The Economic Substance Doctrine of Charitable Gift Financing

Our goal at Wealth Excel is to help high-wage earners and profitable small-business owner clients amplify charitable giving by leveraging third-party financing. Our blueprint outlines the advantages of capitalizing on the law enacted in 1978 (IRC §170(a)) that is true today.

Small businesses donate 250% more than larger businesses to local non-profits and community causes, with about 75% contributing an average of 6% of their profits annually. The reason for this generosity is simple — 85% of consumers look favorably on a company that gives back to its community. The results translate to boosted sales, building trust, increasing word-of-mouth marketing, and establishing a small business as a critical member of the local economy.

We think donating your money to charities is a meaningful endeavor and using third-party financing could make it substantially rewarding. That is where charitable gift financing (CGF) comes into play.

What is Charitable Gift Financing?

The idea of CGF is straightforward and somewhat formulaic, benefiting all parties involved — donors, charities, and lenders. It is a strategy that empowers those charitably inclined high-net-worth individuals and small business owners to utilize third-party lenders to make a tax-deductible contribution to qualified 501(c)(3) organizations.

Suppose the donor wishes to give a significant cash donation but only has the funds for a modest giving. That giver can leverage a third-party lender to make a more substantial gift registered in the donor's name. The loan will need to be paid off sometime in the future using life insurance proceeds. The law says that when debt to a third party is used to make a charitable contribution, the taxpayer is entitled to a tax write-off under IRC §170(a) in the year the gift was made, and the deduction may not be postponed until the taxpayer pays the indebtedness. Rev. Rul. 78–38, 1978–1C.B.67, Granan v. Comm. 55 T.C. 753 (1971).

Leveraging CGF allows donors to make much greater cash donations with less burden on their cash flow while minimizing current income tax and or capital gain tax liability. Should the donor desire to continue giving, they can borrow more to apply in future tax situations. If it sounds too good to be true, let's review what the law says.

The Economic Substance Doctrine

In 2010, then-President Obama signed the Health Care and Education Affordability Reconciliation Act of 2010. Under IRC section 1409 of this act, language was introduced to codify the economic substance doctrine as it applies to transactions entered into after March 30, 2010.

The economic substance doctrine exists to test whether a transaction meets a two-prong test. Otherwise, it is viewed as doing nothing more than lowering an individual or entity's federal income tax obligation.

Section 7701(o) outlines that the IRS can determine if a transition has economic substance. In other words, is the charitable gift financing the taxpayer is entering into relevant to the situation or is the taxpayer just trying to reduce their tax. The CGF passes this test as follows:

1. A donor will enter into a credit line agreement with a third-party lender for the purpose of making a charitable donation. The substantial purpose of this charitable gift financing is to provide immediate funding to a qualified 501(c)(3) charitable organizations.

2. The economic effect of financing this gift creates a more significant immediate cash donation than may be possible without financing. Contribution is more considerable because financing allows donors time to repay the debt from their future earnings or use collateral such as life insurance.

As for the economic substance doctrine in general, a transaction must change the donor's economic position in a meaningful way other than federal income tax effects, and it must fulfill a substantial purpose other than reducing your tax obligation.

At Wealth Excel, we focus on small but profitable business owners between 40 and 65 looking to take the next step in their life and retirement needs. We work diligently for our clients to build up substantial retirement accounts faster while also controlling cash flow and tax payables. This allows for a graceful exit strategy where you can focus on the future of your business while we handle the future of your personal income. We invite you to give us a call today, and let's build a stronger tomorrow with our Charitable Gift Giving Blueprint for your Charitable Gift Giving.

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Wealth Excel is a highly specialized consulting and investment advisory company providing wealth-growth solutions for profitable small business owners through comprehensive tax-saving strategies, precision retirement plans, and custom-built investment portfolios. Launched in 2020 in Los Angeles, California, the Wealth Excel team has over 30 years of combined experience serving the needs of high-income and high-net-worth clientele nationwide.