

Contributions and Premiums

By Pamela McAllister

The IRS recently revised the rules regarding premiums for charitable donations. Here's what the new rules mean for 501(c)(3) organizations and their donors.

When a charity gets a donation, what the donor generally gets in return is a warm feeling and a full tax deduction. Sometimes charities also offer small items – address labels, T-shirts, mugs, or calendars – as a token of their appreciation. More ambitious fundraising campaigns may involve large donations and more valuable enticements. And membership campaigns may offer prospective members certain benefits, such as newsletters, tickets to special events, and discounts on products.

Goods and services that you offer in exchange for contributions are referred to as "quids pro quo" in the federal tax law. Most fundraisers call them "premiums."

Premiums can affect the amount of the tax deduction to which a donor is entitled. In general, the donor's deduction is limited to the value of what the donor gave the charity, less the value of the premiums that the charity gave the donor in exchange. Charities need to inform donors of this rule and give them a reasonable estimate of the value of the premiums they've received, although the value of certain premiums may be disregarded.

This is what you need to tell each donor:

- the first rule of the charitable contribution deduction – that the donor's deduction is the amount of the contribution less the value of any premiums, and
- your good faith estimate of the value of the premiums that the donor is receiving.

There's no prescribed form for the statement you provide the donor. As long as you include the required information, you can use any wording that suits your organization's style. Here are two examples of what you might say (assuming you've received a cash donation in exchange for a premium worth \$30):

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- For federal income tax purposes, you can deduct as a charitable contribution the amount of your contribution less the value of the premiums you have received. We estimate the value of the premiums you've received to be \$30.
- We are required to inform you that your federal income tax deduction for your contribution is the amount of your contribution minus the value of the premiums you receive. We estimate the value of your premium to be \$30. We would also like you to know that all fundraising premiums are donated to this organization, so your entire donation will be used to support our programs. [The last sentence is not required, but donors might like to know. Include it only if it's true!]

Be sure to include on your solicitations and receipts anything state laws require. And always properly acknowledge contributions of \$250 or more.

Note: A valuable premium reduces the donor's contribution deduction even if the donor receives the premium in a later year.

What categories can you disregard?

There are five categories of premiums you can disregard for purposes of determining the amount of the donor's charitable deduction. If a premium falls in any of these categories, it may be disregarded.

1. Low-value premiums

Premiums can be disregarded if the fair market value of all the premiums received in connection with the contribution is not more than 2 percent of the contribution or \$71 (in 1998), whichever is less. The dollar amount is adjusted annually for inflation.

Examples (for 1998):

- A donor contributes \$100 and receives a premium worth \$10. Two percent of the contribution is \$2 (which is less than \$71). Since the premium is worth more than \$2, the premium cannot be disregarded under this rule.
- A donor contributes \$100 and receives premiums worth a total of \$2. Two percent of the contribution is \$2 (which is less than \$71). The premium is not worth more than \$2, so it may be disregarded.

- A donor contributes \$4,000 and receives a plaque. Two percent of the contribution is \$80. The lesser of \$80 and \$71 is \$71. The plaque may be disregarded if it's not worth more than \$71.

2. Low-cost logo premiums

It's common to offer a T-shirt or similar logo product as a premium. These premiums may be disregarded if:

- the contribution is at least \$35.50 (in 1998),
- the only premiums are token items – bookmarks, calendars, key chains, mugs, posters, T-shirts, etc. – bearing the organization's name or logo, and
- the organization's total cost (not the fair market value) for all the premiums is not more than \$7.10 (in 1998). The \$35.50 and \$7.10 amounts are adjusted annually for inflation.

Examples (for 1998):

- A donor contributes \$30 and receives a calendar bearing the organization's logo. The calendar cost the organization \$4. The calendar cannot be disregarded because the contribution was less than \$35.50.
- A donor contributes \$35.50 and receives the same calendar, plus a key chain that cost the organization \$1. The premiums may be disregarded because the contribution was at least \$35.50 and the organization's total cost for the premiums (\$5) was not more than \$7.10.

A donor contributes \$80 and receives a calendar that does not bear the organization's name or logo. The calendar cost the organization not more than \$7.10. The premium cannot be disregarded because it's not a logo item. On your notice to the donor you will need to include your good faith estimate of the value of the calendar.

3. Free, unordered, low-cost premiums

Solicitations are often sent accompanied by address labels, note cards and other small premiums. These premiums may be disregarded if

- they are mailed (or otherwise distributed) to prospects without the request or consent of the prospect,
- they are accompanied by a request for a charitable contribution,

- they are accompanied by a statement that the prospect may retain the item whether or not she makes a contribution, and
- the organization's total cost (not the fair market value) for all the premiums sent to the prospect during a calendar year is less than \$7.10 (in 1998). The \$7.10 amount is adjusted annually for inflation.

4. Membership benefits

You may disregard membership benefits if they are offered for \$75 or less per year and consist of

- rights that the member can exercise "frequently" during the membership period, such as free or discounted admission to the organization's facilities or events, free or discounted parking, preferred access to goods or services, and discounts on the purchase of goods or services, and
- admission to members-only events, each of which costs the organization less than \$7.10 (in 1998) per person. The member can actually pay more than \$75 for the membership, as long as the membership benefits are available for \$75 or less.

It is not altogether clear what "frequently" means. Twice a year is not "frequent," but 50 times a year is. This is an area in which you'll need to exercise some judgment. If in doubt, consult your professional advisors.

There's a special rule for the right to purchase tickets to college athletic events. If you're with a college or university and this is one of your premiums, here's the rule: The right to buy tickets for seating at college or university athletic events is treated as having a value equal to 20 percent of the contribution. So if a donor pays \$312.50 and receives in exchange the right to buy such tickets, the donor's charitable contribution is only \$250 (\$312.50 less 20 percent).

5. Premiums rejected by the donor

You may have seen solicitations that offer premiums, but also include a checkbox on the return coupon so that the donor may decline the premiums being offered. If the donor uses such a mechanism to decline the offered premiums, the premiums may be disregarded.

If the donor does accept a premium – such as tickets to an event – and simply decides not to use it, the premium cannot be disregarded. But if the donor returns the premium to the charity for reuse or resale, it can be disregarded.

Don't confuse the cost of a premium with its value!

The cost of premiums is used for convenience in determining whether premiums can be disregarded using some of the rules described in this section. That doesn't change the first rule: the donor's tax deduction is always the amount contributed less the value (not the cost) of any premiums that cannot be disregarded.

Determining the cost of premiums

There are several rules to follow in determining the cost (not the fair market value) of premiums offered in fundraising and membership campaigns.

1. Members-only events

As discussed above, certain membership benefits can be disregarded, including admission to members-only events that cost the organization less than \$7.10 per person (in 1998). You should determine the projected cost of members-only events at the time you first offer your membership package for the year. Include only the direct costs of the event—ignore any organizational overhead that might be allocable to the event.

Many organizations obtain donations of food and other goods and services to put on their events. Unfortunately, you have to include in your cost calculation a reasonable estimate of the amount you would have had to pay for the goods or services if they hadn't been donated.

2. Newsletters and other publications

Newsletters, program guides and other publications are treated as if they have no cost if

- their primary purpose is to inform members about the activities of the organization,
- they're not available to nonmembers by paid subscription or through newsstand sales, and
- they're not commercial quality publications. Whether something is a "commercial quality publication" depends on all the facts and circumstances. Publications that accept advertising and contain articles written for compensation are treated as commercial quality publications. Professional journals are also treated as commercial quality publications, whether or not their articles are written for compensation and whether or not they accept advertising.

If a publication is commercial quality, its cost includes the costs of production and distribution. Income from advertising or newsstand and subscription sales cannot be used to reduce the cost for the purposes of the rules discussed above.

3. Donated premiums and services

Most organizations work hard to obtain donated premiums for fundraising campaigns. Unfortunately, the "cost" of a donated premium equals a reasonable estimate of the amount you would have had to pay for the premiums if they had not been donated.

Similarly, if donated services are used to produce a premium, the cost of the premium must include a reasonable estimate of the amount you would have had to pay for the services if they had not been donated.

Example: You receive a donation of 100 videotapes, which you use as premiums in a fundraising campaign. You estimate that you would have had to pay \$1500 to buy the videotapes if they hadn't been donated. Your cost for each videotape is considered to be \$15.

Finding the inflation-adjusted amounts

Toward the end of each calendar year, the Internal Revenue Service considers inflation and adjusts the \$71, \$35.50 and \$7.10 amounts referred to here. The new amounts, which are effective for the following calendar year, are published in a Revenue Procedure (a type of official Internal Revenue Service publication). The ruling contains a diverse collection of inflation adjustments for all sorts of tax rules. What you're looking for are the "Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns," the "\$5, \$25, and \$50 guidelines in section 3 of Rev. Proc. 90-12." For 1998, these amounts are \$7.10, \$35.50, and \$71, respectively.

You can find the current amounts, as well as those for recent years, at <http://www.exemptlaw.com>. (Do a search for "low cost article" or look through the FAQs on charitable contributions.) You can also watch for announcements of the new rates in the nonprofit press, or ask your attorney or accountant.

There's no automatic inflation adjustment for the \$75 amount used in determining whether you're required to give the notice described above, or whether membership benefits are disregarded.

Determining the value of premiums

When you offer premiums that cannot be disregarded under the rules discussed here, you must provide your donors with "a good faith estimate" of the value (not the cost) of the premiums. You can use any reasonable method to determine this estimate. Examples of reasonable methods include comparison with comparable resale prices and markup from wholesale cost.

Be sure to keep records of how you've determined the value of premiums.

Premiums available commercially

If a premium is a product sold in stores (or otherwise available commercially), you could survey a few stores and determine a reasonable retail price for the product. As long as the price is within the range of typical retail prices for the premium, it will be a good faith estimate of the value of the premium.

Example: You offer as a premium a book that is sold in stores in your community. You survey a few stores and find prices ranging from \$18 to \$25. You select a price in this range as your estimate of the book's value.

A similar approach would be appropriate for services that are commercially available.

Example: You offer as a premium a one-hour tennis lesson with a certain tennis professional who ordinarily provides one-hour tennis lessons for \$100. The value of the premium is \$100.

Premiums not available commercially

If the premium is not available commercially, you can estimate its value by comparing it to similar or comparable goods or services. You can disregard any unique qualities of the premium.

Example: Your museum allows a donor to hold a private event in a room at the museum, in exchange for a suitably large donation. You don't ordinarily rent the museum for private events. There are two hotels in the community

with ballrooms similar to the museum's room in capacity, amenities and atmosphere. The hotels, of course, don't have the museum's unique art collection. The value of the right to hold a private event at the museum is the cost of renting a ballroom at one of the two hotels. (You can choose one of the ballrooms – you're not required to take an average or select the higher-cost facility.)

Celebrity presence disregarded

If you involve celebrities in your fundraisers, you don't need to consider the value of their presence in determining the value of your premiums.

Example: You offer a tour of a community museum, to be conducted by a famous artist, in exchange for a certain level of donation. Ordinarily, tours of the museum are free and are conducted by museum staff. The presence of the celebrity is disregarded, so the tour is considered to have no value.

Examples of premium packages

The following are just a few examples of how to apply these rules. There are countless possible combinations of premiums, so you'll need to consider the variables in your own particular situation.

Example 1

An arts center offers a package of basic membership benefits for \$75 a year. The benefits include

- the right to buy tickets to performances a week before they go on sale to the general public,
- free parking in the center's garage during evening and weekend performances, and
- a 10% discount on merchandise sold in the gift shop. The center holds about 50 performances each year. The gift shop is open several hours a week and at performance times. Therefore, all of the basic membership benefits may be disregarded because they are available for \$75 or less per year and they are rights that the member can exercise frequently during the membership period. The full amount of the \$75 membership fee is tax-deductible. The center can state on its fundraising materials and receipts that no premiums were given to the donor.

The arts center also offers a preferred membership package. Preferred members pay \$150 a year and receive the basic membership benefits, plus

- a poster that sells for \$20 in the gift shop.

The basic membership benefits can still be disregarded, but the poster cannot. Its value is \$20. A member who pays \$150 for a preferred membership and accepts the poster can deduct only \$130 (\$150 less the \$20 premium). The center must state on its fundraising materials and receipts that a premium worth \$20 was given to the donor.

Example 2

A community theater performs four different plays each summer. Each play is performed twice. The theater offers members free admission to any of its performances. The theater's membership fee is \$60. Nonmembers can buy tickets to the performances for \$10 each.

The membership benefit cannot be disregarded because it can't be exercised frequently (due to the limited number of performances each year). A reasonable value for the four free admissions would be \$40. A member who pays \$60 for a membership can deduct only \$20: the \$60 membership fee less the premium worth \$40.

Example 3

A museum offers \$50 junior memberships that entitle the member to

- free admission to the museum and to weekly films, slide show and lectures, and
- a bimonthly, noncommercial quality newsletter with information about the museum's programs and events.

All of the premiums may be disregarded. The free admissions are a membership benefit that can be exercised frequently. The newsletter is considered to have no cost or value. So the entire \$50 membership fee is tax-deductible.

Multiple memberships: If a donor pays the museum \$300 for six junior memberships – one for each of her grandchildren – the museum can say that no premiums were given, and the donor may deduct the full \$300.

Example 4

A museum offers a \$40 basic membership package that includes

- free admission to the museum, and
- a 10% discount on merchandise purchased in the museum's gift shop.

These basic membership benefits may be disregarded because they are available for \$75 or less per year and can be exercised frequently during the membership period. So an individual who becomes a basic member for \$40 may deduct the entire \$40.

Variation: A corporation donates \$50,000 to the museum. In return, the museum offers the corporation's employees

- free admission for one year,
- a T-shirt with the museum's logo that costs the museum \$4.50, and
- a 25% gift shop discount for one year.

The free admission may be disregarded because it is available for less than \$75 (as part of the \$40 basic membership package) and can be exercised frequently during the year. The T-shirt can be disregarded because it is a low-cost logo premium. But the gift shop discount is more valuable than the discount offered in the basic membership package, so it cannot be disregarded. The museum must describe the gift shop discount – including the percentage and any other terms – in its gift acknowledgment to the corporation. Under the special rule for premiums provided to the donor's employees, however, the museum does not have to assign a value to the discount.

Premiums expected but not promised

If a donor expects to receive a valuable premium, the value of the premium reduces the donor's charitable deduction. This is true even though the charity did not explicitly offer or promise the premium.

You may be wondering how you can be expected to know what your donors are thinking. You can't know for sure, but you can look at your fundraising practices and decide whether there are patterns that might lead donors to expect certain premiums. The Internal Revenue Service takes this approach and looks at all the facts and circumstances to determine whether donors are expecting premiums.

Here's a common situation that illustrates this rule: Many organizations recognize their major donors by providing annual appreciation events. For example, you may have a history of sponsoring an annual dinner-dance for major donors. In that case, a donor making a substantial contribution may reasonably expect to receive an invitation to a similar dinner-dance. And the value of the dinner-dance must be considered in determining the donor's charitable deduction.

To complicate matters, the Internal Revenue Service believes that a donor can be expecting an event invitation, even though the charity sponsors a different type of donor appreciation event each year.

Ignoring this principle may lead you – and your donors – into troubled waters. Perhaps the most direct approach is to be up-front with your major donors, telling them (in writing) what they can expect at each level of contribution, the estimated value of the premiums, and that their charitable contribution deduction is limited to the excess of their contribution over the value of the premiums.

And remember that donors are free to decline premiums and avoid any loss of their tax deduction.

Premiums to employees or partners

When soliciting contributions from businesses, you may want to offer premiums to the donor's employees. If the business is a partnership, as many professional firms are, you may want to offer premiums to the partners as well.

If the premiums can be disregarded under the rules described in "Which premiums can you disregard?" above, you can also disregard them in this context.

For valuable premiums that cannot be disregarded, you'll need to describe the premiums on the receipt or thank-you note that you give the donor. But you don't have to estimate the value of the premiums.

*Pamela McAllister is an attorney who specializes in tax-exempt organizations. This article is excerpted, with permission, from *The Charity's**

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