

When Charitable Gifts are Restricted – or Not

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Charitable contributions are the financial lifeblood of most Section 501(c)(3) nonprofits, so access to these funds is of vital importance! Should nonprofits allow financial gifts restricted for certain purposes? Should they encourage fundraising campaigns for specific initiatives? And what happens if gifts are identified as restricted in purpose, but such conditions later no longer make sense?

Whenever possible, nonprofits have maximum flexibility when donations are made as *unrestricted*. The nonprofit's leaders then may use the donated funds in their full discretion but still appropriately and legally within the parameters of the nonprofit's tax-exempt purposes – set forth in its corporate governance documents, website information, and other communications – and as permitted under federal and state laws.

But sometimes identifying a specific initiative may promote increased generosity through enthusiasm, passion, and dedication to a particular need. Capital building campaigns provide a prime example. “Deputized fundraising” efforts aimed at supporting certain people's work through various ministries or other Section 501(c)(3) causes are quite common. As many fundraising professionals may attest, identifying a *preferred use* of a gift may prove quite advantageous.

Further along the spectrum of specificity, a nonprofit may decide to receive a *restricted gift*, commonly seen when a donor initiates a major gift for a specific use (e.g., \$50,000 or more). In these cases, a written agreement memorializing such an arrangement is quite helpful. The agreement should set forth clear conditions for the donation and any related terms such as naming rights, and it may allow for later modification upon donor consent.

What should responsible nonprofit leaders consider in connection with charitable gifts given as unrestricted, with preferred-use, or as restricted, and what are the related legal aspects accompanying such matters? This thorough article addresses these questions particularly with respect to (1) written gift acceptance and restriction policies, (2) applicability of related laws such as the Uniform Prudent Management of Institutional Funds Act and judicial remedies like the *cy pres* doctrine, and (3) communications that optimally foster positive donor relations.

Key Elements of a Gift Acceptance and Restriction Policy

As an initial matter, a nonprofit should have a written gift acceptance and restriction policy. Such policy should identify whether and what types of donations it will receive – unrestricted, preferred-use and/or restricted gifts – along with related distinctions. Here is sample policy language that could be customized for a nonprofit's goals and specific activities.

Unrestricted Gifts

The organization should strive to accept only unrestricted gifts – that is, gifts made with no restriction or preference expressed for a particular program usage. Such approach is consistent with the organization’s Section 501(c)(3) status and particularly its legal obligation to retain control and discretion over charitable resources, to use them in furtherance of the organization’s tax-exempt purposes.

Preferred-Use Gifts

Notwithstanding the foregoing, and as the Board may determine in its discretion, the organization may identify certain ministry goals for which donors may indicate a preference through fundraising solicitations and related donor communications (e.g., for a particular large purchase or to support a specific program initiative). Consistent with Section 501(c)(3) restrictions, however, such donations should always be subject to the organization’s control and final discretion as the recipient. Consequently, an organization must communicate clearly to all prospective and current donors that it retains control and final discretion.

Such disclaimer information may be made through written solicitations, receipting, or other donor communications such as the following: *“This contribution is made with the understanding that the organization has complete control and discretion over the donated funds, including the right to use such funds for other purposes consistent with its tax-exempt mission.”* Any verbal communications may not be inconsistent with this disclaimer language.

Restricted Gifts

Additionally, and in the Board’s discretion, the organization may accept donor-restricted gifts but only upon the following conditions: (a) the organization enters into a separate written donation agreement with the donor that clearly identifies any such restrictions; (b) such restrictions may not be inconsistent with the organization’s corporate purpose, mission, and priorities; (c) the donation agreement reserves the organization’s right to broaden or alter the gift’s purpose and use if, at a later date and in the organization’s discretion, the gift’s original purpose no longer meets the needs or serves the organization’s mission – unless the Board expressly decides otherwise at the time of the donation agreement; and (d) the Board approves such written donation agreement.

Record-keeping

The organization shall maintain records regarding all restricted gifts, including copies of donation agreements and accurate accounting showing the amounts and nature of such gifts. Additionally, the organization may designate certain funds or accounts as “internally restricted” for its own programmatic and operational purposes – or more accurately and for better clarity, as “internally designated.”

Variance Power

Unless otherwise approved in advance by the Board, the organization will reserve the right, in any document that restricts the use, or reserves a preference for the use, of a gift, to broaden or alter the purpose of the gift should it be determined in the future that the original purpose of the gift no longer meets the needs or serves the mission of the organization.

Such policy should additionally address the types of gifts allowed, such as cash, stocks, real estate, vehicles, other tangible property, digital currencies, and gifts from foreign donors. The policy should also at least briefly address receipting and related IRS compliance aspects, such as appraisals to be provided to donors for gifts valued at more than \$5,000.

Applicable Legal Aspects for Gift Acceptance, Classification, and Later Modification

Nonprofit leaders benefit from understanding the applicability of related laws to ensure proper handling of charitable gifts. Clear communication with donors is best achieved with a foundational understanding of the laws defining restricted and unrestricted charitable gifts. Once a nonprofit receives restricted funds, future modifications to the legally designated use may only be possible by court order, as explained in more detail below as well.

Gift Classification Per Uniform Prudent Management of Institutional Funds Act

The Uniform Prudent Management of Institutional Funds Act (“UPMIFA”) has been adopted in all states and provides significant guidance for charitable organizations in connection with their management and investment of charitable funds. UPMIFA also imposes related legal duties, which operate to protect the interests of donors who want to see their contributions used wisely and, in some instances, for a specific purpose. UPMIFA recognizes gift classifications consistent with the above sample policy language.

Although UPMIFA is quite detailed, the following key points may be particularly helpful:

- Unrestricted funds are not subject to limitations and thus may be used by the nonprofit for whatever purpose it deems necessary, including normal operating costs, so long as such usage is consistent with its tax-exempt purposes.
- Board-designated funds are distinguishable from legally restricted funds. Such funds are technically unrestricted because any limitation on use of the funds was imposed by the Board, not a donor.
- UPMIFA recognizes that certain funds may be temporarily restricted, resulting from gifts received with a donor-imposed restriction that will be satisfied in the future (generally within one year).

- UPMIFA further recognizes permanently restricted funds (also known under UPMIFA as “endowment funds”), which are not wholly expendable on a current basis under the terms of a written gift instrument (e.g., an agreement or trust document).

- UPMIFA does not expressly address preferred-use funds, distinguishing instead between unrestricted and restricted gifts. Technically, preferred-use gifts thus should be treated as unrestricted gifts. But as pointed out elsewhere, a lack of clarity may lead donors and/or nonprofit leaders to consider them as restricted.

Identifying Types of Gifts, Per UPMIFA and Beyond

Distinguishing whether funds are unrestricted or restricted and, if restricted, the nature of the restriction, requires a careful review of the facts and circumstances to determine donor intent. UPMIFA requires a nonprofit and those who manage and invest its funds to give primary consideration to donor intent as expressed in a gift instrument. Notably, only the donor can legally restrict funds by designating a contribution to a particular use.

In addition, legally restricted funds may be received either in response to a specific solicitation campaign or offered by a donor without a prior targeted solicitation. When donations are made in response to a nonprofit’s request for donations to be used for a particular cause, the donations may become legally restricted and must be dedicated or restricted to the purpose for which they were solicited. When funds are donated with a restrictive designation independent of any solicitation communication, whether the donative funds are legally restricted or not will be determined by whether the nonprofit organization agrees to the donor’s designated use. If the donation is accepted without exception, the donation will be deemed legally restricted to the purpose specified by the donor. If, however, the nonprofit provides a disclaimer – for example, if it reserves the right to use the funds as it sees fit or advises the donor that any amounts received in excess of the budgeted amount for a particular program will be directed into the general fund for operating expenses – then the nonprofit is free to act consistent with the disclaimer.

Judicial Modification of Restricted Gifts

How may court involvement be needed in connection with gifts? Consider the following real-life example. A church raised funds over several years solely for its organ repair and maintenance. The church’s congregation then began exclusively using its piano instead of its organ. The piano then needed significant repair work. Could the church use the organ funds for the piano repair? All available information indicated that the organ funds were restricted, and the original donors are no longer involved. What permissible options does the church have?

As a starting legal point, use of restricted charitable funds outside of a donor's specifications is generally prohibited absent written donor consent or court approval. As noted above, funds with a preferred-use designation may be repurposed in the board's discretion. Similarly, a nonprofit board may designate and budget funds for a particular use and even move those funds into a protected account, but such funds may be repurposed for an alternate use at any time in the Board's discretion. So perhaps upon further investigation, the organ funds could be determined to be raised only for a preferred-use, or perhaps they were designated as such internally by the Board and not by the donors. Either finding could be quite helpful financially for the church!

Alternatively, the church could seek court permission to use the organ funds for the piano instead, under the legal doctrine of *cy pres*, which provides as follows:

If property is given in trust to be applied to a particular charitable purpose, and it is or becomes impossible or impracticable or illegal to carry out the particular purpose, and if the settlor manifested a more general intention to devote the property to charitable purposes, the trust will not fail but the court will direct the application of the property to some charitable purpose which falls within the general charitable intention of the settlor.[1]

A reviewing court thus may apply the *cy pres* doctrine to a restricted gift when the designated purpose becomes impractical, impossible to carry out or unlawful or if it becomes wasteful to continue to apply the gift to its designated purpose. *Cy pres* may be invoked only where the donor has not specified an alternate charitable purpose when changed circumstances preclude use of the gift toward its intended purpose. Even when the doctrine applies, a reviewing court typically limits use of the gift to a charitable purpose that reasonably approximates the donor's intent – not any alternate purpose.

A second, similar principle is called the doctrine of equitable deviation. This doctrine applies to charitable trusts and, again, allows a court to "direct or permit the trustee of a charitable trust to deviate from a term of the trust if it appears to the court that compliance is impossible or illegal, or that - owing to circumstances not known to the settlor and not anticipated by him - compliance would defeat or substantially impair the accomplishment of the purposes of the trust." [2] In other words, where the doctrine of *cy pres* engages the question of a change in purposes; the doctrine of equitable deviation treats the question of a change in means to fulfill the same purpose.

With respect to the organ versus piano repair question, perhaps the *cy pres* doctrine could be applied to change the purpose of the charitable funds. Or perhaps the equitable deviation doctrine could be applied, in the spirit of overall musical purposes – i.e., to provide for the church's worship music other than through an organ. But either case, the church must head to court in order to obtain such result – and likely at some expense for legal and court fees.

Fostering Positive Donor Relations

Nonprofit leaders should continue striving for very positive donor relations as an essential hallmark of organizational flourishing and future success, particularly with respect to potential gift agreements and related donation arrangements.

Clear Donor Communications

Consistent with the above policy language, nonprofits should be very clear in their communications about any restrictions that may apply to donations. Such clarity should be provided initially in connection with hoped-for donations, through follow-up charitable receipting language, and as part of any related communications such as thank-you notes from fundraisers, ministry reports from program workers, or other information aimed at encouraging a nonprofit's supporters.

These points are particularly important with respect to preferred-use gifts. Nonprofits (especially ministries) may expect their program workers to engage in their own fundraising (sometimes known as "raising one's own support" or "deputized fundraising"). All well and good. But doing so without communications clarifying that such funds raised are subject to the nonprofit's ultimate control and discretion, as indicated in the above sample policy language, may invalidate the gift's tax deductibility and instead render it only a gift given for personal benefit. In other words, if the nonprofit is operating as a "mere conduit" (in IRS parlance) for a financial gift, with no control or other power over the use of such funds, then the donation itself will not qualify for tax-deductible treatment. The nonprofit's control and discretion over such funds serve an additional legal purpose – to keep the gift from being interpreted as only for restricted purposes, which may or may not later be feasible.

Applying these concepts, consider the following example. Johnny works for Do-Gooder Nonprofit, which asks him to raise \$100,000 for earthquake relief efforts - \$30,000 for his compensation and \$70,000 for related materials. Johnny agrees and sends out letters asking for charitable support for his humanitarian trip to Syria for earthquake-related relief. He does not include any language, however, indicating that funds raised will be subject to Do-Gooder Nonprofit's control and discretion. Nor does he indicate how the funds will be divided between his compensation and materials to be purchased and distributed. Donations pour in, all specifying only that they are for "Johnny's trip." Johnny meets his target fundraising goal of \$100,000.

Are the funds restricted? Unrestricted? The answer seems rather unclear, which isn't good! It doesn't seem right for Johnny to pocket the entire \$100,000 since the arrangement was for him to be paid only \$30,000. But the donor communications did not make any such distinction, and each check and related communication came with a "Johnny's trip"

designation. One solution may be to provide clarifying follow-up charitable receipting communications that the funds will be subject to Do-Gooder Nonprofit's control and discretion. That may be enough, but likely only if no donor later raises any question.

Now consider if Johnny turns out to be a scoundrel, not at all interested in helping out with foreign humanitarian work but instead only wanted the paycheck. May Do-Gooder Nonprofit still use the entire \$100,000 raised – for earthquake relief efforts only in Syria? Or more generally for relief efforts? Perhaps, but it would be far better and clearer if all related fundraising communications specified that while Johnny may have been doing the fundraising work, all such raised funds are available for earthquake relief efforts as Do-Gooder Nonprofit may decide in its discretion.

In sum, preferred-use gifts may be helpful for a variety of practical reasons. But related communications should clarify that such gifts are neither restricted nor a mere conduit for any individual's personal financial benefit.

Questions to Address Before Accepting Restricted Gifts

When a donor offers to make a restricted donation, a nonprofit's leaders should consider some key questions, including the following:

- a. Does the restriction align with the organization's exempt charitable purpose?
- b. Can the organization abide by the restrictions, both from a programmatic and an administrative perspective?
- c. Does the gift meet the criteria of the organization's gift acceptance policy?
- d. Does the organization have any additional rules, standards, procedures, or limitations related to restricted giving?
- e. As a practical matter, may this donor be persuaded to make a preferred-use gift instead, leaving ultimate control and discretion to the nonprofit?

Depending on the answers to these questions, the proposed restricted donation may be a good match. If there is any doubt that a proposed restricted donation can be put to its intended use, the leaders should further engage the donor to determine whether a broader restriction, preferred-use specifications, or fully unrestricted donation can be developed instead.

Make It Plain – Again and Again

The examples of "Johnny" and the "organ repair" commonly arise, and resoundingly illustrate the benefit and importance of clarifying gifts as unrestricted or – at most – as preferred-use (therefore legally unrestricted). A gift acceptance and restriction policy should provide

critically important guidance for nonprofit leaders.

Fundraising-related communications should make the nonprofit's control and discretion abundantly clear. Particularly with respect to any individual support-raising or similar deputized fundraising, the following sample instruction may be helpful:

[Nonprofit] is a tax-exempt organization under Section 501(c)(3), and donations given in support of its programs are generally tax deductible. In all fundraising activity, both verbal and written, [Worker] must make clear that donations are intended to benefit [Nonprofit and [Worker's] involvement with it. Solicitations for donations thus may include a request that [Worker's] supporters designate their preference for supporting a specific worker, but with the disclaimer that such donations are always subject to [Nonprofit's] control and final discretion as the recipient. When making written donation solicitations, [Worker] must provide all potential donors with the following statement: *"This contribution is made with the understanding that [Nonprofit] has complete control and administration over the use of the donated funds."*

Correspondingly, all fundraising solicitation materials for a particular program or person should include the express disclaimer that the organization reserves the right to use contributions as it sees fit and in furtherance of its charitable purposes. Additionally, if the nonprofit intends to distribute a certain amount of funds for a specific charitable program, it may be helpful to specify in its solicitation materials that any contributions received over and above the budgeted amount for the that charitable program will be put into the general fund for operating expenses. Donation receipts should likewise reiterate this disclaimer.

When and if a restricted gift is made, the surrounding communications should be abundantly clear such as through a carefully articulated written gift agreement. Note too that it may be possible to ask donors later to modify or release restrictions imposed by a gift agreement, such as to repurpose the gift toward general operating expenses, and they may be quite amenable to doing so. But then again, it may be difficult to track down donors later, and if so, modification will be available per court order as explained above.

Final Thoughts

Donations come in a variety of forms, and some with actual or potential strings attached, presenting complexities, ambiguities, or other problems for nonprofits. Developing a strong policy upfront, articulating clear donation parameters such as through appropriate disclaimers, and addressing related issues such as the advisability of accepting restricted gifts (or otherwise internally identifying certain funds as restricted) should all promote positive donor relations and effective advancement of nonprofit goals – and fewer headaches for nonprofit leaders!

[1] Restatement 2d of Trusts, § 399. See *also* City of Aurora ex rel. Egan v. YMCA, 9 Ill. 2d 286, 294 (1956) (quoting Restatement 2d of Trusts, § 399). A court should not apply the property in question necessarily “to purposes as nearly as possible like those designated by the terms of the gift,” but rather seek[] to frame a scheme which on the whole is best suited to accomplish the general charitable purpose of the donor.” *Restatement 2d of Trusts, § 399 (comment b)*. Furthermore, in creating such a scheme, a court must engage in a holistic analysis to determine an appropriate way to accomplish such general charitable purpose. See *Restatement 2d of Trusts, § 399 (comment d)*.

[2] Restatement 2d of Trusts, § 381. This doctrine is different from the *cy pres* doctrine - the rule under the doctrine of equitable deviation: *has to do with the powers and duties of the trustees of charitable trusts with respect to the administration of the trust; it has to do with the methods of accomplishing the purposes of the trust,” whereas the doctrine of cy pres engages the “question of the extent to which the court will permit or direct the trustee to apply the trust property to charitable purposes other than the particular charitable purpose designated by the settlor where it is or becomes impossible or illegal or impracticable to carry out the particular purpose.” Restatement 2d of Trusts § 381 (comment a)*.



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