Harmon, Curran, Spielberg + Eisenberg, LLP

eUpdate

Legal News & Developments for Nonprofits

2011 Issue 5

IRS Seeks to Impose Gift Taxes on 501(c)(4) Donors

Recent evidence that the IRS is seeking to impose gift taxes on major donors to 501(c)(4) organizations has brought renewed attention to an issue that has long been looming. With the increasing involvement of 501(c)(4) and 501(c)(6) organizations in electoral activities following the *Citizens United* decision and other rulings See eUpdate 2010-7, many are starting to consider whether donors to these organizations might subject to gift taxes and whether there are ways to contribute to these organizations without triggering the gift tax.

The Gift Tax, Generally

At the most basic level, an individual who makes a gift worth more than $13,000 in any year owes a tax equal to 35% of the value of that gift over the $13,000 threshold. However, the gift tax is actually more complex, with special provisions exempting gifts to certain types of recipients and giving each donor a credit that lets the donor avoid paying gift tax on a significant amount of giving over the donor's lifetime.

More specifically, the gift tax applies to transfers of money or property that an individual makes without the expectation that the person making the transfer will be getting anything of equivalent value in exchange. (Transfers in exchange for something else of value – i.e. purchasing goods or services – are not transfers subject to gift tax.) When an individual, during that individual's lifetime, makes such a "gratuitous" transfer to another individual or to most types of organizations, the gift is generally subject to federal gift tax to the extent the value exceeds certain excluded amounts.

Smaller gifts are not subject to gift tax. There is an "annual exclusion" that permits an individual to make gifts of up to $13,000 each to any number of recipients during any year. Married couples are allowed to give twice that amount ($26,000) without triggering the gift tax. The amount of this annual exclusion is regularly adjusted to reflect inflation.

Gifts to certain, specifically exempted, types of recipients likewise do not trigger the gift tax. The law provides that donors do not have to pay gift tax on any contributions to 501(c)(3) organizations (charitable organizations) or to 527 organizations (political organizations). However, there is no such statutory exemption for other types of organization.

Donors who make a gift that could be subject to gift tax – a gift in excess of the annual exclusion to a recipient other than a 501(c)(3) or 527 organization – are required to file a federal gift tax return IRS Form 709, but the donor still may not actually have to pay gift tax on the excess amount. The law permits every individual to make a certain amount of gifts over the course of his or her life free from gift tax. This "unified lifetime exclusion" is currently set at $5 million. Only after a donor gives $5 million in gifts that exceed the annual exclusion (and to recipients other than 501(c)(3)s or 527s) would the donor actually have to pay gift tax. However donors need to be careful: Every gift made in excess of the annual exclusion (to a recipient other than a 501(c)(3) or 527) reduces the amount that the donor is permitted to pass to his or her heirs free from estate tax after death.

(In fact, the gift tax was originally created to prevent people from making gifts during their lifetime to avoid paying estate taxes, and the gift tax is inextricably intertwined with the estate tax. As a

result, changes in the estate tax law usually have an impact on the gift tax too. For example, the law now in place as a result of recent changes to the estate tax will result in the gift tax rate – currently 35% – going up to 55% at the end of 2011, unless further changes are made.)

If a donor fails to pay the required tax on a gift subject to gift tax, the IRS may seek to hold the recipient of the gift liable for the gift tax.

Gift Taxes and 501(c)(4)s (and Others)

Unlike the exception for gifts to 501(c)(3)s and 527s, there is not an exception in the statute for gifts to other types of tax-exempt organizations, such as 501(c)(4)s, 501(c)(5)s, and 501(c)(6)s. The IRS takes the position that contributions to these types of organization are gifts that could subject the donor to the gift tax.

Until recently, there was thought to be little if any effort by the IRS to impose gift tax on gifts donors made to 501(c)(4)s. (Some have theorized that this may, in part, be the result of IRS reluctance to take on the legal arguments discussed below.)

In recent months, however, lawyers representing 501(c)(4)s and their donors have indicated that some donors are being audited based on their failure to pay gift taxes on their donations to 501(c)(4) organizations. This rumor was confirmed with the recent release of a redacted letter from the IRS to the target of such an audit. The release of the letter led to a flurry of news reports about IRS efforts to impose the gift tax on 501(c)(4) donors. In response, the IRS released a statement clarifying that the gift tax audits of 501(c)(4) donors were of limited number and not politically motivated.

Whatever the scope of these efforts by the IRS to try to assess gifts taxes on 501(c)(4) contributions, it is clear that individuals who may not have focused on the issue in the past will be paying greater attention to the possible impact of the gift tax on their giving plans. Donors and their counsel will be looking more closely at legal arguments – arguments that are, as yet, largely untested before the IRS or in the courts – that certain transfers of funds are not subject to the gift tax:

- Prior to the enactment of the law exempting gifts to 527s from gift tax, for example, two different courts held that contributions to political organizations were not “gifts” subject to the tax because the donors received value for the contributions in the form of support for the contributor’s preferred ideology. However, another court rejected a donor’s argument that his gift to a 501(c)(4) organization that was committed to “preserv[ing] private enterprise” was a payment for services to protect the donor’s economic interests. The strength of this type of argument may turn on how specifically the payment is targeted to a particular program or the degree to which the work of the organization might be expected to benefit the donor directly.
- One of the courts in the cases above even seemed to suggest that political contributions were wholly outside the scope of the types of transfers that Congress sought to regulate under the gift tax, which might suggest that gifts to 501(c)(4)s to promote a particular political agenda could be argued to be exempt from gift tax.
- Some commentators have also suggested that restricting gifts to advocacy groups might violate a donor’s First Amendment rights of free speech and association. No court has addressed this argument head on, but recent First Amendment cases decided by the current Supreme Court (including *Citizens United*) seem to suggest that the Court might be sympathetic to such arguments.

In light of the recent enforcement efforts by the IRS, we expect to see more rulings on the merits of these arguments in the coming years, and we will continue to keep you informed about important developments through *eUpdate*.

In the meantime, Harmon Curran has provided advice to many clients over the years about the gift tax and the ways to make contributions least likely to trigger gift tax liability for the donor or the recipient of the contribution. If you would like more information about the gift tax, recent IRS

enforcement efforts, or legal strategies related to giving, please contact us.

This publication is designed to provide accurate and authoritative information about the subject matter covered. It is not distributed with the intent to render legal, accounting, or other professional advice. The services of a competent professional should be sought if legal advice or other expert assistance is required.

Harmon, Curran, Spielberg + Eisenberg, LLP
1726 M Street, Suite 600
Washington, DC 20036-4523
202.328.3500
harmoncurran.com