CHARITABLE GALAS AND AUCTIONS, PART 1

Introduction

Fundraising is one of the most important responsibilities for a nonprofit because public donations fund the nonprofit's causes. An exciting and popular method for nonprofits to raise funds is by hosting events such as galas and auctions. These fundraising events allow donors to interact with each other and give the nonprofit the opportunity to engage directly with their donors. While these events are meant to be entertaining, there are often misunderstandings regarding the tax implications of attending, donating or purchasing an item during the event.

Part one of this article series offers an overview of the often-overlooked rules surrounding purchasing tickets to charitable events. It will highlight how donors can ensure compliance by understanding both the tax treatment of these purchases and the appropriate assets donors can use to purchase tickets. Part two will give an overview of the rules for donating and purchasing items at charity auctions, equipping advisors to better assist donors who wish to claim a charitable deduction.

The Price of Admission…Trust but Verify

Attending a charity event often involves purchasing a ticket. The purchase of a ticket is generally a contribution to the nonprofit which the nonprofit should acknowledge through a receipt (the exception is a concert at fair market value). Donors attending charitable events will often be interested in claiming a deduction for their contribution. However, any charitable contribution must first satisfy substantiation requirements for a donor to claim a charitable deduction. As such, the nonprofit must provide a contemporaneous written acknowledgement (CWA), which typically includes language stating that no goods or services were exchanged for the contribution and that the nonprofit has exclusive control of the gift asset.

IRC Section 170(f)(8) provides that deductions are permissible only if the contributions are verified. Verification through a CWA is required when contributions reach certain thresholds. For example, for donated items valued at $250 or more, the donor is required to obtain a CWA from the nonprofit. An acknowledgment letter from the nonprofit in the form of a thank you letter typically suffices as a CWA. While a donor may want to deduct the full amount paid in exchange for admission to the event, quid pro quo rules must be followed for a donor to claim the appropriate deduction.

Quid Pro Quo Transactions

When attending a charitable event, a donor purchases a ticket in exchange for dinner and entertainment for the evening. This exchange creates a quid pro quo transaction where the donor is receiving a good or service in exchange for their contribution to the nonprofit. Since a donor is receiving something in exchange for the purchase of their ticket, they are unable to deduct the ticket's entire cost.

Quid pro quo contributions occur when a donor makes a payment to a nonprofit and receives goods or services in exchange. Additional substantiation rules apply if there is quid pro quo. For

instance, a disclosure statement must be provided by the nonprofit to the donor if the donor's contribution exceeds $75. If a nonprofit fails to provide a disclosure statement, the organization could be subjected to a penalty of $10 per contribution, not to exceed $5,000 per fundraising event or mailing. However, the nonprofit can avoid the penalty if it can prove the failure was due to reasonable cause.

If the ticket exceeds $75 and the value of the benefits received by the donor, such as the dinner and entertainment, is lower than the cost of the ticket, the donor is allowed to deduct the difference. In essence, if the donor pays more than fair market value for the goods and services they are receiving in exchange for the ticket, they can deduct the amount that exceeds the fair market value. However, the donor must know at the time of purchase that the value of the ticket was less than the amount paid. Adequate disclosure from nonprofits can be helpful for donors and advisors in claiming the charitable deduction.

Example 1 A theater group offers premier seating for a play that is advertised with a fair market value of $40 and the contribution list price is $100. In essence, the donor pays $100 for the ticket and the fair market value of the seat is $40. The donor will be able to deduct $60 as it represents the difference between $100 and the fair market value of $40. Even though the deductible part of the payment does not exceed $75, a disclosure statement must be provided by the theater group to the donors because each donor's payment is more than $75.

Token Gifts Exception

There is a limited exception to the quid pro quo rules if the value of the item received by the donor fits a "token gift" exception, which is tied to inflation. To qualify in 2025, the token benefit is disregarded if it is worth not more than 2% of the donor's payment or $136, whichever is less. Additionally, goods or services may be considered insubstantial if the item bears the nonprofit's name or logo, cost the organization no more than $13.60 to produce and the donor contributed at least $68. In these cases, the donor may claim the full charitable deduction. Common examples include mugs, tote bags, or stickers with the organization's branding.

Example 2 Tom attends an art gallery showcase at his favorite nonprofit's annual gala and decides to contribute $5,000 to the gallery. In return, the art gallery sends Tom a framed print as a thank you gift. The fair market value of the print is $90. Since the fair market value of the framed print is less than 2% of the $5,000 contributed, the print is considered insubstantial. Tom is not required to reduce his deduction, and the print is not considered quid pro quo.

Prohibited Methods to Purchase Tickets

Donor Advised Funds Donor advised funds (DAFs) remain a favored gift planning vehicle and some DAF donors may explore whether it is permissible for them to use a grant from his or her DAF to purchase tickets to charitable events. However, a donor is prohibited from using their DAF to purchase event tickets because this would be considered an excess personal benefit to the donor. IRC Sec. 4967. DAFs are prohibited from conferring "more than incidental" benefits to the DAF owner. This is to ensure that DAF funds are used exclusively for charitable purposes and to maintain the tax-exempt status of a DAF.

The IRS holds the position that grants from a DAF that are used to purchase event tickets provide more than an incidental benefit and could result in excise taxes on the DAF distribution. The potential excise tax is a penalty of 125% of the "excess benefit" to the donor and potentially a penalty of 10% on the fund manager if there was knowledge of the prohibited benefit. Sec. 4966(a)(2). Considering this possible penalty, most sponsoring organizations require that grants from a DAF be for charitable purposes only and will not approve grants that involve prohibited benefits. Attendees should instead be required to use personal funds outside of the DAF to purchase admission to any charitable event.

Qualified Charitable Distributions Qualified charitable distributions (QCDs) have grown in popularity in recent years as donors use their IRAs to make charitable gifts. Similar to the rules regarding DAFs, a donor is prohibited from using a QCD to purchase event tickets. Donors cannot receive any benefit in exchange for making a QCD gift because the entire QCD must be eligible for a deduction. IRC Sec. 408(d)(8)(C). The use of a QCD to purchase admission to a charitable event will result in an excess benefit to the donor as they will be receiving food and entertainment in exchange for the donation. Using personal funds to purchase the event tickets will ensure that a donor is adhering to the QCD rules and avoids taking a taxable distribution from their IRA.

Private Foundation Assets Donors may explore the possibility of purchasing charitable event tickets through a private foundation. Using private foundation funds comes with the risk of violating self-dealing rules. Under Section 4941(d)(1), private foundation self-dealing rules prohibit direct or indirect financial transactions between a foundation and disqualified persons. A disqualified person can include founders, substantial contributors, managers or family members. If a disqualified person uses a private foundation to purchase a ticket, it is an act of self-dealing since the disqualified person is receiving benefits such as food and entertainment. IRC Sec. 4941, Reg. 53.4941(d)-2.

There are some limited exceptions to the self-dealing rules. Reg. 53.4941(d)-3. For example, the foundation can claim it has a business need for the disqualified person to attend the event on behalf of the foundation. If an exception does not apply, the IRS can impose a penalty tax on the disqualified person equal to 10% of the amount involved in the act. In addition, the disqualified person must pay the foundation back for the price of the ticket. If the act of self-dealing has not been corrected, the IRS can further impose an excise tax of 200% of the amount involved. An excise tax of 5% may also be levied on foundation managers who knowingly participate in an act of self-dealing.

Given the strict rules that private foundations must adhere to, donors should use personal funds rather than private foundation funds in purchasing tickets to avoid having to pay excise taxes. If there is a legitimate business need of the private foundation to have a disqualified person attend the event, it is best to have that business purpose documented to show the attendance is in furtherance of the foundation's charitable purposes.

Conclusion

Charitable events such as galas and auctions are exciting ways to fundraise while encouraging donor engagement. However, this excitement is accompanied by specific tax rules that affect both the nonprofit and the attendees. Adhering to IRS guidelines enables professional advisors to assist nonprofits in organizing successful events that generate significant donations, while also allowing donors to support their favorite causes and potentially claim tax deductions.

ABOUT JAMES E. CONNELL

James E. Connell FAHP, CSA of Connell & Associates, Pinehurst, North Carolina, is a respected gift planning consultation firm with over four decades of experience offering a broad range of charitable estate and gift planning services to non-profits throughout the country. He heads CONNELL & ASSOCIATES, Charitable Estate & Gift Planning Specialists in Pinehurst, North Carolina. Contact him to help your organization analyze the value CGAs may provide.

Contact James at 910-295-6800 or james@connellandassoc.com or fax him at 910-295-6866