STATE BAR OF CALIFORNIA
TAXATION SECTION
TAX EXEMPT ORGANIZATIONS COMMITTEE[1]

THE TREATMENT OF PLEDGE WORKOUTS INVOLVING DISQUALIFIED PERSONS UNDER SECTION 4958

This proposal was principally prepared by Carrie E. Miller and Barbara A. Rosen, members of the State Bar of California Taxation Section. The authors wish to thank Reynolds Cafferata and Bill Choi for their contributions to this paper.[2]

Contact Persons:

Carrie E. Miller
California Institute of Technology
Office of Gift Planning
MC 5-32
Pasadena, CA 91125
(626) 395-3709

Barbara A. Rosen
Evans & Rosen LLP
425 Pacific Avenue
San Francisco, CA 94133
(415) 677-8955

[1] The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the State Bar of California or the Los Angeles County Bar Association.

[2] Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

EXECUTIVE SUMMARY

Currently, if a substantial contributor, or other disqualified person to a public charity, has an outstanding pledge agreement with the charity, and wishes to revise the agreement in any way that reduces the amount of the pledge, it could be considered an excess benefit transaction under Internal Revenue Code Section 4958[3] and the Treasury Regulations thereunder.

Current Treasury Regulation 53.4958-6 provides a rebuttable presumption of reasonableness for transactions with disqualified persons where the transactions meet certain requirements described in the Regulations and where the charity documents the steps it has taken to meet these requirements. The requirements described in the Regulations are not applicable to transactions involving pledge workouts with donors who are also disqualified persons.

This paper proposes that Treasury issue Regulatory guidance providing a procedure for obtaining a rebuttable presumption that certain transactions involving pledge workouts with disqualified persons are not excess benefit transactions.

Guidance in this area would result in at least three benefits. First, it would eliminate added costs and hidden risks to charities and their donors created by the current uncertain state of the law. Second, it would reinforce the use of charitable pledges, thereby increasing much-needed funding in the charitable sector. Finally, it would promote fairness by giving donors who use pledge agreements, and who are also disqualified persons, the same protection as disqualified persons have in other types of financial transactions with charities.

[3] All statutory references in this paper are to the Internal Revenue Code of 1986, as amended.

DISCUSSION

I. BACKGROUND

This background discussion first provides an overview of Section 4958 and the requirements for a transaction to come under Section 4958. It then addresses the concern that a pledge workout might be considered an economic benefit to a disqualified person under Section 4958, and finally discusses the issue within the context of the specific concerns that the proposed guidance will address.

A. Section 4958

There are three requirements for Section 4958 to apply to a transaction. There must be an "applicable tax-exempt organization" that has entered into an "excess benefit transaction" with one or more of its "disqualified persons." Section 501(c)(3) public charities are among the applicable tax-exempt organizations affected by the statute.

Section 4958(c)(1)(A) generally defines the term "excess benefit transaction" to mean any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including performance of services) received for providing such benefit. The burden of proof is on the taxpayer.

The term "disqualified person" means any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization.[4] Treasury Regulation 53.4958-3(c) defines disqualified persons to include the charity's officers, directors, and key employees, as well as anyone else with substantial influence over the charity. Treasury Regulation 53.4948-3(e)(2)(ii) lists among the facts and circumstances tending to show that a person has substantial influence over the affairs of an organization the fact that the person is a "substantial contributor" to the organization, taking into account those contributions received by the organization during its current taxable year and the four preceding taxable

[4] I.R.C. § 4958(f)(1)(A).

years. For these purposes, a "substantial contributor" to an organization is any person who contributes or bequeaths more than the greater of $5,000 or 2% of the total amount contributed or bequeathed to the organization within a taxable year.[5]

Section 4958 assesses excise and penalty taxes on "disqualified persons" who engage in "excess benefit transactions" directly or indirectly with a public charity and requires that such transactions be corrected. Further, charity managers who knowingly engage in such transactions with disqualified persons may also be subject to excise taxes under Section 4958. The law contains no exception for situations involving pledge workouts.

B. Economic Benefit

A pledge workout generally includes total or partial relief from an enforceable pledge agreement. Although state laws vary, most pledges are enforceable because they involve promises on which the recipient charity relies. Entering into a pledge workout could therefore be construed as an economic benefit provided by a charity to its donor. Tending to support this interpretation is the fact that the donor is being released from a promise made to the organization that, depending on the specific terms of the agreement and the extent of reliance by the organization, may be enforceable through a lawsuit. Though there are questions about when it is economically and strategically advisable for a charitable organization to actually pursue legal enforcement of a pledge, the option to enforce the pledge still exists.

The Service has indicated that in the realm of private foundations, economic benefit is present even when a disqualified person is relieved of something resembling more of an implied, rather than an enforceable, obligation. In Revenue Ruling 77-160[6], the Service ruled that payment of a disqualified person's membership dues to their church resulted in a direct economic benefit to the disqualified person because they would have been expected to pay the membership dues personally if they had not been paid by the foundation. Despite the fact that any benefits the disqualified person received from membership were likely incidental or tenuous, the Service

[5] I.R.C. § 507(d)(2)(A).

[6] 1977-1 C.B. 351.

stated that "it may be presumed the disqualified person is being relieved of the obligation, whether or not legally enforceable, to make such payment."[7]

In the context of substitution of a larger pledge due at a later date for a smaller pledge not yet due, the Service in GCM 39644[8] concluded that modification of pledges "did not result in acts of self-dealing because the modification discharged the original pledges before maturity and the disqualified persons could not be said to derive any benefit as a result of the proposed transactions."[9] In this case the donor actually increased the pledge, but extended the time for payment. In the discussion, however, GCM 38103 was cited, and it was noted that in that situation the GCM cautioned that "cancellation of an enforceable pledge without consideration, the prepayment of a pledge at less than present value, or forbearance of enforcement of a pledge after maturity could constitute acts of self-dealing."[10] It was further noted that the Service did not agree that any modification to a pledge was immune to self-dealing prohibitions simply because the terms were acceptable to both parties. Finally, a memorandum dated March 8, 1973 was cited in which the concern was expressed that "[a]ny forbearance of enforcement could be construed as a use of a foundation's assets (the right to collect money) for the benefit of a disqualified person."[11]

Following the above analyses, if a substantial contributor, or other disqualified person, makes a pledge to a charitable organization and later enters into an agreement with the organization that will relieve all or a portion of such pledge, it is reasonable to believe there is a risk that the relief may be considered an excess benefit transaction.

These analyses, although instructive, concern private foundation self-dealing and do not necessarily apply to Section 4958 transactions. Section 4958 provisions are in many respects less stringent than Section 4941 prohibitions against private foundation self-dealing. Section 4958 is

---

[7] Id.

[8] G.C.M. 39644 (June 26, 1987).

[9] Id at 11.

[10] Id at 6. GCM 38103 dealt with a situation where the foundation, in order to meet its grant commitments, asked donors, who were disqualified persons, to satisfy their pledges early, but at less than face value.

[11] Cited in Id at 9.

concerned not with prohibitions but rather with fairness and reasonableness of transactions with disqualified persons. In enacting Section 4958 Congress did not intend to make private foundation excise tax rules applicable to public charities.

Treatment of pledges under the income tax regime would indicate that there are no economic benefits in a pledge workout, as there are no income tax consequences if a donor's pledge is terminated or reduced prior to fulfillment. In the income tax arena a charitable pledge is of little, if any, consequence. In Revenue Ruling 55-410[12], the Service ruled that satisfaction of a pledge of a specific dollar amount by a contribution of appreciated or depreciated property does not result in taxable gain or loss to the donor, reasoning that characterization of the transfer as a contribution takes precedence over its characterization as a debt, in effect stating that a charitable pledge does not constitute debt for federal income tax purposes.

II. PROPOSED ACTION

Current Treasury Regulations defining excess benefits provide a rebuttable presumption of reasonableness for transactions with disqualified persons where certain steps are taken by the charity to verify reasonableness at the outset.[13] Unfortunately, the steps contained in the current Treasury Regulations to establish a presumption of reasonableness, which entail fair market value comparisons and the like, are not applicable to pledge workouts between a charity and its disqualified persons. Thus, there is no clear Regulatory or Administrative guidance addressing pledge workouts where the pledgor is a disqualified person to the organization. We propose that Treasury provide a similar rebuttable presumption of reasonableness for pledge workouts, incorporating requirements that will allow certain pledge workouts to meet a presumption of reasonableness. Such a presumption will allow charitable organizations to use pledge agreements to their full advantage, without fear of monetary sanctions for their donors or managers.

[12] 1955-1 CB 297.

[13] Treas. Reg. § 53.4958-6.

III. SUPPORT FOR PROPOSED ACTION

A. The Benefits of Guidance

Guidance in this area would eliminate added costs and hidden risks to charities and their donors. Added costs would be avoided by eliminating the need for charities or their donors to obtain costly legal opinions on pledge workout situations, and for charities to pursue costly legal claims against their donors, especially when such claims may not be otherwise in the charities' best interests. The current state of law may lead charities and their donors to unknowingly violate Section 4958. Indeed, these hidden risks are a danger to less sophisticated charities that may not even think of Section 4958 when entering into pledge negotiations.

Guidance in this area will encourage charities to use pledge agreements without fear of risks associated with Section 4958. Use of pledge agreements fosters charitable giving at a time when the charitable sector's contribution to society is significant.

From a charitable organization's perspective, pledge agreements are important fundraising tools. A pledge agreement is often the first step in obtaining funds from a particular donor. It is an express, oftentimes public, statement of the donor's intent to benefit the charity. A pledge agreement psychologically involves the donor with the charitable organization, and provides a link for communication between those at the organization and the donor. To a charitable organization, more opportunities for contact with the donor provide more chances to involve the donor in the activities of the organization, demonstrate the good work the organization is engaged in, and inform the donor of the organizations' plans for implementing and expanding their charitable mission in the future. It is the charitable organization's hope that upon signing the pledge agreement the donor has, at the very least, a moral obligation to make a good-faith effort to fulfill the pledge.

Pledge agreements can benefit both the charitable organization and the donor by providing an opportunity to spell out intentions and expectations for all parties involved. A clear, written statement of the donor's and the charitable organization's intentions for the pledge can serve to both assure the donor of the future use of funds and demonstrate to the donor that the charitable organization is relying on their support. Details

such as naming opportunities and the donor's additional expectations are often incorporated into pledge agreements.

A pledge may also be used as publicity for the charitable organization. Press generated by a significant commitment can make others in the public aware of the charitable organization and the work that it does. The organization, with consent from the donor, may publicize the commitment among its constituency of current friends and supporters in hopes of attracting additional donors by demonstrating the willingness of others to step forward financially.

In the current climate of economic uncertainty, donors may be unwilling to contribute large amounts of cash or securities all at once. Particularly in recent years, subsequent to philanthropic optimism we saw stock prices and donors' corresponding wealth fall. A pledge agreement can give the charitable organization the relative security of a promised payment, while allowing the donor some flexibility in timing and choice of assets to contribute to charity.

The proposed guidance would promote fairness by giving donors who use pledge agreements the same protection as disqualified persons have in other types of financial transactions with charities. Donors would have access to a rebuttable presumption tailored to meet their needs and the needs of their recipient charities. The proposed guidance would also resolve an inconsistency in the treatment of substantial contributors. A donor who has made fewer payments on a pledge may have an easier time reducing a pledge under current law than a donor who has made several payments before seeking to reduce the pledge. The donor who has made substantial payments on their pledge is more likely to be a disqualified person by virtue of substantial contributor status than the donor who seeks to reduce the pledge before making significant payments.

Finally, guidance in this area will resolve an inconsistency in treatment of charitable organizations based on their size. Smaller charitable organizations with less revenue from donations and bequests will likely have more donors that fall into the category of substantial contributor. As the "in excess of 2%" amount is reduced closer to $5,000, it is also possible that a greater percentage of those categorized as substantial contributors will be donors who are less able to weather the storms of the stock market or other volatilities in the economy, and thus more likely to be in a position where

they need to renegotiate a pledge. Donors and charitable organizations that are aware of the risks might be reluctant to enter into any type of pledge agreement in order to be certain they are not at risk of sanctions.

B. Potential for Abuse is Low

Section 4958 was designed to address excessive compensation, sales of assets or loans to insiders that are to the detriment of the charity. A reduction of a pledge does not present the same potential for abuse. This transaction does not involve a transfer of tangible benefits from the charitable organization to the donor, unlike the situation where an economic benefit received by a disqualified person comes at the expense of the charitable organization (e.g., an inflated salary). Prior to the creation of the pledge, the charity has nothing of value. Rather, all value flows from the donor to the charity. Even when a pledge is reduced, the charity still benefits to some extent. If the pledge is reduced to zero, the charity is no worse off than before the donor signed the pledge, except perhaps to the extent it has relied on the pledge or has provided naming rights to the donor. When the arrangement is viewed as a whole, the donor can never get an excess economic benefit from renegotiating a pledge because only the donor is providing value.

Guidance here would have no effect on timing or amount of the donor's income taxes because only completed gifts to charity are deductible under Section 170. Taxpayers would have no income tax deduction for any unpaid pledges, so would have no tax benefits from prior deductions to recapture.

C. Problems Addressed by Proposed Change

Public Charities benefit from encouraging their donors to make long term pledges. Guidance in this area would benefit public charities that solicit long-term gifts from their donors by alleviating risk in situations where donors are also disqualified persons to the charity. It would encourage donors to make long-term gifts in which the terms of the gift are documented, but without risk of application of Section 4958 if the donor's economic circumstances change significantly.

Assuming that a substantial contributor would sign a pledge agreement to a charitable organization in good faith, it is likely that a desire to reduce the amount of the pledge would arise from circumstances such as financial difficulty on the part of the substantial contributor, or a bona fide dispute between the organization and the donor. In both cases, particularly that in which the substantial contributor is facing economic difficulty, it is unlikely that the pledge would be fulfilled even if the charity did not agree to its reduction, and possibly even if the charity chose to sue the substantial contributor in order to enforce the pledge.

Because charitable pledges are by nature meant to be satisfied over a term of years, financial circumstances are likely to change for donors. The proposed change provides flexibility for donors and for charitable organizations, particularly smaller organizations that might be more likely to have donors that rise to the level of substantial contributors. Providing a safe harbor for certain pledge workouts from the 4958 excise taxes would remove a barrier to disqualified persons entering into pledge agreements. They may otherwise not want to risk incurring a penalty if they need to reduce or withdraw their support at a later date.

For the charitable organization, a pledge agreement is a serious obligation on the part of the donor, and considered a big step in securing committed funds. Once an agreement exists, it will be harder, for many reasons, for a donor to back out of payment, but in circumstances where there is a genuine need to reduce the commitment, it should be worked out mutually between the charity and the donor without risk of prohibitive excise taxes.

D. Proposed Language for Rebuttable Presumption

This paper proposes Treasury Regulations under Section 4958 that will provide a rebuttable presumption that a pledge workout transaction is not an excess benefit transaction. The presumption would be very similar to current Treasury Regulations under 53.4958-6, except the presumption would require board approval based on factors relevant to a pledge workout scenario. We propose that the new Regulation contain the following language:

> (a) In general. Pledge workouts are presumed not to be excess benefit transactions if the following conditions are satisfied –

(1) The pledge workout is approved in advance by the board of directors of the applicable tax-exempt organization composed entirely of individuals who do not have a conflict of interest (within the meaning of paragraph (c)(1)(iii) of this section) with respect to the pledge workout.

(2) The board reviewed and weighed relevant factors as to the appropriateness of the pledge workout prior to making its determination, as described in paragraph (c)(1) and (2) of this section; and

(3) The board adequately documented the basis for its determination concurrently with making that determination, as described in paragraph (c)(3) of this section.

(b) Rebutting the presumption. If the three requirements of paragraph (a) of this section are satisfied, then the Internal Revenue Service may rebut the presumption that arises under paragraph (a) only if it develops sufficient contrary evidence to indicate that the board did not act in good faith in reviewing the relevant factors by ignoring relevant factors that would have reasonably led to a different conclusion.

(c) Requirements for invoking rebuttable presumption

(1) Approval by vote of the board of directors after consideration of the relevant factors included in (c)(2) of this section without counting the vote of any member of the board who has a conflict of interest with respect to the pledge workout.

(2) Relevant factors as to the appropriateness of the pledge workout to be considered by the board

(i) In general. The board has reviewed and weighed relevant factors as to the appropriateness of the pledge workout if it has considered sufficient information to determine that the pledge workout is reasonable and is in the best interest of the tax-exempt organization.

(ii) Relevant factors include, but are not limited to the following:

(A) The pledge was made in good faith;

(B) Since signing the pledge agreement, the donor's economic situation has changed so that it will be difficult or impossible for the donor to fulfill the pledge;

(C) It is unlikely that the organization would receive the promised funds even if they do not agree to the pledge workout;

(D) The impact of the workout on the organization's image and exposure to publicity;

(E) The impact on the organization's relationship with the donor and its other donors;

(F) Whether the donor's philanthropic interests have changed since signing the pledge agreement;

(G) Whether the donor has received any incidental benefits such as naming rights and whether the workout agreement addresses those incidental benefits;

(H) The ability of the organization to obtain another gift for a naming opportunity;

(I) The organization has not materially relied on the promised funds;

(J) Other available options for the organization and the overall strength of the

organization's legal position to enforce the pledge; and

(K) The capacity of the organization to fund an action to enforce the pledge relative to the donor's ability to resist enforcement.

If a court action is already in progress, the approval of a workout agreement by a court of competent jurisdiction will by itself be a sufficient factor for the Board's consideration.

(3) Documentation. For a decision to be documented adequately, the written or electronic records of the board meeting must meet the requirements of Section 53.4958-6(c)(3)(i)(A), (B) and (D) and must list the relevant factors considered by the board in making its decision.

(d) No inference from lack of presumption. The fact that a pledge workout between an applicable tax-exempt organization and a disqualified person is not subject to the presumption described in this section neither creates any inference that the workout is an excess benefit transaction, nor exempts or relieves any person from compliance with any Federal or state law imposing any obligation, duty, responsibility, or other standard of conduct with respect to the operation or administration of any applicable tax-exempt organization.

IV. CONCLUSION

It is currently unclear whether a pledge workout between a disqualified person and a charitable organization will be considered an excess benefit transaction resulting in intermediate sanctions. Administrative guidance providing a rebuttable presumption of reasonableness for pledge workouts with disqualified persons in certain situations and if certain requirements are met would clarify the situation for charities and their donors, and for the Service as well. Doing so will eliminate unneeded costs and risks for charities, will encourage charities to

use pledge agreements as an important fundraising tool, and will promote fairness and equity in application of Section 4958 to disqualified persons.