
Charitable contribution rules and requirements

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In brief

Contributing to charity is an integral component of the American culture. One reason for charitable giving is the income tax benefit resulting from most donations. Individuals expecting to claim a charitable income tax deduction must be very careful to satisfy the sometimes complex rules behind the deduction.

In order for a taxpayer to benefit from the act of giving to a charity and take advantage of the tax savings associated with the contribution, a taxpayer must consider the charitable organization, the nature of the contribution and the documentation substantiating the contribution. The Internal Revenue Service (IRS) has prescribed guidelines that address these areas. Details underlying the guidelines are discussed below.

In detail

Qualifying charity

In order for an individual to claim a charitable deduction, the individual must make a charitable contribution to a qualified organization.

Generally, the organization must be organized or created in or under the laws of the United States, and must be organized and operated for religious, educational, scientific, or literary purposes, or for the prevention of cruelty to children or animals. Not all tax-exempt organizations are considered charities in the eyes of the IRS.

Contributions by individuals to a charity created or organized under foreign law are not deductible for income tax purposes. However, a

charitable deduction may be allowed if an organization created or organized in the US uses some or all of the donated funds in foreign countries for charitable or educational purposes.

- For example, in *Welti v. Commissioner of Internal Revenue*, the US Tax Court held that a contribution was not deductible because it was made to a church that was organized under the laws of Switzerland, even though the church was essentially a branch of a US church organized under Massachusetts law. Another case, involving contributions to the Bilingual Montessori School of Paris, concluded

the contributions were deductible because the school was incorporated under the laws of Delaware, even though all of the school's activities took place in France, and it had no assets or employees in the United States.

If an individual desires to make contributions specifically for the benefit of a particular foreign charitable organization, they could receive a tax deduction by contributing to a US 'friends of organization. These domestic charities are often established solely for the purpose of raising funds in the US that will be distributed to one or more foreign charities. However, if they meet certain requirements, contributions to these

organizations will be deductible for US income tax purposes.

Taxpayers can use the 'Exempt Organizations Select Check Tool' on the IRS website to determine if a particular organization is eligible to receive tax-deductible charitable contributions. One problem with the tool is that it contains the 'official' charitable organization name without any reference to common naming conventions. Many organizations are known by shorter and less formal names which can cause a problem when verifying a charitable organization's status.

Qualifying contribution

Generally, an individual may claim a deduction for cash or property donated to a qualifying charity. Possible types of charitable donations include:

- *Cash* – donations of cash are the most common type of gift to charity. Most, if not all, charities accept cash donations, and the donor can claim an income tax charitable deduction for the full value of the cash donated.
- *Stocks and Bonds* - giving stocks or bonds, instead of cash, as a donation can greatly benefit both parties. Most charities, hospitals, schools and other nonprofit organizations will accept publicly-traded stocks as a gift or donation. Many charities also accept corporate or government bonds. If the stock or bond has increased in value from the time of purchase, the donor can avoid paying the capital gains tax by donating the security to charity. When the security is donated to a charitable organization, the total fair market value of the security is eligible for the charitable income tax

deduction, if the security has been held by the donor for more than one year. Securities that have declined in value since the date of purchase (loss securities) should not be donated to charity. Instead, the donor should sell the security, claim a capital loss deduction, then donate the resulting cash to charity.

- *Real estate* – a donation of real estate to charity can have the same advantages as a donation of stocks or bonds. If the real estate was held for more than one year, the donor can claim an income tax charitable deduction equal to the fair market value of the real estate. In many cases, if one takes into consideration the on-going property taxes, maintenance costs, income taxes - or if the property is sold, the cost of legal fees, brokerage fees, estate taxes, inheritance taxes and capital gains taxes - it can be financially preferable to donate real estate to charity. It also saves heirs the trouble of trying to divide up the gains if the will is potentially contentious or inequitable.
- *Tangible personal property* - tangible personal property is one of the most interesting types of property contributed to charity because of its infinite varieties. The most common types of tangible personal property contributed to charity include art, collectibles, motor vehicles, and items of business inventory or equipment. If appreciated property is considered related to the public charity's tax-exempt purpose ('use-related' property), the deduction is based on the fair market value of the property

donated. If property is considered unrelated to the public charity's exempt purpose ('use-unrelated' property), the deduction is based on the lesser of its fair market value and its cost basis.

- *Out-of-pocket expenses* - volunteers may deduct reasonable direct out-of-pocket expenses incurred while helping a qualifying charity. The charity must request the services of the volunteer, supervise the volunteer, and have some level of accountability for the volunteer's actions. There are many types of out-of-pocket expenses that are deductible, including mileage associated with volunteer work for a charitable organization. In 2013, the IRS also permits a 14 cents-per-mile deduction for charitable use of a vehicle. Travel related expenses associated with a charitable organization's management (i.e., board or trustee meetings) may constitute a deductible out-of-pocket charitable expense. Deductible travel related expenses include round-trip airfare costs for an overnight stay, transportation to and from the destination, lodging and meals. A lesser-known example of a deductible out-of-pocket expense is the cost associated with hosting an event for charity. Such events might include fundraising or recruiting events at a private residence where the volunteer pays for food, beverages or entertainment.

Certain types of donations, even if made to a qualifying charity, are not deductible for income tax purposes. These non-deductible donations include:

- *A contribution consisting of a mere right to use property* – in order to be deductible, contributions must be made in cash or other property. Giving a charity the right to use a taxpayer's property is not considered cash or other property and as such, is not deductible.

- For example, if Joe allows a tax-exempt organization to use an office in his office building rent-free, Joe will not be entitled to claim an income tax deduction.
- In a revenue ruling, the IRS caused a charitable donation of property to result in a triple disallowance. The donor allowed the charity to use his vacation home for one week, which the charity turned around and sold at a charitable auction. The donor could not deduct anything for the donation of the property, the purchaser could not deduct his payment even though the check was payable to the charity, and the donation of the property was considered personal use property, thereby disqualifying the property from rental property status.

- *A donation of services by the taxpayer* - the value of one's services does not qualify as a charitable contribution. Charitable contributions can only be taken for money or property that is donated to a charity. Thus, the value of pro bono services or donated time is not considered to be a charitable deduction.

- For example, if Sam donates 12 hours of his time building

houses for a tax-exempt organization, Sam will not be entitled to claim a federal income tax deduction.

- If a personal trainer donates 8 free training sessions to a charitable auction, the value of the training sessions is not deductible, even if the charity provides the personal trainer with a receipt.
- *A donation of less than the donor's entire interest in property* – gifts of partial interests in property in which the donor retain an interest in the property are not deductible.
 - For example, if Larry creates an irrevocable trust, and the trust terms indicate that Larry is entitled to receive all the income from the trust for his life, with the remainder of the trust passing to charity, no deduction will be allowed when the trust is established. However, there are several exceptions to this 'partial interest' rule that would permit an individual to receive an income tax deduction. Donations to a charitable remainder trust, charitable lead trust, pooled income fund and a qualified conservation easement would all be considered exceptions to the rule, and therefore may qualify for a charitable contribution deduction.
- *Indirect expenses* - indirect expenses, such as payments to a babysitter for taking care of the volunteer's children while the volunteer is helping out a charity, are considered personal expenses and are not deductible.

Substantiation

Even if a charitable contribution of cash or property is made to a qualifying organization, failure to strictly comply with the various substantiation requirements can result in the disallowance of a deduction. The substantiation rules depend upon the amount of deduction being claimed.

For deductions less than \$250, the donor must maintain a record of the contribution in the form of either a cancelled check or other bank record, or a receipt or other written communication from the charity. If the contribution was made via payroll deduction, the donor can use a pay stub, W-2 or other form of employer-furnished document that shows the amount paid to the organization.

For deductions of \$250 or more, the donor must obtain a contemporaneous written acknowledgment of the contribution from the recipient organization. The acknowledgment, which is essentially a 'thank you' note, must contain the name of the recipient organization, the date of contribution, the amount of contribution and whether any goods or services were received in exchange for the donation.

- A recent US Tax Court case, *Durden v. Commissioner of Internal Revenue*, showed that even if a taxpayer receives a written acknowledgement of a charitable contribution, such acknowledgement may be insufficient to substantiate a charitable contribution and thus, the deduction is disallowed. The case involved contributions to a local church. The taxpayer received a letter from the church acknowledging the charitable contribution. The court disallowed the taxpayer's \$25,000 charitable

deduction because the letter did not contain all of the disclosures required by law. The letter must disclose whether the taxpayer received any goods or services in exchange for the contribution. The taxpayer in the case had a thank you letter and it was clear from the testimony (and from a second letter obtained subsequently from the church by the taxpayer) that the contributor received nothing in exchange for his contribution. However, the law requires the thank you letter to be received contemporaneously and specifically contain all the disclosures required by law. As such, the court disallowed the deduction.

Substantiation requirements can be more difficult to satisfy when out-of-pocket costs are involved. The donor often ends up with a vendor receipt that doesn't contain the charity's name or event date.

- A church is hosting a fundraising event and John is in charge of refreshments. The church will not reimburse John. He purchases two cases of soda from a local store several days before the event and pays with his own funds. He keeps the store receipt, and notes on the receipt "church fundraising event" and the date of the event. In this example, John has a store receipt that has an amount and a date. The receipt is missing the name of the charity, and the date on the receipt does not correspond with the date of the charitable event.

For volunteers in this situation, obtaining a written acknowledgement of out-of-pocket expenditures from the charity will suffice. The acknowledgement must contain a description of the service provided,

and a statement about whether goods or services were provided by the charity to reimburse the taxpayer for the expenses incurred (including an estimate of any goods or services provided). The charity must substantiate the type of services performed, but not the dates or amounts of expenses.

- In a recent court case, the court disallowed a youth football and cheerleader coach's out-of-pocket expenses for the cost of a charter bus. The court disallowed the \$600 charter bus expense because it was over \$250 and the taxpayer failed to substantiate the cost by producing a written acknowledgment from the donee organization. However, the court allowed the taxpayer's deductions for amounts less than \$250 related to party supplies, even though the taxpayer did not strictly comply with the Treasury Regulations, on the grounds that the taxpayer offered other reliable written records which substantiated the deduction.

Some property donations require the donor to obtain a qualified appraisal. Qualified appraisals are required for contributions of property worth more than \$5,000 (except publicly-traded securities). A qualified appraisal must be provided by a 'qualified appraiser' (i.e., someone who has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in the regulations).

The donor, the charity, or a party to the transaction cannot be a 'qualified appraiser.' Thus, helpful statements from a charity about the value of the donated property cannot be used. This poses added difficulty in the context of donations of life insurance

or annuities where the insurance carrier is required to maintain valuation records, but those records cannot be used to substantiate a charitable contribution because the carrier would be a party to the transaction.

- A recent court decision denied a charitable deduction for millions of dollars in real estate contributed to a special type of trust for charity. The taxpayer was a real estate broker and provided his own market value statements that were attached to his tax return. The IRS initially argued that the taxpayer had overstated the values of the properties and was prepared to contest the value of each property. However, when the issue went to court, the IRS took the position that the taxpayer should not be allowed a deduction, since the taxpayer failed to obtain a qualified appraisal. The Judge agreed that the real estate broker could not provide a qualified appraisal for his own donation and as such disallowed the entire deduction.

Individuals claiming charitable contribution deductions should be mindful of these substantiation requirements to avoid having a deduction denied because of an administrative oversight.

The takeaway

Taxpayers have the opportunity to satisfy their charitable inclination and realize the tax savings associated with their philanthropy. While both objectives are attainable, taxpayers should act prudently when complying with the IRS's requisite guidelines related to charitable contributions, when it comes to choosing the charity, donating the property, and documenting the deduction. Individuals intending to donate to charity should take necessary

precautions to ensure their contributions will entitle them to an income tax deduction.

Let's talk

For a deeper discussion of how this issue might affect you, please contact:

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