, in the 1990s, threatened the viability of this gift-planning vehicle and exposed hundreds of charities to potentially large liability.

In this case, the loss of goodwill by the charities involved was wholly unwarranted since the charities were ultimately vindicated in the litigation.

On the other hand, Doug White chronicles the fall from grace of the American Red Cross, beginning with the diversion of huge amounts raised following the attacks of September 11, 2001 – – which the Red Cross led the public to believe would be used only for victims of that disaster – – to other purposes. The controversy was fueled when the press and Congressional researchers revealed that the Red Cross had faced earlier criticism for fundraising appeals in the wake of disasters that resulted in funds being diverted to other uses. Finally, this organization, which has been one of the most trusted nonprofits in America, faced further severe criticism for perceived mishandling of relief efforts following hurricane Katrina.

But White's purpose in cataloguing scandals and shortcomings involving charities is not to discourage donors from giving. Quite the contrary. He makes a compelling case that human beings are hardwired to assist their fellow human beings and to contribute to the good of society. Moreover, there are societal needs that simply cannot be filled by our government and can only be filled by charity in one form or another. America's charities should, therefore, be the perfect vehicle for donors to fulfill their objectives and make sure that these societal needs are met. But how should one approach the task after the book's series of reminders that some charitable organizations may not be worthy of the trust donors place in them?

Doug White's answer is that donors need to help – – really need to force – – charities to do a better job. After observing that "educated, caring donors will do more to get charities to be more honest and transparent than anything else," he offers an action plan including these points:

- Figure out where your heart is.
- Find out what you can before you contact the charity.
- Download a copy of the charity's 990 from GuideStar.
- Ask yourself, what will happen to the community if the charity stops operating?
- Ask to see the annual report.
- Ask about programs.
- Ask how many years the charity has been in business.
- Ask about the trustees and the board.
- Ask about the key staff.
- Ask about transparency policies.
- Ask why you should give.
- Ask about infrastructure.
- Ask about fundraising.
- Target your giving.
- Ask how the charity communicates important news to the public.
- Ask about gift acceptance policies.
- Ask about ethics policies.

In laying out his case that donors should demand more accountability from the charities they support, Doug White does not shy away from controversy. After quoting Lester Salamon's observation that, "[u]ltimately, the lack of a compelling vision may threaten the future of the non-profit sector as a vehicle for socially beneficial change," White says, "Some charities should go out of business. We simply have too many . . . of the several hundred thousand charities that ask for donations from the public, the world would not suffer very much if perhaps a hundred thousand or so closed their doors tomorrow. I say this not on the basis of their economic inefficiency, although that surely is part of the idea, but because of their lack of impact." At the end of the day, the author advocates a tough love approach by donors: they should force charities to do a better job of serving society's needs by demanding that those charities provide more and better information about their work and, based on that information, providing their support to charities that are doing a good job and withholding their support from those that are not.

Charitable Sector Practice Group Profile

Faithful readers will recall that we periodically profile a member of our charitable sector practice group. We think it helps you get to know us better and provides a context for the person on the other side of the telephone or e-mail conversation. In this issue we introduce you to our colleague, Felicia Chang.

Felicia graduated, with High Honors, from the University of California, Berkeley, with a Bachelor of Science in Business Administration from the Haas School of Business and obtained her law degree from the UCLA School of Law. Prior to joining MSK, Felicia was an estate planning associate at another national law firm.

Felicia is currently the Third Vice-Chair of the Executive Committee of the Los Angeles County Bar Association Taxation Section. She is Co-Chair of the 2009 Washington Delegation, in which the California tax bar sends a delegation of attorneys to Washington, DC, to present proposed changes to the tax law to the IRS, Treasury, House Ways & Means and Senate Finance Committees, and the Tax Court. Felicia was also a member of the 2007 Washington Delegation, where her paper, titled "Dueling Powers Under Section 678," was selected to be presented before the IRS and the Treasury Department.

As a member of MSK's Charitable Sector practice group, Felicia works with private foundations, charitable trusts, public charities, religious and educational institutions, and other tax-exempt organizations on a variety of issues relating to their compliance, tax exemption and charitable gift planning programs. Felicia also assists wealthy families and individuals meet their philanthropic objectives by helping them select the appropriate charitable planning vehicle and explaining the tax consequences of different proposed structures.

Felicia is fluent in Mandarin Chinese and her language skills were really useful in her recent work with a wealthy overseas Chinese client. This complex philanthropy project involved the creation of a U.S. private foundation, funded with assets from China and Hong Kong, to operate from the U.S. to support several Chinese and Hong Kong charities under its control, as well as U.S. public charities not under its control. The intricate corporate structure required Felicia to assist the foundation in designing and implementing internal policies and procedures to ensure compliance with private foundation rules.

Currently, Felicia is working with a Fortune 500 company to form a tax-exempt entity with a creative venture. The new entity will fund and conduct programs that use multimedia products in new ways to educate youths in Africa about HIV prevention.

In addition to her dedication to the charitable sector, Felicia is an avid traveler who happens to be extremely afraid of flying. Her fear of flying makes every vacation an interesting experience for her family, friends, and, at times, unlucky seatmates.

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