



MAY 2019

Historic Gift Relieving Student Debt for Morehouse Class of 2019 Highlights Philanthropic Opportunities, Tax Challenges

During his commencement address to the newest graduates of Morehouse College on May 19, 2019, private equity billionaire and philanthropist Robert F. Smith surprised the 400 graduating seniors with the gift of a lifetime: “This is my Class, 2019. My family is making a grant to eliminate their student loans.” Estimated at \$40 million, the Smith family pledge marks the largest gift ever made to a historically black college or university.

This incredible generosity has inspired Morehouse graduates to “pay it forward,” and it is fueling a national conversation on ways to address America’s growing student debt crisis. The gift also raises significant tax law and policy questions regarding using philanthropy as a vehicle to pay off student debt.

Without speculating about tax planning around the Smith gift in particular, in this alert we examine the important tax considerations for the parties involved in pledges and gifts of this nature. We also offer guidelines on how best to structure this kind of philanthropy to maximize the charitable deductions for the donor, to minimize gift tax for the donor, to minimize legal risks for the charity and to avoid income tax for the students.

Takeaways

- To qualify for both gift tax and income tax charitable deductions, the donor should give directly to a college or other organization exempt under Section 501(c)(3) of the Internal Revenue Code to be used in furtherance of charitable and educational purposes, rather than giving to the student or to the holder of the debt on the student’s behalf. The gift should not be “earmarked” for the benefit of an individual or an identifiable group of individuals. Instead, the charity (not the donor) should have complete control over the contribution and discretion with respect to the selection of beneficiaries.
- The recipient educational institution or charity can reduce its own legal risk by tailoring a student loan relief program to benefit students who are part of a charitable class — such as students from families of lower economic means or who are the first in their family to attend college. The broader and more open-ended the beneficiary class, the better.
- To ensure that the funds are considered nontaxable income to the recipients, the terms of any individual grant should not require a student/graduate to provide any services in return for the payment of student loan debt.

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Maximizing the Income Tax Charitable Deduction

A donor is generally permitted to take an income tax deduction for making a charitable contribution to a university or other Section 501(c)(3) organization, subject to certain limitations relative to the type of property contributed and the donor's adjusted gross income. If the donor earmarks the contribution to benefit one or more designated individuals, then the contribution typically is not deductible.

Many commenters have assumed that the IRS' earmarking rules would deny Robert Smith a charitable deduction for his gift to Morehouse because, by definition, the "Class of 2019" is a finite and identifiable group of individuals. In order to mitigate the risk that a gift to a charity will be deemed earmarked, and therefore not deductible, a donor should avoid designating a clearly ascertainable class of individuals as the ultimate beneficiaries of the gift. Instead, the charity should retain full control and discretion as to which specific students will benefit from the student debt relief fund.

Minimizing the Gift Tax Implications

A donor's gift to a charity is not subject to gift tax if it is made for the charity's use in carrying out its charitable and educational purposes. Here again, however, earmarking for a specific recipient can undermine the desired deduction. If a gift is earmarked (expressly or by implication) by the donor to benefit a particular individual, with the charity serving as a mere pass-through intermediary, the tax law treats the gift as though the donor had given it directly to the individual, rendering the gift taxable to the donor for gift tax purposes.

Alternatives to Consider

While gifts made directly to or earmarked for students would not qualify for either the income tax or gift tax charitable deductions, there are other options. Donors can assist students with education-related costs or debt without incurring a gift tax or inadvertently

exhausting the donor's lifetime gift tax exemption, or both.

- **Payment of Tuition.** If the goal is to assist specified students with tuition assistance while the students are attending school, the donor may make unlimited gifts directly to the educational institution for tuition expenses on behalf of the specified students. While these gifts are not deductible, they do qualify for the unlimited gift tax exclusion for tuition expenses.
- **Annual Exclusion Gifts for Other Expenses/ Debts.** If a donor desires to assist certain students with expenses related to education other than tuition, or to pay off a student's education-related debt, the donor may take advantage of the gift tax annual exclusion of \$15,000 per individual student in 2019 (or \$30,000, if the donor is married) by making annual gifts to individual students or graduates to assist with such costs. Any gifts exceeding the annual exclusion amount per student in each year would utilize the donor's lifetime gift tax exemption amount (currently \$11.4 million) and, if the exemption is exhausted, incur a 40% gift tax.

Minimizing Risks to Charity

Robert Smith's gift to Morehouse College is the stuff of university/charity development officers' dreams. But after the initial glow passes, serious questions arise as to whether a university or other charity may use its charitable resources to pay off students' debt (which may include costs of tuition, room and board, living expenses, and accrued interest) after they have already finished their educational studies. While IRS regulations and guidance provide a general framework for thinking about this question, there is nothing definitive yet on whether using an educational institution's resources in this way serves a permissible exempt purpose.

Federal tax law allows universities and other charities to provide grants to pay student tuition regardless of need on the grounds that these grants serve a permissible educational purpose. So, for example, a well-endowed school such as NYU School of Medicine can offer students a tuition-free graduate education. But it is not currently clear whether the IRS would apply that same logic to the payment of student debt after a student has already graduated. Absent clear guidance or a private letter ruling on the point, perhaps Morehouse will take the position that making individual grants to help graduating students pay off their educational loans is substantively the same as alleviating their tuition obligation, only after the fact. It remains to be seen whether the IRS will agree with this view. But to minimize legal risk, a university or charity should consider focusing a student loan relief program on benefiting graduates from a recognized charitable class, such as graduates who are financially distressed or historically disadvantaged.

Avoiding Taxable Income to Students

Properly structured, gifts to pay off student loans should be income tax free to the receiving students.

If a graduate receives a cash gift from an individual donor or a grant from a university or other charity to be used to pay off student loan debt with no requirement that the graduate perform any services in return for the gift or grant, the value of the gift will not be considered income to the graduate. The same would result if an individual donor or an organization were to pay off a graduate's loans by making payment directly to the lender on behalf of the graduate. But if there are strings attached, the direct or indirect payment may be considered taxable income to the graduate.

Finally, income generally includes discharged indebtedness resulting from a lender or note holder forgiving or discharging a debt currently owed by a borrower. In the case of a gift or grant from a third-party donor or charity to pay outstanding student loan debt, however, this payoff would constitute a gift to the graduate, rather than a discharge of indebtedness by the lender; therefore, no tax would be triggered.

Donors, educational institutions and charities involved in pledges and gifts to alleviate educational debt should consult their respective tax advisers. Please call any of the lawyers listed below, in Loeb & Loeb's Trusts & Estates and Exempt Organizations practices, if we can help with your philanthropic planning during this graduation season.

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