



## **Court of Appeals Issues Gift Substantiation Opinion**

*By Bruce R. Hopkins*

The U.S. Court of Appeals for the Ninth Circuit has issued a troublesome opinion, upholding the decision by the Tax Court that payments made to a charitable organization *are not deductible as charitable gifts*, because the substantiation requirements were not met, in that there was an undisclosed return benefit based on donors' expectations (*Addis v. Commissioner*).

### **The Facts**

H and W claimed charitable deductions for their cash payments (in 1997 and 1998) to a public charity (PC), which used the money to pay premiums on a life insurance policy — a charitable split-dollar life insurance contract — for the life of W. PC was entitled to receive 56 percent of the death benefit; the couple's family trust was entitled to receive 44 percent of the benefit.

In 1997, H wrote to PC stating that the family trust intended to purchase an insurance policy on the life of W and would grant PC an option to acquire an interest in that policy. The policy was issued. H and W owned the policy through the trust.

H, as trustee of the trust, and PC entered into a death benefit option agreement, relating to the policy. H agreed to pay \$4,000 of the \$40,000 annual premium on the life insurance policy. H and PC agreed that, if PC paid \$36,000 of the annual premium, PC would be entitled to its above-referenced share of the death benefit.

H and W created a “foundation” within PC. In 1997, they transferred \$36,000 to PC for this foundation. An accompanying letter from H stated that PC was not required to use the funds to pay the premium on the life insurance policy, but that H “expected” PC to use the payment for that purpose. The next day, the couple paid the \$4,000 of the premium.

PC credited \$36,000 to the foundation account. It simultaneously debited the foundation account in the amount of \$36,000 to pay PC’s portion of the life insurance policy premium. Also on the same day, PC paid its \$36,000 portion of the premium to the insurance company. The same series of transactions occurred the next year. As to both years, PC provided H and W with a document that stated that it did not provide any goods or services to the donors in consideration of the contribution.

The IRS disallowed the charitable contribution deductions claimed by the couple for the transfers to PC in 1997 and 1998, on the ground that the gift substantiation requirements were not satisfied. The Tax Court upheld the IRS position.

### **The Law**

A person is *not* entitled to a deduction for a contribution of \$250 or more unless the contribution is properly substantiated by means of a contemporaneous written acknowledgment of the gift by the charitable donee (IRC § 170(f)(8)). This acknowledgment must include a statement as to whether the donee organization provided any “goods or services in consideration, in whole or in part, for” the contribution, and provide a good-faith estimate of the value of any goods or services provided.

The split-dollar charitable life insurance contract is essentially outlawed (IRC § 170(f)(10)). This aspect of the law references an “understanding or expectation that any person will directly or indirectly pay any premium” in connection with one of these arrangements.

### **Opinion**

H and W asserted that PC was not legally required, and did not promise, to use the contributions to pay the premiums on the insurance policy on the life of W. The Tax Court held.

however, that PC “provided consideration” for the payments because, at the time the payments were made to PC, the couple “expected” to receive a share of the death benefit under the policy. Also, this court concluded that H and W “expected” PC to use the funds they provided to pay PC’s portion of the premiums on the policy in 1997 and 1998. The appellate court agreed that the substantiation letters did not disclose the “consideration” that H and W “expected.”

The appellate court wrote that the couple’s payments “were inducements” for PC to “take the split-dollar deal.” This arrangement was said to confer benefits on H and W that were “disproportionate” to their level of premium payments. This disparity “was the consideration the receipts failed to disclose.”

### **Commentary**

Like the Tax Court, the Ninth Circuit missed the point in this case. Both courts jumped ahead and focused on the inequities — to the charity — in this charitable split-dollar insurance arrangement. Both courts seem to have been swept up in the unfairness of some of these arrangements and the reasons for enactment of IRC § 170(f)(10).

The fact is that H and W gave money to PC under circumstances where PC was legally free to use the funds as it pleased. It would have been perfectly acceptable — and correct as a matter of law — for the court to rule that PC was not under any legally binding mandate to pay the premiums. If the courts wanted to find that PC foolishly invested the money or generated some private benefit to the couple, that might be understandable. The courts were in error in not separating the gifts from the investments, and for tying all of this to the charitable gift substantiation rules.

This arrangement may be compared to the establishment of donor-advised funds (which is what the “foundation” in this case was). Donors make contributions to charities in these circumstances with the “expectation” that the charitable donees will follow the advice of the donors (or their designees). This type of expectation surely is not consideration defeating the concept of a deductible gift.

The mistake of these courts is plainly revealed in the statutes. IRC § 170(f)(8) (the gift substantiation rules)

employs the phrase “goods or services.” IRC § 170(f)(10) (the charitable split-dollar insurance ban) uses the phrase “understanding or expectation.” If Congress wanted IRC § 170(f)(8) to apply to expectations, it could have so legislated. But it did not. The courts in this case went astray in engrafting onto one statute the different phraseology of the other.

Charities must now be ever so cautious in preparing these substantiation documents, in that they must not only disclose any value of goods and services provided in exchange for a gift, they must now also peer into the misty reaches of donor motivation and intent to discern what donors expect to be provided — and value and disclose that.

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