Stay on the Right Track

When to Say "No" to Fulfilling Personal Charitable Pledges

*by Jane C. Nober**

Your giving program looks like a convenient vehicle for fulfilling personal charitable pledges. Here's what you need to know about when to say "no."

- The board of the ABC Family Foundation is considering a number of suggested grants, including a contribution to the local symphony's capital drive. Grandmother ABC mentions in passing that the gift will fulfill her pledge to the symphony.
- The corporate foundation manager is thrilled to learn from the vice president of corporate contributions that the company wants to transfer a considerable sum to the foundation. "We'd especially like the foundation to take on some of our multi-year pledges so we don't have to deal with those FASB rules" says that vice president.
- The executive director of the XYZ Community Foundation receives a call from one of the community foundation's donor advisors. "I'd like you to make a contribution to my church from my fund," says the caller. "I'll deliver it, if you don't mind. They're waiting for me to complete my annual gift."

In each of the above cases, alarm bells should be ringing in the foundation manager's head, for paying any of these pledges or commitments out of foundation resources is not advisable. In the private or corporate foundation context, making the suggested payments will most likely constitute an act of self-dealing, and the payments may be characterized as taxable expenditures; in the community foundation context, such a payment may provide evidence of excessive donor control and operation of the community foundation for a private, non-charitable purpose. This article sets out the problems with such grants and provides guidance for foundation managers who may face these situations.

What is a Pledge?

A pledge is a promise to pay. Since a pledge made to a charity is usually made voluntarily and wit no expectation that a tangible benefit will be flowing back to the pledge maker, some states' courts have declared that such a promise is not enforceable. In other word, if a pledge maker does not pay up, the charity may not rely on a court to secure the unpaid funds. Other states' courts, however, will enforce a charitable pledge on broader, social policy grounds. And when a charity can demonstrate that it has reasonably relied on the promised funds by acting–or not acting–in a particular way, courts are likely to enforce the pledge.

Whether a pledge is legally enforceable matters because when a private foundation satisfies the legal obligation of someone the Internal Revenue Code defines as a "disqualified person" (this class includes foundation managers, substantial individual or corporate donors to the foundation, and certain family members or affiliates of such substantial contributors), the payment constitutes an act of self-dealing. The rationale is that the foundation has relieved the disqualified person of a private obligation he or she would otherwise be required to discharge. Assuming that Grandmother ABC's pledge to the symphony is legally enforceable, for example, the foundation's fulfillment of the pledge would be self-dealing.

Indeed, even if the payment does not fulfill a legal obligation but merely relieves Grandmother ABC of the responsibility of using her own fund, it may be construed as self-dealing; the IRS has characterized a private foundation's payment of a disqualified person's annual church dues as an act of self-dealing.

Such payment also violates the requirement that the foundation, like any charitable organization, be operated exclusively for charitable purposes. By satisfying the legal obligation of an individual who is not a member of a charitable class, the foundation will make a distribution that it is not for a charitable purpose, even though the grantee is a charitable organization. The IRS has deemed such distributions taxable expenditures subject to excise tax.

The best way to prevent such situations from arising is education. Foundation managers who are concerned that disqualified persons may attempt to have the foundation satisfy personal pledges should enlist the aid of a party such as the foundation's lawyer or accountant to explain the rules regarding permissible grants. Included in any such discussion should be information regarding the penalties for violating the self-dealing rules, which include excise taxes on not only the self-dealer but also the foundation managers who approve self-dealing expenditures.

Pledges and Corporate Foundations

The same rules apply when the substantial contributor is a corporation. If the corporation has a pre-existing obligation and the corporate foundation satisfies it the corporate foundation will have committed an act of self-dealing. This problem is particularly noteworthy as it relates to the FASB rules for the reporting of multi-year grants on audit statements. The rules require that the present value of unconditional multi-year grants (grants where the prerequisite for payment in future years is the passage of time) be reported in the first year such commitment are made. Some corporations have proposed shifting ongoing multi-year grants from the corporation to the foundation to avoid showing a major liability on the corporation's balance sheets. This arrangement has the potential to be deemed self-dealing and is generally not advisable; if the corporation has pledged future support, the corporate foundation should not fulfill that pledge.

Even when making a payment does not discharge a legal obligation but only frees the corporation of the responsibility of using its own funds, the payment may be considered an act of self-dealing. For example, the IRS has ruled that a corporate foundation could not split with the corporation the cost of a corporate executive's ticket to a fundraiser; the foundation's payment would relieve the corporation (a disqualified person in relation to the foundation) of an obligation to pay full price for the corporate executive's ticket. The IRS was not at all moved by the suggestion that the corporation would pay the "entertainment" portion of the ticket, while the foundation would cover the "charitable" portion.

These concerns should not, however, prevent corporations from considering ways in which the corporate foundation may play a role in existing or new corporate giving activities. For example, in light of the Omnibus budget and Reconciliation Act of 1993 requirement that contributions of $250 or more to a charity must obtain a receipt to claim a charitable tax deduction, many corporations have considered administering their matching gift programs through their foundations (the $250 rule does not apply to grants by foundations as foundations do not pay income tax and do not take charitable deductions). Where the company's payment of matching gifts is not a pre-existing or contractual obligation, such a shift may be permissible and desirable. Obviously these and other cor-

porate giving arrangements are complex and no significant change should be undertaken without the advice of counsel.

Pledges and Community Foundations

In the community foundation context, the problems with pledges arise because of private inurement and excessive donor control concerns. As public charities, community foundations are not subject to the foundation rules that bar self-dealing (although these rules do provide helpful guidance), but they operate under the same requirement that the organization be operated exclusively for charitable purposes. If community foundation dollars are being used to relieve the legal obligation of someone who is not a member of a charitable class, such as a donor, donor advisor or another disqualified person to the foundation, the requirement regarding charitable operation is not being met and the IRS may impose penalties on parties involved. Again, even when the pledge does not rise to the level of a legal obligation, the community foundation should not be using its resources to fulfill personal pledges that would provide more than an incidental benefit to the pledge maker. Because it can be tricky to determine what constitutes a permissible "mere incidental" benefit versus an impermissible "more than incidental" tangible benefit, community foundations would be wise to steer clear of satisfying any pledges from its funds unless the IRS issues additional guidance on the distinction between these benefits.

Furthermore, if a donor advisor consistently uses his or her fund at the community foundation to satisfy personal pledges, the IRS may conclude, on the basis of this and other factors, that the fund is more properly classified as a private foundation than a component fund of a community foundation.

The best defense against such a problem is a good offense–an advised fund agreement that bars use of advised funds to fulfill pledges of the donor, donor advisor or related parties and that has been signed by the donor at the time the fund is established. Such an agreement alerts donors to the prohibition and helps community foundation staff respond when such requests are made. A community foundation that has established an advised fund program without such an agreement may wish to consider having donors sign such a document when they make an additional contribution to their fund. Alternatively, the board of the community foundation may wish to adopt a policy barring use of funds to fulfill pledges or provide other benefits to donor advisors. Community foundations can also include a certification on grant recommendation forms requiring the advisor to certify that the particular recommendation does not fulfill a pledge or otherwise provide a benefit to a donor, advisor or related party. Such a certification helps protect the community foundation and serves as a reminder to the advisor. Again, no community foundation should undertake significant action without consulting counsel.

No one likes to tell a donor that his or her wishes cannot be accommodated. In the case of pledges, the wise foundation manager should employ preventive education, alternate suggestions and binding agreements to avoid situations in which the only response is a tactful "no."

For additional information, read *Prohibited Benefits from Donor-Advised Funds*.

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