LIABILITY:
Random Thoughts On How To Not Get Burned

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I. MAKE SURE YOU WANT THE ASSET

Due Diligence

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The amount and kind of due diligence may depend upon the charity in question.

Sometimes, it is hard to decide what the "asset" is - for example, a gift of a LLC holding a parcel of real estate.

Gift Acceptance Policy

A charity's GAP should, among other things, address what kinds of assets and gift vehicles the charity will consider accepting.

The *key* issue – who at the charity makes the final "call"?

II. IF YOU DON'T WANT THE ASSET, DON'T TAKE IT

You don't have to accept a gift – not only can you decline a gift as it is being offered, but a beneficiary may disclaim any interest, in whole or in part, by filing a disclaimer. The California disclaimer rules are set forth in California Probate Code Section 275 and following; the IRC disclaimer rules are in Section 2518.

General California Rules

The disclaimer must be in writing, identify the creator of the interest, describe the interest being disclaimed, and state the disclaimer.

With whom the disclaimer must be filed depends upon the situation: the Probate Court (for bequests under a will), the trustee of a trust, the person responsible for distributing the interest, the person having possession of the asset, or the creator of the interest.

Note a beneficiary cannot disclaim an interest after he/she/it has accepted the interest.

A disclaimer is effective if it is filed within a "reasonable time" after the beneficiary acquires knowledge of the interest. In the case of certain types of interests, there are special rules that provide when a disclaimer is conclusively presumed to have been filed within a "reasonable time".

Application to CRTs

Consider a CRT that provides: "at the termination of the trust, the trustee is to distribute the remainder to Charity 1; and if it is not then a qualified charity, the trustee is to distribute the remainder to Charity 2."

If Charity 1 does not want to accept the trust assets, it should disclaim within nine months after the later of: (1) the time it first acquires knowledge of the interest, (2) the time its interest becomes indefeasibly vested, or (3) when the interest becomes an estate in possession (as the remainder interest is a "future estate").

If Charity 1 disclaims, Charity 2 should disclaim within nine months the later of: (1) the time of the first disclaimer, (2) the time it first acquires knowledge of the interest, (3) the time the interest becomes indefeasibly vested, or (4) when the interest becomes an estate in possession (as the remainder interest is a "future estate").

III. If You Want to Have The Economic Value of the Asset, But Not The Asset

What if you really want the economic value inherent in that run-down toxic waste-laden building?

Short Term CRT

Consider having the donor contribute the asset to a 5% net income CRT with the donor serving as trustee and a 3-year term. The liability remains with the donor (now serving as trustee). The donor hopefully sells the property promptly, and invests the proceeds until the trust termination date.

Donor's deduction is approximately 85% of the building value.

How short a term can you use? IRC section 664(d)(2)(A) refers to payments continuing for "a term of years (not in excess of 20 years).

How do you minimize income back to donor after the property is sold? Use a net income payment form, have the donor invest for growth and not income, and include the charity as an income beneficiary.

An alternative: use a more traditional long-term CRT, and have the donor give his income interest to charity after the asset is sold, and then collapse the trust. See Rev. Rul. 86-60.

Have Donor Give to A Single-Member LLC

Consider having the charity form a single member limited liability company (SMLLC). For state law (e.g., liability) purposes, the SMLLC should be respected as a separate legal entity unless a litigant can "pierce the corporate veil". As such, a liability incurred by the SMLLC (due to it having accepted toxic real estate) should be limited to the SMLLC' s assets – not the charity's.

For tax purposes, however, a SMLLC is classified under the so-called "check-the-box" regulations (Treasury Regulation Sections 301.7701-2 and -3). The check-the-box regulations provide, in general, that a SMLLC may choose to be taxed as a corporation, or as a branch or division of its owner (in which case its separate legal existence is disregarded for federal tax purposes).

Thus, a SMLLC that does not elect to be taxed as a corporation is "disregarded as an entity separate from its owner". This means that the activities of a disregarded entity "are treated in the same manner as a sole proprietorship, branch, or division of the owner". These regulations do not limit the scope of the federal tax purposes for which a disregarded entity will be ignored.

Note that it took the IRS a very long time to confirm that the disregarded treatment applies for purposes of IRC Section 170, but they finally did in Notice 2012-52.

Alternatively, the donor can create the SMLLC, contribute the asset, and then give the membership interest in the SMLLC.

Use An Accommodation Charity That Is More Comfortable With "Difficult" Assets.

For example, The Dechomai Foundation, Inc. (full disclosure – Dechomai is a client).

IV. SELL THE GIFT ASSET IMMEDIATELY

What if the donor wants to give you an asset, but you do not want to accept unless you "know" you can sell it promptly. Having the donor identify a buyer and enter into a binding sale agreement with him/her prior to the gift results in the donor being taxed on the gain under the "assignment of income doctrine" (see *Palmer v. Comm'r.*, 62 TC 684 (1974), aff'd on other grounds 523 F.2d 1308 (1975), Rev. Rul. 78-197).

Consider having the charity identify a potential buyer prior to the gift, and enter into a "put" agreement with the buyer. Under the "put", the charity has the right to force the buyer to buy the property at a stated price – but the buyer cannot force the charity to sell. The charity will likely have to pay the buyer some amount before the buyer will agree to be obligated to buy.

At moment of gift, the charity cannot be compelled to sell, as it has power to exercise the put or not. Plus, the donor did not negotiate the put and did not assign "his" income.

This put idea is similar to a gift of property that is subject to a right of first refusal. The IRS issued several PLRs in the early 1990's concluding that such a gift did not violate the rule set forth in *Palmer* and Rev. Rul. 78-197, as the donee charity cannot be compelled to do anything – it is only if donee charity decides to sell that any obligation becomes enforceable. Note, however, that the IRS continues to pursue "assignment of income" matters aggressively, and might argue that matters had progressed to the point where the charity could, under the totality of the circumstances, be compelled to sell.

V. AVOID THE PRUDENT INVESTOR REQUIREMENTS

General Investment Standards Applicable to Charities

California charities are subject to the rules on prudent investments as set forth in both the Corporations Code and UPMIFA (fortunately, the Corporations Code now provides that complying with UPMIFA will be deemed compliance with its standards). UPMIFA articulates a "modern" standard of care for investing charitable funds, requiring (among other things) that the Board act in good faith and with the care of an ordinary prudent person.

Exception

So what if a donor wants to give you an asset, and does not want you to sell it immediately? A Board is relieved of the specific fiduciary duties regarding the investment of funds if the donor authorizes the retention of the gift asset, and is relieved of both the specific fiduciary duties regarding the investment of funds *and* its general overall standard of care if the donor requires the retention of the gift asset (Cal. Corp. Code sec. 5240(c)). The UPMIFA standard of care regarding investments is likewise prefaced with "Subject to the intent of a donor expressed in a gift instrument…."

VI. USE A CAREFULLY DRAFTED GIFT AGREEMENT

Gift Instrument

It is key to understand, and carefully document, all donor restrictions in a "gift instrument". Not surprisingly, it can be very difficult to determine the terms of a gift if there is no clear gift instrument.

Gift terms can be found in "a will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document (including the terms of any institutional solicitations from which an institutional fund resulted)...."

UPMIFA provides that the terms of a gift instrument, and thus any purpose or spending restrictions, must be set forth in a "written record", which includes email but not "oral" representations.

Key Gift Instrument Terms

An introductory section, describing the transaction, the donor's intent, and the donor's connection to the charity in general terms.

Charity's administration policies and procedures (spending, fees, etc.) should be referenced in gift instrument and available to donors.

The purpose to which the donor's gift is dedicated needs to be expressed clearly. With an endowed gift, the funds will be put to this purpose in perpetuity – all parties need to recognize that the purpose must be flexible enough to be meaningful and workable in the future.

The gift instrument should contain a variance power. While a restriction can be released with the donor's consent or a Probate Court order, petitions to modify gift terms are time-consuming and expensive. I strongly encourage charities (and donors) to add a variance power to their gift instruments. Variance powers should address who in the charity may exercise the power (e.g., the Board of Directors), and what standard they are to apply.

As to naming rights, charities should consider a "naming right policy" that addresses a donor who becomes embroiled in a scandal, or a building that needs to be expanded/remodeled/etc.

Spending Rule

An endowed gift should reference the charity's endowment spending rule, which should track UPMIFA. A charity or donor *can* expand (or restrict) the spending limitations by carefully crafting the terms of the endowment (UPMIFA sets forth a "default" rule). I am generally not in favor of restricting the UPMIFA standard. On the other hand, I sometimes include an "Emergency Invasion" power, under which a charity can spend some of the endowment principal in times of financial need.

Consequences of a Default

Gift instruments should address what happens if the charity (or donor) "defaults" on their promise. Often, the remedy for a charity's failure to follow a purpose restriction is to require a "gift over" to another charity.

Who Has Standing to Enforce?

Donors may wish to ensure they have "standing to sue" if the charity does not abide by the purpose or spending restrictions. Absent such language in the gift instrument, however, the donor may not be able to enforce the terms of his/her gift.

Some states have held that unless the donor reserves a right to enforce in the gift instrument, only the state Attorney General has legal standing (*Carl Herzog Foundation v. University of Bridgeport,* 699 A.2d 995 (1997)).

Other states have concluded that a donor does have standing (*LB Research and Education Foundation v. UCLA Foundation*, 29 Cal. Rptr. 3d 710 (2005); *Smithers v. St. Luke's Roosevelt Hospital Center*, 723 NYS2d 426 (2001)).

VII. RELEASING RESTRICTIONS

Often, a charity finds that it cannot use donated funds for the restricted purpose. UPMIFA allows a charity to release or modify a restriction regarding management, investment, or purpose of a fund if the donor consents in writing.

If a purpose or use restriction becomes unlawful, impracticable, impossible to achieve, or wasteful, the court may modify the restriction in a manner consistent with the donor's intent. The Attorney General must be notified.

The court can modify a management or investment restriction if it has become impracticable or wasteful, impairs the management or investment of the fund, or (if due to unforeseen circumstances) the release would further the purposes of the fund. The Attorney General must be notified.

If a fund is less than $25,000 ($100,000 in California) in value and over 20 years old, and the charity determines that a restriction on the management, investment, or use of the fund is unlawful, impracticable, impossible to achieve, or wasteful, the charity can (after notice to the Attorney General) release or modify the restriction. It must thereafter use the funds in a manner consistent with the donor's charitable purposes.

VIII. WHAT IF THE DONOR WANTS YOU TO RETURN THE ASSET?

Donors (or their heirs) occasionally become unhappy with their grantee (or the fact that they made a gift at all), and demand the charity refund their gift.

Does the Donor Have Standing to Complain?

See VI above.

Director Standard of Care.

Board members are generally held to a standard of conduct comprised of two separate duties: the duty of loyalty (to act in good faith, in the corporation's best interests, and without regard to personal interests or the interests of any third party); and the duty of care (to apply reasonable skill and judgment in managing the affairs of the corporation, devote adequate attention to the corporation's affairs, and act only after making inquiries reasonably required by the situation).

Charitable Trust Law.

Assets contributed to nonprofit corporations to be used for charitable purposes are *impressed with a charitable trust* – that is, they may only be used for the charity's stated purposes as possibly narrowed or further defined by the donor. This charitable trust is enforced by the state's Attorney General. The charity's directors are responsible for preserving the corporation's charitable assets, and using those assets only in a manner that satisfies the terms of the charitable trust.

Federal Tax Law - Private Benefit.

Charities, as tax-exempt Section 501(c)(3) entities, must not allow its assets or earnings to inure to the benefit of any private individual. Gifts to individuals who are not members of a charitable class are not permitted by these requirements.

Settlement of A Bona-Fide Dispute.

The California Attorney General's office has taken the position that settlement of a *bona fide* dispute, where refusal to settle would expose the charity's assets to wasteful litigation expenses and the risk of substantially higher damage awards, can represent an acceptable use of a charity's assets within charitable trust requirements. To satisfy this requirement, it is important to confirm that the charity is, in fact, receiving full value in exchange for its payment. This confirmation is often demonstrated to the Attorney General through a vigorous arm's-length settlement negotiation process and a settlement agreement, but it is possible to establish fair market value in other ways.