

AMERICAN BAR ASSOCIATION
2009 Joint Fall CLE Meeting

The Section of Taxation and the Trust and Estate Law Division
of the Section of Real Property, Trust and Estate Law

September 24-26, 2009
Chicago, Illinois

Committee: Exempt Organizations, The Section of Taxation

Panel: Special Charitable Deduction Rules

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SPECIAL CHARITABLE DEDUCTION RULES¹

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¹ These materials are drawn from the presentation by Martin Hall and Jerry J. McCoy, *Setting the Stage for Charitable Giving*, ALI-ABA Course of Study SRO11 “Charitable Giving Techniques” (July 2009) (hereinafter, “ALI-ABA SRO11”).

I. INTRODUCTION

A. Overview

1. A donor is entitled to a federal income tax deduction for the full amount of a “charitable contribution” as defined in Section 170(c) of the Internal Revenue Code.¹ In the case of a cash gift, the deduction amount is the amount of cash contributed. In the case of a gift of property, the income tax deduction generally is measured by the fair market value of the property contributed. In addition, a charitable “and similar” gift made during lifetime, or a “transfer for public, charitable and religious uses” made at death, is not subject to federal gift or estate taxes (§§ 2522 and 2055). This outline will examine the history and place of the charitable deduction in the federal tax system, review the scope of and limitations on the deduction, and highlight the important differences that exist in the deductibility of charitable transfers under income and transfer tax laws.

B. Is it a gift?

1. While the Internal Revenue Code lists the types of organizations to which a contribution, gift or transfer may be deductible, it leaves the actual definition of contribution, gift or transfer open. The courts, in determining whether a contribution to a charity by an individual qualifies for a charitable contribution deduction, have long applied the subjective concept of “detached and disinterested generosity” made out of “affection, respect, admiration, charity or like impulses” (*Comm’r v. Duberstein*, 363 U.S. 278, 285 (1960)).
2. The Test: Despite the implications of *Duberstein*, the regulations accompanying section 170 have applied a more objective, two-part test, recognizing that not all gifts are made with purely philanthropic intent. The regulations provide that a payment made to a charitable organization is considered a contribution or gift only to the extent that (1) the taxpayer intends to make a payment that exceeds the fair market value of goods or services received; and (2) actually makes a payment in an amount that exceeds the fair market value of any goods or services received (Treas. Reg. § 1.170A-1(h)(1)).
 - (a) Indeed, many charities are involved in transactions, such as auctions, fundraisers, and raffles, that raise money for the charity but do not necessarily involve gifts by the contributors.
 - (b) These types of transactions are subject to *quid pro quo* rules, discussed further in Section I.D.3(j), below.
3. Overly Restrictive Gifts: If the terms of a transfer are too restrictive, the transfer might not be considered a gift.

¹ The Internal Revenue Code of 1986, as amended, hereinafter known as the “Code.” All section references are to the Code, unless otherwise indicated.

- (a) *Gifts benefitting specific individuals* – A gift may not be made to benefit a specific individual who is a member of a class that the charity exists to benefit. If a gift is earmarked for a particular individual so that the charity is simply a conduit, the deduction is denied. For example, a gift to a college applied directly to an identified student’s tuition would not be deductible (*see, e.g., Tripp v. Comm’r*, 337 F.2d 432, 435-36 (7th Cir. 1964)).
- (b) *Contingencies and conditions* – A gift must be complete and irrevocable to qualify as a charitable contribution, meaning it cannot leave the donor with any “strings attached.” It may not be subject to the occurrence of a precedent event (unless the possibility that the gift will be defeated is so remote as to be negligible) (*see* Treas. Reg. § 1.170A-1(e)). For example, a donor who assigned a portion of an account receivable to be paid over time to a charitable foundation was denied a deduction for the full amount in the year assigned, since the donor could have revoked the assignment at any time (*Jordan v. United States*, 297 F. Supp. 1326 (W.D. Okla. 1969)). On the other hand, a donor who transferred to a charity stock which the donor would continue to manage for three years was allowed a charitable deduction, since the agreement between the donor and the charity limited the donor’s discretion and control over the stock, and since the charity could access the income and principal from the account at any time (Priv. Ltr. Rul. 8152072).
4. Services: No deduction is allowed for the contribution of services, no matter how valuable those services might be to the donee (Treas. Reg. § 1.170A-1(g)).

C. What is a charity?

1. Detached Generosity is Not Enough by Itself: In general, if a gift is made to a private entity, the recipient must be a recognized 501(c)(3) organization for a charitable deduction to be permitted.
2. 501(c)(3) Organizations: 501(c)(3) organizations have an exclusive purpose that is “religious, charitable, scientific, testing for public safety, literary, or educational” or that is to foster national or international amateur sports competition or to prevent cruelty to children or animals.
3. Non-deductible Gifts to Other Types of Tax-exempt Entities: There are numerous other nonprofit organizations that are themselves exempt from federal income tax. However, contributions made to them are *not* tax-deductible (*see* § 170(c)). Notable examples include section 501(c)(4) civic leagues or social welfare organizations; labor, agricultural, or horticultural organizations (§ 501(c)(5)); business leagues or chambers of commerce (§ 501(c)(6)); private clubs (§ 501(c)(7)); and fraternal orders or associations (§ 501(c)(8)).
4. Public Charities vs. Private Foundations. The distinction drawn between public charities and private foundations is relevant primarily for income tax purposes.

- (a) *Public charities* – Receive funds from a broad group of donors and are responsive to such donors. There are less restrictive limitations on the deductibility of contributions to public charities for income tax purposes.
- (b) *Private foundations* – Are generally funded and managed by one person or members of the same family. The deduction rules reflect Congress’s decisions that (1) private foundations need enhanced regulatory oversight and (2) donors should forego part of the income tax benefit in return for the ongoing control of the donated property.
- (1) A donor receives a charitable income tax contribution deduction for a gift of appreciated property to a private foundation measured by the lesser of the donor’s cost basis and the fair market value of the property (§ 170(e)(1)(B)(ii)) *unless*, as described in section 170(b)(1)(F), the recipient foundation is:
- A private operating foundation described in section 4942(j)(3);
 - A conduit foundation that distributes all contributions received for a particular year by the 15th day of the third month of the following year, as described in section 170(b)(1)(F)(ii); or
 - A pooled common fund foundation as described in section 170(b)(1)(F)(iii).
- (2) A full fair market value deduction is permitted, however, if the property consists of “qualified appreciated stock.” “Qualified appreciated stock” is stock of a corporation for which market quotations are readily available on an established securities market (§ 170(e)(5)(B)). This definition does not include bonds or other debt instruments.
- (3) Contributions to “purely” private foundations are also subject to different annual deduction limits (*see* Section I.D.3(c) below).
- (c) *Supporting Organizations: blurring the public-private line* – A supporting organization (“SO”) is classified for tax purposes as a public charity, but is not required to meet the public support test. Instead, an SO attains its public charity status due to a close relationship with one or more other public charities, known as “supported organization(s).” To qualify as an SO under section 509(a)(3), a charity must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified public charities; must be operated, supervised or controlled by or in connection with one or more public charities; and must not be controlled directly or indirectly by any disqualified person.

- (1) The Pension Protection Act of 2006 (“PPA”) instituted several significant changes for SOs, including their statutory division into three types (previously set forth in Treasury regulations). A Type I SO is “operated, supervised, or controlled” by the supported organization (§ 509(a)(3)(B)(i)) – a “subsidiary-parent” relationship. A Type II SO is “supervised or controlled in connection with” the supported organization (§ 509(a)(3)(B)(ii)) – a “brother-sister” relationship. A Type III SO has the least restrictive relationship with its supported organization, being merely “operated in connection with” the supported organization (§ 509(a)(3)(B)(iii)).
 - (2) Type III SOs are subject to greater scrutiny and now more legislative restrictions. Failure to satisfy the new PPA requirements means that a Type III SO may be classified as a private foundation on a going forward basis.
 - (3) For more information on SOs and private foundations, *see, e.g.*, Victoria B. Bjorklund, *Giving to the Private Foundation, Donor-Advised Fund and Supporting Organization*, ALI-ABA SRO11 at p.137 *et seq.*
5. Domestic vs. Foreign Charities: Under section 170(c), a donor receives an *income tax* charitable deduction only for gifts to: (1) a state, a United States possession, the United States government or the District of Columbia, or any political subdivision, for charitable purposes; (2) a corporation, trust, community chest, fund or foundation created or organized in the United States, any state, the District of Columbia, or any U.S. possession, and operated exclusively for charitable religious, scientific, educational, and other limited purposes (requirements parallel to those in § 501(c)(3)); (3) domestic veterans organizations and lodges; and (4) nonprofit cemetery companies.
- (a) With the exception of non-profit cemetery companies, no income tax deduction is permitted for gifts to non-domestic charities or governmental agencies.
 - (b) A deduction will be permitted for a gift to a domestic charity even though all or some portion of the funds may be used in a foreign country (Treas. Reg. § 1.170A-8(a)(1)). However, the charity must have control and discretion as to the use of the grants and must approve overseas projects as being in furtherance of its own exempt purposes – in other words, the domestic charity must act as more than a mere conduit (*see, e.g.*, Rev. Ruls. 66-79, 1966-1 C.B. 48, 63-252, 1963-2 C.B. 101).
 - (c) This “domestic entity” rule applies *only* in an income tax context. For gift and estate tax purposes, the regulations state that the deduction is not limited to domestic corporations or associations, or to trustees for use within the United States (Treas. Reg. §§ 20.2055-1(a), 25.2522(a)-1(a)). However, a foreign organizations must meet the general requirements of a 501(c)(3) organization.

- (1) The particular area of controversy concerns gifts to foreign governments, which are not deductible for transfer tax purposes if made for public purposes, but which may be deductible if made for charitable purposes (*see, e.g., Old Colony Trust Co. v. United States*, 438 F.2d 684 (1st Cir. 1971) (holding bequest to Canadian public hospital corporation deductible as a gift for charitable purposes)).

D. How does the charitable deduction work?

1. Different Tax Systems - Different Rules: As eluded to previously and as will become further evident, there are significant differences in the deduction rules between the income tax and estate and gift tax systems. These differences are based on underlying structural differences between the two tax systems. Estate and gift taxes are levies on the transfer of property; the charitable deduction prevents property that is transferred to a charitable entity from attracting a tax. Not surprisingly, the gift and estate tax deduction is without limit (other than the amount of the transfer itself) and is granted without drawing distinction between the type of charitable entity benefited. The income tax charitable deduction, on the other hand, is not tied to providing relief against a tax liability that is attributable to the assets transferred. (Such relief is indeed provided in many circumstances – for example, the ability to avoid a capital gains tax on appreciated property donated to charity – and is in addition to the permitted deduction.) Instead, the deduction serves to reduce the donor’s overall taxable income, and provide an incentive or subsidy to give. As a consequence, charitable deduction rules for income tax purposes are more numerous and complex, distinguishing among types of property contributed and types of charitable recipients, and are subject to overall annual limitations.
2. Charitable Deductions vs. Business Expenses: Questions about the relationship between section 162 (the business deduction) and section 170 (the charitable deduction) can arise when a corporation faced with its 10 percent limitation on charitable contributions (see Section I.D.3(i), below) attempts to deduct a payment to a charitable organization as an ordinary and necessary business expense under section 162.
 - (a) Section 162(b) provides that no ordinary and necessary business expense deduction will be allowed “for any contribution . . . which would be allowable . . . under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in” section 170. (Note that under its terms, section 162(b) can apply only where the use of section 170 is precluded because of those requirements imposed by sections 170(a) and (b).) In other words, a payment made under section 162(b) must be economically motivated, as opposed to “gratuitous.”
 - (b) Neither the Code nor the courts have supplied clear guidance as to when a section 162 deduction is precluded, and the outcome generally depends on the facts and circumstances of each case. A series of racetrack rulings illustrate this case-by-case nature and the contrast between a case where there was sufficient economic

motivation to produce a section 162 deduction and a case in which such motivation was not present and only the section 170 deduction was available. Revenue Ruling 72-542 determined that a racetrack corporation that made its facilities available to a charity for a “charity day” was able to deduct the payments under section 170, and therefore not under section 162 because there was no expectation of an economic return (Rev. Rul. 72-542, 1972-2 C.B. 37). However, in another ruling, the opposite conclusion was reached and the payments were deductible under section 162 because there were state regulatory agency benefits to the taxpayer from the payments of such proceeds, and therefore the payments did not qualify as section 170 deductions (Rev. Rul. 77-124, 1977-1 C.B. 39).

3. Income Tax Rules: As a general rule subject to many limitations, a donor is entitled to an income tax charitable contribution deduction for the full amount of the donor’s contribution to a qualified charitable organization.

(a) *Cash* – The deduction amount is the amount of cash contributed.

(b) *Property* – The deduction amount generally is measured by the fair market value of the property contributed, although this amount also depends upon the nature of the property and if the property contributed, if sold, would produce long-term capital gain, short-term capital gain, or ordinary income.

(c) *Individual taxpayer percentage limitations: The basic limit*

(1) The basic limit is 50 percent of the taxpayer’s “contribution base” (§ 170(b)(1)(A)).

(2) The contribution base equals the taxpayer’s adjusted gross income (“AGI”) computed without the net operating loss (“NOL”) carryback deduction (§ 170(b)(1)(F)). Note that only a carryback is excluded; a NOL carryforward will reduce the contribution base.

(3) Note that the basic limit is a percentage of the taxpayer’s AGI, not a percentage of the gift.

(4) The basic limit applies to all gifts; other limitations are simply sublimits within the basic limit.

- However, the only gifts that qualify for the full 50 percent limit are gifts of cash or property that is taken into account at its basis **to** (as opposed to **“for the use of”**) public charities listed in section 170(b)(1)(A) or private foundations listed in section 170(b)(1)(E). Public charities listed in section 170(b)(1)(A) include churches, hospitals, certain medical research organizations, educational organizations, organizations that support public colleges or universities, governmental units and organizations that normally receive a substantial portion of their support from a governmental unit or the general public. The private foundations listed in

section 170(b)(1)(E) that qualify for the 50 percent limit are operating foundations, pass through foundations, and pooled common funds.

- All other gifts are subject to the special sublimit rules.

(5) A contribution in excess of the 50 percent limitation may be carried over and deducted until exhausted for the five years following the year in which the gift is made (§ 170(d)).

- The carryover deduction is subject to the same limit (50 percent of contribution base) for the year to which the carryover is made.
- The result is to spread the deduction for a large gift (large in relation to the donor's AGI) over up to a six year period.
- In applying the limit for the carryover year, gifts to public charities made in that year are taken into account first. Although gifts of capital gain property are taken into account last, it appears that, for purposes of applying the carryover rule, a current gift of capital gain property to a public charity will be taken into account before a carryover gift of cash to a public charity (See Treas. Reg. § 1.170A-10(b)(2)(i)).
- If a donor plans to make gifts of 30 percent capital gain property and 50 percent non-appreciated property, the 50 percent property will count first.

(6) Note that if the donor gives property that is not capital gain property or is tangible personal property that is not used by the charity in carrying out its exempt purpose, section 170(e) limits the deduction to the basis of the property.

- In such a case the applicable limit is the 50 percent limit.
- Donor can elect to have the 50 percent limit apply to gifts of capital gain property, if the donor does not take a deduction for the long term capital gain.
- If property has a relatively high basis, consider making the election in order to use the 50 percent limit rather than the 30 percent limit. If the property has any gain at all, donor must make the election in order to use the 50 percent limit.

(d) *Individual taxpayer percentage limitations: the first 30 percent sublimit (§ 170(b)(1)(B))*

(1) The first sublimit applies to gifts “**for the use of**” any charitable organization.

- A gift “**for the use of**” as opposed to a gift “**to**” a charitable organization is, in essence, a gift of an income interest in property whether or not the

interest is in trust (Treas. Reg. § 1.170A-8(a)(2)). For example, a gift to a grantor lead trust is considered a gift **“for the use of”** the named charity because the charity’s interest is held in trust. But a gift of a remainder interest in a charitable remainder trust (“CRT”) is considered to be a gift of the remainder interest **to** the charity rather than a gift **“for the use of”** the charity unless the remainder interest will continue to be held in trust on termination of the CRT (Treas. Reg. § 1.170A-8(a)(2)).

- Out of pocket expenses incurred in performing services for charity are considered a gift **to** rather than **“for the use of”** the charity (*Rockefeller v. Comm’r*, 767 T.C. 178 (1981), *aff’d.*, 676 F.2d 35 (2d Cir. 1982)).

(2) It also applies to all gifts to all private foundations other than operating foundations, pass through foundations, or pooled common funds.

- Note that gifts of “capital gain property” to private foundations (other than those listed in section 170(b)(1)(E)) are subject to a special 20 percent sublimit, discussed below.
- Capital gain property is any capital asset which, if sold at its fair market value, would generate a long term capital gain (§ 170(b)(1)(C)(iv)).

(3) The limit is the *lesser* of:

- 30 percent of the contribution base or
- The excess of 50 percent of the contribution base over the amount of the contributions allowable under section 170(b)(1)(A) (*i.e.*, contributions **to** public charities or foundations listed in section 170(b)(1)(E) that qualify for the 50 percent limit determined without applying the second sublimit described below).

(4) Therefore, gifts of cash or property to a public charity in excess of 20 percent of the contribution base will reduce the sublimit for gifts to private foundations.

- For example, a taxpayer with a contribution base of \$60,000 who makes a gift of \$20,000 (1/3 of the contribution base) to a public charity will only have \$10,000 of contribution base left to make a gift to a private foundation without running into a carryover situation.
- Note that in applying the limit, gifts of capital gain property to a public charity are not reduced by the 30 percent sublimit applicable to such gifts. As a result, a gift of capital gain property to a public charity may reduce the sublimit for gifts to private foundations, even if the capital gain property is not fully deductible. For example, suppose the taxpayer with a contribution base of \$60,000 makes a gift of capital gain property worth

\$25,000 to a public charity and a cash gift of \$20,000 to a private foundation. The property gift is deductible only to the extent of \$18,000 (30 percent of \$60,000). This would appear to leave \$12,000 of the 50 percent limit available for the foundation gift. But only \$5,000 of the gift to the foundation is deductible, because the limit is 50 percent of the contribution base (\$30,000) less the amount of the property gift, computed without the 30 percent limit (*i.e.*, \$25,000)).

- (5) As in the case of contributions subject to the 50 percent limit, a contribution that exceeds the first 30 percent limit may be carried forward to the five years following the year in which the gift is made and deducted in those years subject to the same limits in the carryover years (§ 170(b)(1)(B)).
- For purposes of applying the carryover rules, all gifts made during the carryover year are taken into account before any carryover gifts.
 - Carryover gifts representing gifts to public charities are deemed to be gifts made during the year for purposes of applying carryovers of foundation gifts.

(e) *Individual taxpayer percentage limitations: the second 30 percent sublimit (§ 170(b)(1)(C))*

- (1) The second sublimit applies to gifts of “capital gain property.” Capital gain property is
- Any capital asset which, if sold at its fair market value, would generate a gain that is taxable as long term gain, and
 - Section 1231 property, *i.e.*, property used in a trade or business which, by virtue of section 1221(2), is excluded from the definition of a capital asset (§ 170(b)(1)(C)(iv)).
- (2) Gifts of such property are deductible at fair market value without the recognition of gain and are, therefore, subjected to a lower limit than gifts of cash or property that is deductible at basis.
- (3) In applying the limits, gifts of capital gain property are taken into account after all other contributions, except for gifts of capital gain property to private foundations (§ 170(b)(1)(C)(i)).
- Thus, a cash gift to a public charity in excess of 20 percent of the contribution base will, in effect, reduce the 30 percent limit for gifts of capital gain property.
 - For example, suppose a taxpayer with a contribution base of \$60,000 makes a cash gift of \$20,000. The maximum gift of capital gain property would be \$10,000, the unused portion of the 50 percent limit.

(f) *Individual taxpayer percentage limitations: special sub-sublimit of 20 percent (§ 170(b)(1)(D))*

- (1) A special sub-sublimit applies for gifts of certain capital gain property to certain private foundations (§ 170(b)(1)(D)).
 - Gifts of marketable securities to private non-operating foundations are deductible to the extent of full fair market value. A donor may not give more than 10 percent of all the outstanding stock of the corporation.
 - Gifts of capital gain property to private foundations other than marketable securities, such as real estate or closely held stock, are deductible only to the extent of basis.
 - Gifts of marketable securities to private foundations (other than operating foundations, pass through foundations or pooled common funds) are subject to the special sub-sublimit in applying the second 30 percent sublimit.
- (2) The special limit is lesser of:
 - 20 percent of the contribution base or
 - 30 percent of the contribution base less the gifts that qualify for the second 30 percent sublimit, *i.e.*, gifts of capital gain property to public charities and section 170(b)(1)(F) foundations.
- (3) The special sub-sublimit is applied after all of the other limits are applied.
- (4) Gift in excess of the second 30 percent limit and the special sub-limit are carried forward and deducted until exhausted in each of the five years following the year of the gift subject in each case to the same limit as applied in the carryover year and subject to the rule that gifts made during the carryover year are taken into account first (§ 170(d)(1)(A)(i)).

(g) *Individual taxpayer percentage limitations: special election.*

- (1) Under section 170(b)(1)(C)(iii), a taxpayer may elect to have capital gain property deducted at basis under section 170(e)(1) rather than at fair market value.
- (2) If such an election is made, the 50 percent limit rather than the 30 percent limit applies, provided the gift is made to a charity described in section 170(b)(1)(A).
- (3) The election applies to all gifts of capital gain property made during the year.

- (4) Any carryover from an earlier year (in which the election was made) to a year in which such election is made must be recomputed as though the election had been made in the earlier year, but the taxpayer is not required to go back and recompute the deduction for the earlier year.
- (h) *Trusts and estates: no percentage limitations* – The limitations contained in section 170(b)(1) apply only to individuals and limit the deduction taken under section 170(a). Section 642(c)(1) provides a trust or an estate a deduction “in lieu of” the deduction under section 170(a) for any amount of the gross income, without limitation, which, pursuant to the terms of the governing instrument, is paid during the taxable year for a charitable purpose. Thus, trusts and estates are allowed a charitable income tax deduction limited only by gross income; and there are no carryforward provisions.
- (1) A private foundation that has lost its exemption is not entitled to the benefits of section 642(c) and is instead subject to section 170 (§ 642(c)(6)).
- (2) If a trust has income which, if it were exempt, would be treated as unrelated business taxable income (“UBTI”), any deduction with respect to that income may not be taken under section 642(c)(1) (§ 681(a)). A deduction is not lost, however. Instead, such trusts are entitled to take deductions against UBTI pursuant to section 170(a), subject to the limits as though they were individuals (Treas. Reg. § 1.681(a)-2(a)). The limits are applied to the UBTI, rather than the regular AGI contribution base.
- (i) *Corporate percentage limitation* – Corporations are subject to a simple limit of 10 percent of taxable income computed without regard to the charitable contribution, the dividends received deduction, the NOL carryback deduction, or any capital loss carryback (§ 170(b)(2)). The amount of any corporate gift in excess of the 10 percent limit can be carried forward and deducted until exhausted in the five years following the year of the gift (§ 170(d)).
- (1) The type of asset (cash or property) is irrelevant, as is the form (“to” or “for the use of”) and the type of charity.
- (2) Long-term capital gain property and section 1231 property are deductible at fair market value; all other property is deductible at the lower of basis or fair market value (*see* § 170(e)(1)(A)).
- (3) Contributions of inventory – Deduction for some of the ordinary income gain is allowed for certain contributions of inventory to a charity that uses the property solely for the care of the ill, needy, or infants (§ 170(e)(3)); tangible personal property donated to an institution of higher education or a scientific research organization that uses the property for research, experimentation, or research training in the physical or biological sciences in the United States (§ 170(e)(4)); or contributions of computer technology and equipment for elementary or secondary school purposes (§ 170(e)(6)). The allowable

deduction is basis plus half the difference between basis and fair market value, up to a limit on the deduction of twice the basis (§ 170(e)(3)(B)).

- Such contributions of inventory were enhanced by the Katrina Emergency Tax Relief Act of 2005 (which expires January 1, 2010), and now include donations of “apparently wholesome food” inventory by both corporate and non-corporate taxpayers engaged in a trade or business (§ 170(e)(3)(C)) and donations of book inventory by corporate taxpayers (§ 170(e)(3)(D)).
- (j) *Quid pro quo* – As was discussed in Section I.B.2, the amount of any deduction is reduced by the value of any goods or services received in exchange for the gift (Treas. Reg. § 1.170A-1(h)(1)). A charity that provides goods or services in return for a contribution of more than \$75 must furnish the donor with a written statement indicating a good faith estimate of the value of those goods or services (§ 6115(a)). The quid pro quo rules must be considered in the following situations:
- (1) Fundraisers – Because there is widespread misunderstanding about the rules for deductibility of donations made in connection with fundraising events such as balls, banquets, concerts, and bazaars, the IRS has issued regulations to determine the extent to which such contributions are deductible. Under Treasury Regulation sections 1.170A-1(h)(1) and 1.170A-13(f), no deduction is allowable unless the amount paid exceeds the fair market value of the benefits received. If a taxpayer makes a gift and does not intend to attend the dinner, the show, or otherwise take advantage of the benefits provided by the donee, an outright gift should be made and any tickets should be returned before the event.
 - (2) Token benefits – If the contribution occurs in the context of a fundraising campaign and the charity gives a more modest thank you (e.g., an umbrella, mug, invitation to an event), and the fair market value of all benefits received does not exceed the lesser of 2 percent of the payment or \$95 (in 2009), the quid pro quo may be ignored (§ 513(h); Rev. Proc. 2008-66, 2008-45 I.R.B. 1107 (2009 amounts); Rev. Proc. 90-12, 1990 C.B. 471 (setting original standards)). It is irrelevant if these low cost articles were donated to the charity.
 - (3) Membership benefits – Other benefits may be disregarded if they are given as part of an annual membership offered in return for a payment of \$75 or less and fall into one of two categories (Treas. Reg. § 170A-13(f)(8)):
 - Admission to events that are open only to members and in which the donee organization reasonably projects that the cost per person will be equal to or less than the low cost amount (\$9.50 for 2009) (Rev. Proc. 2008-66, 2008-45 I.R.B. 1107).

- Rights or privileges that members may exercise frequently during the membership period, such as free admission to a museum or discounts to museum gifts shops or merchants in the community (such benefits may be ignored to the same extent as if they were provided directly by the recipient charity). If the payment is \$75 or less and the only benefits are these frequently exercised rights and privileges, the entire amount may be treated by the donor and acknowledged by the donee as a charitable contribution (*see* Treas. Reg. 1.170A-13(f)(8)(ii), Example 1).
- (4) “Exclusive” events – While most charities have adopted procedures for acknowledging and estimating the value of the quid pro quo for goods or services given in exchange for a contribution, charities also should be aware of the potential for further quid pro quo issues that arise when offering special, exclusive events only to certain groups of donors. For example, an organization may have a “President’s Circle” for annual donors who contribute more than \$5,000, and all “President’s Circle” members may be invited annually to a day-long seminar by a top university professor, including a lunch worth \$100. A donor’s reported charitable contribution would subtract the \$100 quid pro quo lunch, and she would report a contribution of \$4,900. However, shouldn’t she also have to lessen the contribution by the value of the professor’s lecture? What if tickets to hear the same speaker at another, unaffiliated event cost \$250? Or what if the value hearing this professor speak might be worth even more? Shouldn’t her reported contribution be even less than \$4,900? While the IRS has no published guidance on this issue, it is ripe for scrutiny, especially if this “exclusive donor” is expecting a similar sort of annual event in exchange for her annual gift and admission to the “President’s Circle.” Charities may decide it is simpler just to give those President’s Circle members who want to attend the management seminar the right to pay for the cost of attending.
- (5) Charity auctions – The value of items purchased at a charity auction will not be presumed to be equal to the payment received if the charity has reasonably established a lower value in advance (*see* Treas. Reg. § 1.170A-1(h)(5), Example 2).
- (6) Celebrity presence – The presence of a celebrity at an event adds no value to what a donor receives unless the celebrity provides a service for which he or she is typically paid, e.g., a tennis lesson by a prominent tennis professional purchased by a donor for \$500 when the professional typically charges \$100 would result in a \$400 gift to the charity (*see* Treas. Reg. § 1.6115-1(a)(3), Example 2). A museum tour by that same tennis professional, however, would be deemed to have no value.
- (7) Raffle tickets – Raffle tickets purchased from a charity are not deductible as a charitable contribution (*see, e.g., Goldman v. Comm’r*, 46 T.C. 136 (1966), *aff’d* 388 F.2d 476 (6th Cir. 1967), Rev. Rul. 67-246, 1967-2 C.B. 104, Example 5).

- (8) Unreimbursed volunteer expenses – Unreimbursed expenses incurred by a taxpayer incident to the rendition of services to a donee charity have always been deductible (Treas. Reg. § 1.170A-1(g)).
- (9) Payments for the right to purchase tickets to college athletic events – Some colleges and universities offer preferred status for purchasing seats at events to contributors to athletic programs. Treasury Regulation section 1.170A-13(f)(14) holds that if a donor obtains the right to purchase tickets to college athletic events, 20 percent of any such payment is treated as non-deductible while the remaining amount is deductible in full, regardless of the nature of the tickets purchased. This can be a “trap for the unwary” for schools utilizing a “point” system that rewards substantial donors with the right to purchase premium seats – donors will want to avoid losing the tax deductibility of 20 percent of a very large gift simply because they are permitted to purchase seats only marginally better than those that may be purchased by virtue of a smaller contribution.
- (10) Corporate sponsorship rules – Under certain circumstances, a payment from a corporate sponsor to a charitable organization is treated as a contribution, as opposed to business income to the charity. Qualified sponsorship payments, when received by tax-exempt organizations and state colleges and universities, pursuant to a safe-harbor provision, are exempt from unrelated business income tax when there is no arrangement or expectation that the sponsor will receive any substantial return benefit other than the use or acknowledgment of the name or logo of the sponsor’s business (§ 513(i)(1)).
- This use or acknowledgment, however, does not include advertising of the sponsor’s product or services (*see* § 513(i)(2)(A)).
 - Nor may the payment be contingent on the level of attendance at events, broadcast ratings, or other factors that would indicate the degree of public exposure to an event (§ 513(i)(2)(B)(i)).

4. Transfer Tax Rules: Instead of creating a tax benefit (a lower overall income tax liability after charitable contributions are deducted from gross income), transfer tax rules prevent a tax from arising as a result of the transfer of property. Thus, in general, a donor may make unlimited lifetime or testamentary gifts to either a public charity or a private foundation.

- (a) *Gift tax* – In computing taxable gifts, a donor may deduct charitable gifts (§ 2522). Otherwise, there is in general a \$13,000 annual limit per donee on tax-free gifts (§ 2503(b)) and a \$1 million lifetime exclusion amount (§ 2505).
- (b) *Estate tax* – All “bequests, legacies, devises, and transfers” for public, charitable, and religious uses can be deducted in determining the decedent’s taxable estate (§ 2055). Otherwise, there is a \$3.5 million exemption that can shelter transfers

not made to charities (§ 2010). The exemption is reduced by use of the donor's lifetime \$1 million gift tax exclusion amount.

E. The historical evolution of the charitable deduction

1. Early in the life of the U.S. income tax, in 1917, the Bureau of Internal Revenue was faced with a technical issue: When property (e.g., stock or artwork) was contributed to charity, was the donor's deduction based upon the value of the property or the donor's cost? The answer at the time, which is more or less still the same, was that the current market value was deductible. Since then the tax code has struggled to reflect concerns of abuse – that the donor could “make money by giving it away” – which have resulted in certain deduction limitations. The following are the highlights of the charitable deduction as it evolved as an essential part of the tax code.
2. Revenue Act of 1917 – First appearance of the charitable deduction, not to exceed 15 percent of taxpayer's taxable net income, of such amounts contributed to charities.
3. Revenue Act of 1918 – Rule that the current market value of the gift is deductible.
4. Estate Tax Act of 1921 – The estate tax charitable deduction was applied retroactively to the estates of all decedents who died after December 31, 1917.
5. Gift Tax Act of 1932 – Created the charitable gift tax deduction.
6. Tax Reform Act of 1969 – Congress revised the basic tax rules governing charitable contributions, formulated the partial-interest rule, and tried to eliminate the possibility that a donor could “make money by giving it away” by enacting the current deduction limitations.
7. The Tax Reform Act of 1984 – Changes in appraisals of property contributed to charitable organizations, following a scandal involving gifts by taxpayers of gemstones to the Smithsonian which in some cases yielded deductions based on values representing five times the purchase price paid months earlier.
8. Tax Reform Act of 1986 – Dramatic reform which sought to simplify the Code, broaden the tax base, and reduce the overall number of deductions and tax brackets.
9. Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Act) – Repealed the estate tax for the year 2010; however, the current status of estate tax is unclear, and it is expected that a new law will be proposed to hold 2009 rates.
10. Omnibus Budget Reconciliation Act 2003 – Substantiation requirements strengthened, requiring written acknowledgment for all contributions of more than \$250.
11. American Jobs Creation Act of 2004 – Further changes in substantiation and reporting rules.

12. Katrina Emergency Tax Relief Act of 2005 – Extended exceptions for inventory deductions.
13. Pension Protection Act of 2006
 - (a) Adopted IRA rollover
 - (b) Adopted stricter rules for appraisals and appraisers
 - (c) New fractional interest gift rules for tangible personal property (important for gifts of art to museums)
 - (d) Adopted limits on and substantiation requirements for donations of clothing and household items; cancelled check or receipt required for charitable contributions of money
14. Emergency Economic Stabilization Act of 2008 – Extended through December 31, 2009 the IRA charitable rollover enacted by the PPA, along with other provisions that allowed for favorable treatment of contributions by S corporations and of gifts of inventory such as food and books.

II. BASIC DEDUCTION RULES

A. General

1. A donor is entitled to an income tax charitable contribution deduction for the full amount of the donor's contribution to a qualified charitable organization. While the basic rules stipulate that a donor may deduct from his or her taxable income the amount of cash contributed or the fair market value of contributed property, the rules are tied to a number of variables, such as what is being given and to whom; when the gift is made or can be considered complete; and how the gift is valued for deduction purposes.

B. Cash

1. What: In general, cash gifts are subject to relatively straightforward rules, but certain critical factors need to be understood, including the timing of a gift.
2. To Whom: Whether a cash gift is made to a public charity, a private foundation, or a supporting organization, the amount of the deduction equals the amount of cash transferred. No distinctions are drawn other than the percentage limitations discussed in Section I.C above.
3. When: Generally, an income tax deduction for a charitable gift arises at the time of and in the year in which the gift is actually paid (§ 170(a)(1)).
 - (a) *Gifts of cash* – Deductible for the year in which the cash is delivered to the donee.

- (b) *Gifts made by check and the “relation-back doctrine”* – Title to the funds passes and the gift is considered complete when the check is mailed or otherwise delivered, assuming that the check subsequently clears the account on which it is drawn (Treas. Reg. § 1.170A-1(b)). This is significant because it gives rise to the “relation-back doctrine,” under which end-of-the-year gifts are deductible for the year in which the signed check is mailed or otherwise delivered, even if the check is not deposited by the charity or, if deposited in the year written, does not clear until the following year.
- (1) The result is generally different in cases where the gift check is made out to a non-charitable donee. The IRS has held that a gift is “not consummated by the mere delivery of the donor’s own check or note. The gift of a check does not become complete until it is paid, certified or accepted by the drawee, or is negotiated for value to a third person” (Rev. Rul. 67-396, 1967-2 C.B. 351). Nevertheless, in *Estate of Metzger v. Commissioner*, a case which did not involve a charitable gift, the court overruled the IRS and found that when the taxpayer can establish (1) the donor’s intent to make a gift; (2) unconditional delivery of the check; and (3) presentment of the check within the year for which favorable tax treatment is sought and within a reasonable time of issuance, the “practical realities of everyday commerce” warrant the application of the relation-back doctrine (100 T.C. 204, 215 (1993)).
- (c) *Gifts made by credit card* – The gift is complete when the donor charges the gift (and not when the charge account balance is paid). But what if the donor charges the gift on a website on December 31 and the charity processes the charge (and thereby charges the card) on January 2?
- (d) *Pledges* – The tax consequences of a pledge are frequently misunderstood. The making of a pledge – whether or not enforceable under local state law - does not itself give rise to a charitable deduction. A deduction may only be taken when a payment is made pursuant to the pledge agreement (Treas. Reg. § 1.170A-1(a)). An enforceable pledge is also not considered a debt for income tax purposes. Accordingly, there is no capital gain recognition if an enforceable pledge is satisfied with appreciated property (Rev. Rul. 64-240, 1964-2 C.B. 172; Rev. Rul. 55-410, 1955-1 C.B. 297). Additionally, even if an enforceable pledge is forgiven by charity, there is no discharge of indebtedness income to the donor under section 108, which also states that income is not realized to the extent that payment of the liability would have given rise to a deduction (§ 108(e)(2)).
- (1) However, an enforceable charitable pledge does create a debt for federal gift tax purposes. As a consequence, if a third party discharges the pledge, the payment by the third party will be treated as a taxable gift by the third party to the person who originally made the pledge and not as a charitable gift. The original pledgor (not the person making the payment) is then entitled to an income tax deduction for the payment (Rev. Rul. 81-110, 1981-1 C.B. 479). Likewise, an enforceable pledge creates a debt for federal estate tax purposes, and is deductible as a claim against the estate under section 2053 rather than

as a charitable contribution under section 2055. Deductibility under section 2053 is, however, generally dependent on showing that the pledge would have constituted an allowable deduction under section 2055 had it been a bequest (Treas. Reg. § 20.2053-5).

- (2) An enforceable pledge is also treated as a debt for federal excise tax purposes. Consequently, if a pledgor is a disqualified person with respect to a private foundation, and if the private foundation pays that pledgor's pledge to another charity, there is a prohibited act of self-dealing (Treas. Reg. § 53.4941(d)-2(f)(1)).
- (3) Note that there are separate accounting issues surrounding pledges. The Financial Accounting Standards Board ("FASB") promulgated rules in the mid-1990s that require charities to book pledges in certain circumstances. For example, under Statement of Financial Accounting Standards ("SFAS") No. 117, all unconditional enforceable pledges must be accrued as balance sheet assets at their current value (reflecting appropriate discounts for delayed payments), and under SFAS No. 116, all unconditional enforceable pledges must be recorded as revenue in the period the pledges are made, again on a discounted basis.

4. Recording the Gift – Substantiation and Acknowledgement:

- (a) Contributions of \$250 or more are deductible for federal income tax purposes only if the donor has a contemporaneous, written acknowledgement from the recipient charitable organization (§ 170(f)(8)); *see also* Prop. Treas. Reg. § 1.170A-16, 73 Fed. Reg. 45,908, 45,913-19 (Aug. 7, 2008)). In general, separate contributions to the same organization will not be aggregated for purposes of the \$250 threshold. In addition to the name of the donee organization, the acknowledgment must contain the following information:
 - (1) The amount of cash contributed;
 - (2) A statement whether or not the charitable donee provided any goods or services to the donor in consideration for the contribution; and
 - (3) If any goods or services were provided to the donor, a description and good-faith estimate of the fair market value of the goods or services provided (§ 170(f)(8)(B)).
- (b) In addition, for all cash contributions (*regardless of amount*) made in taxable years beginning after August 17, 2006, the donor can satisfy recordkeeping requirements only by maintaining as a record of the contribution either a bank record or a written communication from the donee showing the name of the donee organization and the date and amount of the contribution. If these records are not kept for a particular donation, no deduction is allowed for that donation (§ 170(f)(17)).

- (1) Prior to this change, regulations had provided that small cash gifts could be substantiated by other reliable written records showing the name of the donee and the date and amount of the contribution. As many commentators have observed, this change in law effectively eliminates the deductibility of anonymous small cash gifts, such as cash contributed to a church collection plate or a Salvation Army kettle.

C. Property

1. In General: The amount deductible for a charitable contribution of property is the fair market value of the property on the date of the contribution. However, this amount is reduced by any amount that would *not* be taxed as long-term capital gain if the property were sold (§§ 170(e)(1)(A), 1221(a)). A further exception to this rule is for tangible personal property that would generate long-term capital gain upon its sale. Such property is deductible at its full fair market value only if it is “reasonable to anticipate” that the charity will use the property for a purpose related to the charity’s exempt purpose (§ 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4(b)(3)(ii)(b)).
2. What: The rules for contributions of property generally differ depending upon whether the property is capital gain property (property that would produce long-term capital gain income if sold), non-capital gain property (property that would not produce long term capital gain income if sold), or tangible personal property.
 - (a) *Capital gain property* – Donors to charity often like to contribute appreciated property (long-term gain) rather than cash because of a two-fold tax benefit. The donor can take a deduction for the appreciated, fair market value of the property. Then, the charity can sell the appreciated property and will not pay any income tax on the gain (because it is tax exempt), and this gain will not be taxed back to the donor because the charity is not treated as the donor’s agent.
 - (1) To whom – Gifts of long-term capital gain property made to private non-operating foundations (other than conduit or pooled fund foundations) may only be deducted to the extent of the lesser of the donor's cost basis and fair market value, unless the property consists of qualified appreciated stock (§170(e)(1)(B)(ii)).
 - (b) *Non-capital gain property (section 170(e)(1)(A))* – Property affected by this rule includes short-term capital gain property, inventory property (but see exceptions, below), property subject to recapture under sections 1245 or 1250, section 306 stock, and works of art or manuscripts created by the donor.
 - (1) To whom – This rule applies no matter the nature of the donee organization.
 - (2) Short-term capital gain property – If the donor has held the property for one year or less, the donor's deduction cannot exceed the donor’s cost basis in the property.

- (3) Business inventory – Subject to the limited exceptions set forth in section 170(e), a gift of business inventory property will only generate a deduction measured by the lesser of the donor's cost basis and fair market value (*see, e.g., Greer v. Comm'r*, 70 T.C. 294 (1978), *aff'd* 634 F.2d 1044 (6th Cir. 1981) (limiting charitable donation deduction for contribution of race horses by the dealer to dealer's basis in the horses)).
- (4) Creative works – Since works of art and manuscripts are ordinary income assets (as opposed to capital gain assets) in the hands of their creators (§ 1221(a)(3)), a gift of such property by the artist or author results only in a cost basis deduction, or in no deduction at all if costs attributable to the creative work already have been deducted by the donor as a business expense (Treas. Reg. § 1.170A-1(c)(4)). This same rule applies to the donor of a work of art or manuscript who acquired the property by inter vivos gift from the creator (§§ 1015, 1221(a)(3)(C)). In contrast, due to the operation of the stepped-up basis rules at death that remove the ordinary income taint, a person who inherits a work of art from the artist may claim a full fair market value deduction for a later charitable gift of the work (§ 1014).
- (c) *Tangible personal property* – The deduction for a gift of tangible personal property that would generate long-term capital gain upon its sale is limited to the donor's basis in the property (even if the organization is a public charity) *unless* it is “reasonable to anticipate” that the organization's use of the property will be related to its tax exempt purpose (§ 170(e)(1)(B); Treas. Reg. § 1.170A-4(b)(3)(ii)(b)).
- (1) To whom – For a gift of tangible personal property to a private foundation other than an operating foundation, conduit foundation, or pooled common fund, the same rules that are applicable to any gift of appreciated property other than qualified appreciated stock apply: the deduction is limited to the donor's basis (even if the foundation uses the property in accomplishing its charitable purpose) (§ 170(e)(1)(B)(ii)).
- (2) “Reasonable to anticipate” – This phrase, as used in the regulation, provides some latitude in the application of the related-use rule. For example, assume a donor contributes property of a type normally retained by a museum for its exempt purposes. Unless the donor has actual knowledge to the contrary, the regulations provide that it is reasonable for the donor to anticipate that the property will not be put to an unrelated use (whether or not the property is later sold or exchanged by the museum). However, the burden of proving that the property is to be put to a related use, or that the donor can reasonably anticipate that it will be put to such a use, is on the donor (Treas. Reg. § 1.170A-4(b)(3)(ii)). Accordingly, a donor might obtain a letter that indicates the use to which the charity expects to put the property.
- (3) Recapture Rules – The 2006 PPA added a rule that recaptures a donor's tax benefit if such a contribution is made and a fair market value deduction of

more than \$5,000 is claimed but the donee fails to put the property to a related use (§ 170(e)(1)(B)(i)(I); *see also* Pension Protection Act of 2006, Pub. L. No. 109-280, § 1215, 120 Stat. 780, 1078 (2006)). If the donee disposes of the property within three years after the contribution, an amount equal to any excess of the deduction claimed over the donor's basis is added to the donor's income for the year in which the disposition occurs (§ 170(e)(7)).

- The donor's tax benefit will not be adjusted under this rule if the donee organization makes a written certification to the IRS under penalty of perjury, certifying that the donee's use of the property was substantially related to its charitable function and describing how that occurred (*i.e.*, detailing the relationship) (§ 170(e)(7)(D)). A copy of this certification must be supplied to the donor, and a \$10,000 penalty applies in the event of a fraudulent certification of exempt use of property (§§ 6050L(a)(1), 6720B).

(4) The above rules do not apply to estate and gift taxes.

(d) *Mortgages* – The existence of a mortgage secured on real estate will affect the amount of the donor's charitable deduction and possibly generate taxable income to the donor when the charitable gift is made.

(1) In all events, the amount of the contribution is reduced by the amount of the mortgage on the property.

(2) In addition, a gift of real property subject to a mortgage is treated as if the donor had sold the property to the charity for the amount of the indebtedness, and bargain sale rules may apply (Treas. Reg. § 1.1001-2). The donor will have taxable income equal to the difference between the mortgage amount and the portion of the donor's adjusted cost basis attributable to the deemed sale portion unless the donor agrees to hold the charity harmless and pays off the mortgage as it comes due (Priv. Ltr. Ruls. 8536061, 8526015). Please see Section III.D.3(j), below, for further discussion of the bargain sale rule and mortgages.

(3) A charity may have UBTI when it holds property subject to a mortgage. If the property is not used by the charity for its exempt purposes, it is treated as debt-financed property, which can cause rental income and gain realized on a later sale to be taxed as UBTI (§ 512(b)(4)). This liability can be avoided during a 10-year grace period following acquisition, provided that the charity does not assume or agree to pay the mortgage and provided, in the case of a lifetime gift, that the mortgage was placed on the property more than 5 years prior to the gift and the property was held by the donor for more than 5 years (§ 514(c)(2)).

(e) *S-Corporation stock* – Prior to 1998, a 501(c)(3) organization was not a permitted shareholder of an S-Corporation. Consequently, while a charitable gift of S-

Corporation stock could be made, the gift caused the S-Corporation to lose its tax status. This rule has since changed, and organizations described in Section 501(c)(3) and exempt from taxation under section 501(a) are now permitted to be shareholders (§ 1361(c)(6)). It should be noted, however, that CRTs are still not eligible S-Corporation shareholders. It should also be noted that a donor's deduction for a gift of S-Corporation stock is reduced by the amount of any recapture or other ordinary income that would have been realized on the sale of S-Corporation assets as if the gift had been made in the form of a partnership interest (*see* §§ 1367 (describing adjustments to basis caused by contributions), 1368 (describing income treatment of property distributions to the shareholders)).

- (1) Even though a charity is an eligible shareholder of an S-Corporation, all income paid out by S-Corporations to 501(c)(3) shareholders is taxable as UBTI. As a consequence, gifts of S-Corporation stock may not be desirable from the charity's standpoint.
 - (2) Gifts of assets owned by S-Corporation may be made by an S-Corporation. Such gifts do not in and of themselves give rise to UBTI issues, and are not subject to the 10 percent corporate entity limitation (because they are passed through to the shareholders and are thus subject to the individual limits on the shareholders' returns (§ 1366(a)(1)(A)).
 - (3) For a further explanation of gifts of S-Corporation stock, *see, e.g.*, Christopher R. Hoyt, *Charitable Tax Planning for Closely-Held Businesses and Their Owners*, ALI-ABA SRO11 at p.621 *et seq.*
- (f) *Stock acquired through ISO exercise* – An employee who wishes to contribute stock acquired through the exercise of an ISO must be careful that the transfer does not occur before he or she has satisfied various holding periods. If he or she contributes ISO stock before these holding periods are satisfied, the gift will be treated as a “disqualifying distribution” and the donor/employee will be required to include as ordinary income for the year in which the transfer occurs the difference between the exercise price and the fair market value of the stock on the date the option was exercised (*see* §§ 421(b), 422(a)(1), 424(c)).
- (g) *Patents and copyrights* – Prior to the American Jobs Creation Act of 2004 (“JOBS Act”), the deduction generated by the gift of an intellectual property interest depended on the nature of the property transferred. For all gifts of intellectual property interests after June 3, 2004, however, the rule is now the same: the charitable income tax deduction is limited to the lesser of the donor's adjusted cost basis in the property or the fair market value of the property (*see* § 170(e)(1)(B)(iii); *see also* JOBS Act, Pub. L. No. 108-357, § 882, 118 Stat. 1418, 1627 (2004)).
- (1) In addition, the JOBS Act added section 170(m), which allows an additional deduction for certain amounts in the year of contribution and in later tax years based on a sliding scale percentage of the so-called “qualified donee income”

received by the charity that is allocable to the donated intellectual property. In the year the contribution is made, the donor's deduction is equal to basis. Over the next 12 years, the donor is allowed to claim additional deductions based on a percentage of the royalty income received by the donee from the transferred property.

- (2) The donor must give notice to the charity at the time of contribution that he intends to treat the contribution as a qualified intellectual property gift to claim the benefits of the additional section 170(m) deduction.
 - (3) Each year, the charitable donee must file a Form 8899, Notice of Income From Donated Intellectual Property, with the IRS and provide a copy to the donor by the last day of the first full month following the close of the donee's tax year (Treas. Reg. § 1.6050L-2).
- (h) *Boats, planes, cars* – Under section 170(f)(12) as added by the JOBS Act, the rules for contributions of boats, planes, and cars depend upon whether the donee charity retains the vehicle (including boats and planes) or sells it (*see also* JOBS Act § 884, 118 Stat. at 1632-33).
- (1) If the charity subsequently sells a donated vehicle, deductions in excess of \$500 for such contributions are limited to the gross proceeds received by the donee charitable organization upon subsequent sale of the vehicle. The charity must report to the donor the amount of sale proceeds within 30 days after the sale date.
 - (2) If the charity retains the vehicle (including boats and planes) for its own use, the donor is eligible for a fair market value deduction provided that the charity and the donor provide certification to that IRS that the use is in direct furtherance of the donee's charitable purposes. Such acknowledgement must be "contemporaneous."
 - See the discussion of "related use" of donated tangible personal property in Section II.C.2(c), above.
- (i) *Taxidermy* – At hearings in 2004, the Senate Finance Committee heard testimony describing an organization that purported to enable hunters to enjoy "tax deductible hunting" by contributing mounted animals to the organization and claiming inflated deductions based on the cost of travel incurred in hunting the animals. In an effort to prevent such abuses, the 2006 PPA prescribed new rules for contributions of "taxidermy property" such that when the contribution is made by the person who prepared or paid for the preparation of the property, the deduction is limited to the lesser of basis or fair market value (Pension Protection Act of 2006, Pub. L. No. 109-280, § 1214, 120 Stat. 780, 1077 (2006); *see also* § 170(e)(1)(B)(iv), (f)(15)). In determining basis for these purposes, only the cost of preparing, stuffing, and mounting is considered (not indirect costs such as

travel). These rules for taxidermy property apply to contributions made after July 25, 2006.

(j) *Clothing and household items* – Valuation of contributions of used clothing and household items has been a problematic area for the IRS. Under the 2006 PPA, clothing and household items are denied a deduction unless they are in “good used condition or better” (See § 170(f)(16)).

(k) *Life insurance* – A contribution of a policy (i.e., a transfer of ownership) is deductible, but mere payment of premiums of a policy payable to charity is not deductible if the donor/payor still has the right to change the beneficiary.

(1) For a further discussion of life insurance policies and charitable giving, see, e.g., Lawrence Brody, *The Use of Life Insurance in Charitable Planning*, ALI-ABA SRO11, at p.311 *et. seq.*

3. When:

(a) *Gifts of real estate* – The gift is complete upon delivery of the deed to the charity’s agent, or mailing of the deed to the charity. Recording is not necessary.

(b) *Gifts of tangible personal property* – The gift is complete upon physical delivery of the property to the charity (or to the delivery service if it is acting as the charity’s agent).

(c) *Gifts of securities* –

(1) Certificate form securities – When stocks, bonds, and other securities are evidenced by a certificate, the title to the security is transferred by an endorsement of the certificate. A charitable deduction for a gift of securities to a charity may be taken when the endorsed certificate is delivered to the charitable organization.

- When such a certificate is mailed, the deduction can be taken on the date it was mailed.
- But the gift is not complete until the certificate *and* a separate stock power are mailed or delivered. If the donor wants to make only a partial donation (50 shares represented by 100 share certificate) and submits the certificate to a company, the gift is not complete until the new certificate for charity is entered on the company’s books (Treas. Reg. § 1.170A-1(b)).

(2) Brokerage account – if the charity has a brokerage account with a different broker, the gift arguably is completed as soon as it is wired out of the donor’s account. However, it is also arguable that the gift is not complete until the charity receives the stock. If the charity has an account with the same

brokerage house, the gift is not complete until the stock is received by the charity's account (*Morrison v. Comm'r*, 53 T.C.M. 251 (1987)).

(d) *Anticipatory assignment of income and step transactions* – Charitable gifts are often prompted by upcoming taxable events. For example, an owner in the process of selling her business may want, as part of that transaction, to make a gift of part of her stock to charity to avail herself of the dual tax benefit of (1) creating a charitable contribution income tax deduction to offset income generated by the transaction and (2) avoiding capital gain income that would have been realized and taxed to the owner if she still held the gifted stock at the time of the sale. The latter objective frequently triggers issues in connection with timing. Timing issues also arise frequently with real estate gifts. The question simply stated is: at what point in the sale process is it too late for the donor to avoid the realization of capital gain income by giving that asset to charity? Under the anticipatory assignment of income doctrine, a taxpayer who earns or otherwise creates a right to receive income will be taxed on any gain realized from it if the taxpayer has the right to receive the income or if, based on the realities and substance of events, the receipt of income is practically certain to occur, even if the taxpayer transfers the right before receiving the income (see *Ferguson v. Comm'r*, 174 F.3d 997 (9th Cir. 1999); *Lucas v. Earl*, 281 U.S. 111 (1930)). The related step transaction doctrine similarly prevents a taxpayer from escaping taxation by collapsing a series of substantially linked steps into a single overall transaction (see *Penrod v. Comm'r*, 88 T.C. 1415, 1428 (1987)).

(1) *Securities* – problems arise when a shareholder of a corporation makes a charitable contribution of stock immediately before a merger, liquidation, or similar taxable event, and when a shareholder makes a gift of closely held stock, which is followed immediately by a redemption of that stock by the issuing corporation.

- In *Palmer*, a donor had voting control of both a corporation and a private foundation. Pursuant to a pre-arranged plan, the donor contributed corporation stock to the foundation and caused the corporation to redeem from the foundation on the day following the gift. The Tax Court concluded that the transaction should be treated according to its form, namely a gift of stock followed by a redemption from the foundation. It should not be collapsed and treated as a redemption by the corporation from the shareholder and a cash gift by the shareholder to the foundation (*Palmer v. Comm'r*, 62 T.C. 684 (1974), *aff'd on other grounds*, 523 F.2d 1302 (8th Cir. 1975)).
- Following *Palmer*, the IRS announced that a gift of closely held stock, followed by a redemption under a prearranged understanding, would result in income to the donor only if the charity is “legally bound or can be compelled by the corporation to surrender the shares for redemption” (Rev. Rul. 78-197, 1978-1 C.B. 83). This ruling was thought to establish a bright-line test.

- In *Blake*, the donor contributed stock to a charity with the understanding that the charity would permit the corporation to redeem the stock and the charity would then use the proceeds to buy the donor's yacht at an inflated price. The yacht was sold shortly thereafter by the charity for less than 50 percent of the price it had paid the donor. The Second Circuit Court of Appeals found the "understanding" enough to re-characterize the transaction as a sale of stock by the donor, followed by a contribution of the yacht to charity. Note that, unlike other situations, there was a quid pro quo required by the donor in order for the donor to make the stock gift (*Blake v. Comm'r*, 42 T.C.M. 1336 (1981), *aff'd*, 697 F.2d 473 (2d. Cir. 1982)).
 - The next significant case was *Ferguson*. It involved a gift of stock, followed by a redemption under a merger agreement. The donors were directors and minority shareholders of Company A. On day 1, Company A entered into an agreement and plan of merger with Company B. Company A's board of directors (the donors abstaining) approved the merger and recommended it to the shareholders. On day 6, Company B made its tender offer. By day 34, more than 50 percent of the shareholders had tendered their shares. On day 43, the donors donated some of their Company A stock to a charity, which in turn immediately tendered the stock to Company B. On day 46, Company B announced its acceptance of all the tendered shares and purchased all of the shares on day 47. The Tax Court found that the donors were taxable on the gain from the stock transferred to charity because by the date of the gift the donors' interest had been converted from an interest in a viable corporation to a fixed right to receive cash. The Ninth Circuit Court of Appeals affirmed, holding that the transaction had "ripened" into a right to receive sale proceeds once 50 percent shareholder approval for the merger had been reached (*Ferguson v. Comm'r*, 108 T.C. 244, 260 (1997), *aff'd*, 174 F.3d 997 (9th Cir. 1999)).
 - There was concern that *Ferguson* had dulled the bright line test. However, in *Rauenhorst*, the Tax Court concluded that Revenue Ruling 78-197 continued as the legal standard for resolving these types of cases. If at the time of the gift there was no legal obligation to sell, a donor will not recognize income on the subsequent sale of the stock by the charity (*Rauenhorst v. Comm'r*, 119 T.C. 157 (2002)).
- (2) Real estate – The published IRS rulings and court opinions all focus on corporate redemptions of stock. However, the principles enunciated would appear to be just as applicable to real estate gifts. When a charity receives real property, it should have the right to negotiate its own sale of the property, or change the terms of any prior agreement made by the donor, or walk away from any agreement entered into by the donor without recourse. If not, the IRS should be able to apply either of the previously enunciated theories and tag the donor with the capital gains tax liability following the closing of a pre-arranged sale that the charity was obligated to complete.

4. Valuation: Perhaps somewhat inevitably, there have been numerous enforcement issues through the years stemming from the valuation of gifts of appreciated property for which there is readily available valuation. One of the ways the IRS has tackled perceived abuses is through substantiation and appraisal rules. The most recent iteration was promulgated in the 2006 PPA and proposed regulations issued in August 2008 (Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219, 120 Stat. 780, 1085-86 (2006); Prop. Treas. Reg. § 1.170A-17, 73 Fed. Reg. 45,908, 45,917 (Aug. 7, 2008)).

(a) *Fair market value* – The definition of “fair market value” is “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts” (Treas. Reg. § 1.170A-1(c)(2)).

(b) *Appraisers and appraisal rules* – Any taxpayer claiming a deduction for a gift of property which cannot be readily valued of more than \$5,000 (or \$10,000 for nonpublicly traded securities) must obtain a “qualified appraisal” prepared by a “qualified appraiser” (Treas. Reg. § 170A-13(c)). Once the qualified appraisal is obtained, the taxpayer needs to file an “appraisal summary” (Form 8283) with the IRS. If the property is appraised for more than \$500,000, a copy of the actual appraisal must be attached to Form 8283 (§ 170(f)(11)(D); Treas. Reg. § 170A-16(e)). These rules apply to deductions claimed by individuals, S Corporations, personal service corporations, and C Corporations for gifts made after June 3, 2004.

(1) No deduction is allowed for any contribution of clothing or a household item (not including food, paintings, antiques, other art objects, jewelry, gems, or collections) unless it is in “good used condition or better” (§ 170(f)(16)). The IRS may also by regulation deny a deduction for such a gift if it has minimal monetary value (e.g., underwear or socks). Notwithstanding the condition of the item, however, these rules do not apply to a contribution of a single item of clothing or a household item for which a donor claims a deduction of more than \$500 if the donor submits a qualified appraisal with the return. If the item is in good used condition or better, a qualified appraisal is only required if the claimed deduction is \$5,000 or more. If the donor claims a deduction of less than \$250, the donor must obtain a receipt from the donee or maintain reliable written records of the contribution including a description of the condition of the item (Treas. Reg. § 1.170A-16(a)). If the donor claims a deduction of \$250 or more, the donor must obtain from the donee a receipt that meets the requirements of section 170(f)(8).

(2) What must be appraised? If the property is not traded in an active market with readily available quotations (e.g., publicly traded securities), the value of the property must be determined by an appraisal. When the aggregate amount contributed is more than \$5,000, a separate appraisal is needed for each item of property that is not included in a group of similar items of property, e.g., stamp or coin collections, paintings, photographs, books, clothing, jewelry,

furniture, toys, china, crystal, silver, and nonpublicly traded stocks and securities (Treas. Reg. § 1.170A-13(c)(7)(iii)).

- However, certain donations may be made without an appraisal:
nonpublicly traded stock of \$10,000 or less; vehicle (car, boat, airplane) for which the deduction is limited to the gross proceeds of the subsequent sale by the donee; qualified intellectual property (e.g., a patent); inventory and other corporate donations that are qualified contributions for the care of the ill, needy, or infants; and stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of trade or business.

- (3) What is a “qualified appraisal”? A qualified appraisal is a document that is made during the period commencing not more than 60 days before the date of contribution and is prepared, signed, and delivered by a qualified appraiser. In addition, the appraisal must (1) describe the property in detail; (2) describe its physical condition; (3) give the date of the contribution; (4) set forth the terms of any agreement or understanding relating to the sale or disposition of the property or earmarking it for a particular use; (5) give the name, address and taxpayer identification number of the appraiser; (6) set forth the qualifications of the appraiser; (7) contain a statement that the appraisal was prepared for income tax purposes; (8) give the date of the valuation; (9) set forth the value of the property when it was contributed; (10) set forth the method of valuation used; and (11) set forth the specific basis for the valuation (Treas. Reg. § 1.170A-13(c)(3)(ii); *see also* Prop. Treas. Reg. § 170A-17(a)(3), 73 Fed. Reg. 45,908, 45,917 (Aug. 7, 2008) (setting forth substantively identical content standards for appraisals)).
- (4) Who is a “qualified appraiser”? The 2006 PPA tightened the appraisal rules by adding section 170(f)(11)(E)(ii), which specifies that a qualified appraiser must be an individual who: (1) has earned an appraisal designation from a recognized appraisal organization, or has minimum education and experience requirements set forth in the Treasury regulations; (2) regularly performs appraisals for which the individual receives compensation; (3) has verifiable education and experience and holds himself or herself out to the public as an appraiser; (4) is familiar with the type of property being appraised; (5) is aware of the civil penalties for false or fraudulent overstatements of value; (6) and is not (i) the donor or anyone claiming a deduction for the gift, (ii) a party to the transaction pursuant to which the donor acquired the property, (iii) the donee (i.e., the charity), (iv) any person employed by or related to any of the above persons, or (v) any person performing a majority of his or her appraisals during the taxable year for the donor, charity, or related party (*see* Notice 2006-96, 2006-2 C.B. 902).
- (5) Reporting sales by a charity – If, within three years of the date on which the contribution is made, the charity sells, exchanges, or otherwise disposes of the property with respect to which the charity has received an appraisal summary,

the charity is required to report the sale to the IRS using Form 8282 (*see* § 6050L).

(c) *Penalties for overstatement*

(1) There is an accuracy-related penalty of 20 percent of the underpayment of tax due to a “substantial valuation misstatement” and 40 percent of the underpayment due to a “gross valuation misstatement” of value on both the taxpayer and the appraiser for valuation misstatements (§ 6662).

- For income tax purposes, in the context of a charitable contribution, there is a substantial misstatement if the value (or adjusted basis) is 150 percent or more of the amount determined to be the correct amount, and a gross misstatement if the value (or adjusted basis) is 200 percent or more (§ 6662(e)(1)(A), (h)(2)(A)).
- Different thresholds apply for estate and gift tax returns. In this context, a substantial valuation misstatement now exists when the claimed value of any property is 65 percent or less of the amount determined to be the correct value; and a gross valuation misstatement exists when the claimed value of any property is 40 percent or less of the amount determined to be the correct value (§ 6662(g), (h)(2)(C)).

(2) A civil penalty may be assessed against appraisers for certain types of valuation misstatements. A person who prepares an appraisal of property value must pay a penalty if he or she knew, or reasonably should have known, that the appraisal would be used in connection with a federal tax return or refund claim and the claimed value of the appraised property resulted in a substantial valuation misstatement related to income tax under section 6662(e) or a gross valuation misstatement (§§ 6662(h), 6695A(a)). The penalty amount is determined as the greater of \$1,000 or 10 percent of the tax underpayment amount attributable to the misstatement, or 125 percent of the gross income received by the appraiser for preparing the appraisal (§ 6695A(b)).

- No penalty is imposed if the appraiser establishes that the appraised value was more likely than not the proper value (§ 6695A(c)).

5. Substantiation and Acknowledgement – How the Gift is Recorded:

(a) A contribution of \$250 or more is deductible for federal income tax purposes only if the donor has an acknowledgement from the recipient charitable organization (§ 170(f)(8); *see also* Prop. Treas. Reg. § 1.170A-15, 73 Fed. Reg. 45,908, 45,914 (Aug. 7, 2008)). In general, separate contributions to the same organization will not be aggregated for purposes of the \$250 threshold. In addition to the name of the donee organization, the acknowledgment must contain the following information:

- (1) A description (but not a valuation) of the property contributed (when the property has a value of more than \$5,000, the appraisal rules will apply).
- (2) A statement whether or not the charitable donee provided any goods or services to the donor in consideration for the contribution; and
- (3) If any goods or services were provided to the donor, a description and good-faith estimate of the fair market value of the goods or services provided.

III. THORNIER PROPERTY-RELATED ISSUES

A. Nonqualified Stock Options

1. If an employer issues non-qualified stock options and if the option plan permits transfer, the donor/employee may transfer the options to a CRT or to a charity without immediate income tax consequences, but will be treated as receiving compensation income when the CRT trustee or charity later exercises the options. The donor is therefore in no better a position than if the options had been exercised first, the donor had realized the income, and then had contributed the stock acquired through the exercised options. In fact the donor could be in a worse position because the value of the option at the time of the gift may be less than the spread upon exercise, thus requiring the donor to recognize compensation income that is greater than the deduction received at an earlier date.

B. Retirement Plans

1. In general, a gift during lifetime from a qualified plan or IRA may be made only by first withdrawing funds from the plan or IRA account. At any given time, depending on the age of the participant and the nature of the plan, withdrawals may not be possible. Even if permitted under the plan, most withdrawals prior to age 59 1/2 are subject to a penalty tax under section 72(t), and regardless of the participant's age, all withdrawals are generally taxed to the participant as ordinary income (§§ 402(a), 408(d)). While this income tax liability may be offset in whole or in part by any permitted income tax charitable contribution deduction, withdrawn retirement funds are not perceived as attractive assets to fund charitable gifts.
2. One exception exists for "qualified charitable distributions" from IRAs, or the so-called "IRA Charitable Rollover" (§ 408(d)(8)). This provision, currently effective through only the end of 2009, is available only to certain donors, applies only to outright transfers to certain types of charitable organizations, and is limited in amount. Furthermore, it operates to exclude the distribution from being taken into the IRA owner's income; it does not also provide an income tax charitable deduction.
3. For further discussion of charitable gifts of retirement assets, and in particular the planning opportunities that exist at death, *see, e.g., Christopher R. Hoyt, Charitable IRA Rollover in 2010? 2011?*, ALI-ABA SRO11 at p.511 *et seq.*

C. General Prohibitions on Partial-Interest Gifts

1. In general, a donor cannot claim a deduction for a contribution of less than his or her entire interest in the property donated. (§§170(f)(3), 2055(e)(2), 2522(c)(2)). This rule – the so-called partial interest rule – was added as part of the Tax Reform Act of 1969. It was designed primarily to disallow a double tax benefit to taxpayers who donated to charity the use of property for a limited period of time. If a deduction for the value of a charity’s rent-free use of property were allowed, the property owner would receive a double benefit through both the exclusion of the foregone rental income and the deduction of the fair rental value of the space donated (*see* H.R. Rep. No. 91-413, pt. 1, at 57 (1969), 1969-3 C.B. 200, 237; S. Rep. No. 91-552, at 83 (1969), 1969-3 C.B. 423, 477; *see also* Treas. Reg. § 1.170A-7(a)(1)).
2. The rule goes beyond, however, prohibiting deductions for contributions of the use of property. Applying Section 170(f)(3), the IRS has disallowed deductions for (a) a contribution of stock with respect to which the donor retains the voting rights (Rev. Rul. 81-282, 1981-2 C.B. 78; *see also* Rev. Rul. 83-45, 1983-1 C.B. 233 (a testamentary gift of stock to a charitable organization coupled with a transfer of the right to dividends to a noncharitable beneficiary is a non-deductible gift)); (b) a contribution of real estate in which the donor retains mineral or timber rights (Rev. Rul. 76-331, 1976-2 C.B. 52); (c) a contribution of a patent license in which the donor retains the right to license the patent to others (Rev. Rul. 2003-28, 2003-11 I.R.B. 594); and (d) a contribution a life insurance policy in which the donor retains one or more incidents of ownership (Rev. Rul. 76-143, 1976-1 C.B. 63).

D. Exceptions to the Partial-Interest Rule

1. Despite its apparent breadth, there are a number of permitted exceptions to the partial interest rule. These exceptions are extensive, with the result that the partial interest rule has become largely defined with the passage of time by its exceptions.
2. Gifts of Certain Trusts: Gifts made in the form of the following trusts are not subject to section 170(f) (*see* § 170(f)(2), (3)(A)).
 - (a) Remainder interest in a charitable remainder unitrust (“CRUT”), charitable remainder annuity trust (“CRAT”), or pooled income fund.
 - (1) For more information on CRTs, *see, e.g.*, Lawrence P. Katzenstein, *Charitable Remainder Trust: Charity Can Begin at Home*, ALI-ABA SRO11 at p.59 *et seq.*
 - (b) Lead interest in a trust that is expressed as a fixed annuity (“CLAT”) or a unitrust interest (“CLUT”).
 - (1) For income tax purposes, a deduction is allowable for such interests only if the donor is taxable on the income of the trust.

(2) For more information on lead trusts, *see, e.g.*, Edward Jay Beckwith, *Charitable Lead Trusts*, ALI-ABA SRO11 at p.219 *et seq.*

3. Gift of Remainder Interests in a Personal Residence or Farm: A donor can give such a property to a charity and retain the right to live in the residence for the rest of his or her lifetime (*see* §§ 170(f)(3)(B)(i), 2055(e)(2), 2522(c)(2)). The donor receives a charitable contribution deduction for the present value of the remainder interest (note, however, that computation of this deduction for income tax purposes is quite complex, and straight-line depreciation must be taken into account) (*see* § 170(f)(4); Treas. Reg. §§ 1.170A-12, 1.170A-12T (updating calculations)).
- (a) *Personal residence* – The regulations define a “personal residence” as any property used by the taxpayer as his personal residence even though it is not used as his principal residence (e.g., a vacation home) (*see* Rev. Rul. 75-420, 1975-2 C.B. 78).
- (1) A “personal residence” includes all land used in connection with the residence (Priv. Ltr. Rul. 8202137 (finding that a donation of a remainder interest in 77.33 acres of a 173.78-acre property was deductible)).
- (2) The definition of “personal residence” also includes stock owned by a taxpayer as a tenant-stockholder in a cooperative housing corporation, if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his personal residence (Treas. Reg. § 1.170A-7(b)(3)).
- (3) Furthermore, the IRS has held that a yacht which “contains all of the amenities found in a house” qualifies as a personal residence (Priv. Ltr. Rul. 8015017).
- (b) *Farm* – The regulations define a “farm” as any land used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. A farm also includes the farmhouse and other improvements, such as barns, sheds, and corrals (Treas. Reg. § 1.170A-7(b)(4)). A farm may include acreage with or without the farmhouse. Thus, a donor may convey a remainder interest in separate parcels at different times, e.g., a gift of a remainder interest in Parcel A consisting of 10 acres of the farm in 2004, Parcel B consisting of 25 acres of the farm in 2005, and Parcel C consisting of five acres of the farm and farmhouse in 2006 (*cf.* Rev. Rul. 78-303, 1978-2 C.B. 122).
- (c) *Term of the reserved interest* – The gift must be an irrevocable remainder interest, not in trust, that follows a life estate in the donor and/or another, or that follows an interest for a term of years (*see* § 170(f)(3)(B)(i); Treas. Reg. § 1.170A-7(b)(4)). The remainder interest cannot pass through a trust to charity (*see Ellis First Nat’l Bank of Bradenton v. United States*, 550 F.2d 9, 16 (Ct. Cl. 1977)).
- (d) *Gift of remainder interest in proceeds of sale* – The IRS originally took the position that the gift of a remainder interest must be an interest in the property itself; it may not consist of the right to the proceeds of sale of the property (*see*

Rev. Rul. 77-169, 1977-1 C.B. 286 (disallowing estate tax deduction for gift of remainder interest in a personal residence where a will directed that, on the death of the life tenant, the residence was to be sold and the proceeds paid to charity)). The Tax Court, however, has held that a remainder interest in the proceeds from the sale of a residence will qualify for the charitable deduction (*Estate of Blackford v. Comm'r*, 77 T.C. 1246 (1981), *acq. in result*, 1983-2 C.B. 1), and the IRS has conceded that, if local law gives a charity the option of taking the property itself despite the terms of the gift, the gift of a remainder interest in the proceeds will be treated as a deductible gift of a remainder interest in a residence (Rev. Rul. 83-158, 1983-2 C.B. 159).

- (e) *Gift of a portion of the remainder interest* – Similarly, the IRS once argued that on the expiration of the life estate(s), the charity or charities must receive the entire residence outright and that a deduction was not available for a gift of a fractional interest in the remainder (*see* Rev. Rul. 76-544, 1976-2 C.B. 288 (disallowing deduction where, upon termination of the life estate, the property vested in a charity and an individual as equal tenants in common)). This position was at odds with the principle that a gift of an undivided fractional interest is deductible. In 1987, the IRS reversed its position and held that a gift of a 10 percent remainder interest was a deductible interest even though 90 percent of the interest passed to an individual, since the gift was of an undivided fractional interest (Gen. Couns. Mem. 39628; Rev. Rul. 87-37, 1987-1 C.B. 295 (expressly revoking Rev. Rul. 76-544)). The ruling suggests that the value of the remainder interest must be reduced to reflect an appropriate valuation discount for the cotenancy arrangement (*see also* Priv. Ltr. Rul. 9336002 (finding that discount should be limited to the estimated cost of a partition proceeding)).
- (f) *Restrictions on disposition* – The gift of the remainder interest may not be subject to restrictions as to its disposition, unless the restrictions are so insubstantial in nature as to have no effect on the value of the contributed property. For example, the deduction will be lost if the life tenant can compel a charity to join in a sale of the property and divide the proceeds (Rev. Rul. 77-305, 1977-2 C.B. 72). The rationale for this position is questionable, for in such a case the charity would presumably receive value equivalent to the value of the donor's charitable deduction, and it is hard to see what purpose is gained by forcing the life tenant to continue the life estate. The position seems to be based on the premise that the donor's reserved right to force the sale of the property makes it impossible to value the remainder interest, a premise that may not make much sense. Therefore, as long as the charity cannot be compelled to do so, it should be permissible for the life tenant and the charity, as an independent matter after the gift has been made, to agree to sell jointly and to divide the proceeds in proportion to the value of their respective interests.
- (g) *Bargain sale of remainder interest* – The donor may sell the remainder interest to charity for less than its value, in which case the bargain-sale rules will apply. The donor's deduction will equal the difference between the value of the remainder

and the amount paid by the charity. The payment for the remainder may take the form of a gift annuity (Priv. Ltr. Ruls. 8120089, 8806042).

- (h) *Calculating the deduction* – The calculation of the deduction for the gift of the remainder interest begins with the fair market value of the property at the time the remainder interest is given. If the deduction claimed exceeds \$5,000, the donor must obtain a qualified appraisal to substantiate the income tax deduction. The \$5,000 threshold is based on the value of the remainder interest rather than the value of the property itself (*see* Treas. Reg. § 1.170A-13(c)). Once the fair market value of the property has been established by an appraisal, the present value of the remainder interest is calculated by discounting the fair market value to reflect the term of the life estate at the section 7520 interest rate in effect when the gift is made (or in either of the two months preceding the month of the gift). When valuing a remainder interest in depreciable real estate for income tax purposes, the remainder interest also must be discounted to reflect straight-line depreciation (§ 170(f)(4)). The computation with respect to the depreciable portion uses a special method (Treas. Reg. § 1.170A-12T; *see generally* Treas. Reg. § 1.170A-12). Depreciation need not be taken into account for purposes of calculating the gift or estate tax deduction. Because of the complexity of the calculation, it is recommended that commercial software be used.
- (i) *Avoiding unnecessary gift tax* – If, in addition to reserving a personal life estate, the donor wishes to permit another person to use the property after the donor’s death for the other person’s surviving lifetime, the gift of the successor life estate represents a gift of a future interest that does not qualify for the annual gift tax exclusion under section 2503(b). Moreover, if the successor life estate is given to the donor’s spouse, it does not qualify for the marital deduction because it is not a present interest. The spouse does not receive the interest “for life” because it does not take effect until the donor’s death (*see* § 2523(f)). The donor can avoid making a taxable gift of a future interest by reserving the right (to be exercised in the donor’s will) to revoke the successor life estate. For gift tax purposes, this renders the gift of the successor life estate incomplete until the donor’s death, at which time it will be taxable as a part of the donor’s estate.
- (j) *Impact of Mortgages* – A gift of property subject to a mortgage is treated as though the property were sold to charity for the amount of the outstanding mortgage. While the donor ought to be able to avoid the bargain-sale rules by agreeing to hold the charity harmless (*see* Section III.E.7(a), below), the value of the property nevertheless will be reduced by the amount of the mortgage for purposes of computing the deduction (*see* Treas. Reg. 1.1001-2). Although most residences are subject to a mortgage, there is a curious dearth of authority dealing with the tax effect of a gift of a *remainder interest* in a mortgaged residence. There are at least three potential analyses:
 - (1) *Ignore the Life Estate* – If a donor gives a charity a remainder interest in a residence that is subject to a mortgage, the transaction might be taxed as though the donor had sold the property to the charity for the full amount of the

indebtedness and the deduction might be reduced by that amount, ignoring the fact that the donor had reserved a life estate. Such a result would appear to be in conflict with the economic reality of the transaction. The donor will continue to live in the residence and will make the mortgage payments during the balance of her lifetime. The gift of the remainder interest does not relieve the donor of any liability for the mortgage payments that fall due during the donor's life expectancy. But the IRS appeared to adopt this approach in Private Letter Ruling 9329017, ruling that, where the taxpayer proposed to donate a remainder interest in real estate worth \$110,000, but subject to an \$80,000 mortgage, the transfer was a bargain sale and the taxpayer was entitled to a charitable contribution deduction for the remainder interest in \$30,000 only, plus the value of the remainder interest in any additional payments of principal under the mortgage made by the taxpayer in the future.

- (2) **Apportion the Mortgage Between the Life Estate and the Remainder** – An alternative approach might be to apportion the mortgage between the life estate and the remainder on the basis of the fair market value of each. Under this approach, the donor would be deemed to have sold the property to charity for an amount equal to the ratio of the value of the remainder interest to the fair market value of the property. While this approach is more rational, it assumes, in effect, that the mortgage is a permanent liability and does not reflect the fact that the mortgage may, in fact, be paid off by the time the remainder interest passes to the charity.
 - (3) **Take the Life Estate Fully into Account** – Perhaps the most rational solution is to compare the length of the retained life estate with the remaining period of the mortgage. If the life estate is longer than the mortgage payment period so that the mortgage should be paid off in full before the remainder interest falls in, the transaction ought not to be treated as a bargain sale. As long as the donor agrees to hold the charity harmless against any liability on the mortgage, the donor ought to be entitled to a full deduction for the value of the remainder interest. In this situation, the obligation to make the mortgage payments is, in effect, similar to the donor's obligation to maintain the property during the life term. If, on the other hand, the mortgage period extends beyond the donor's life expectancy, the gift of the remainder interest is technically subject to a liability, for if the donor dies "on schedule" the remainder interest passing to the charity will be subject to an unpaid liability. In this situation, the donor ought to be able to avoid the impact of the bargain-sale rules by agreeing to hold the charity harmless with respect to any liability arising under the mortgage, but the donor's deduction probably ought to be reduced by the amount of that liability. As in the case of an outright gift, the donor's agreement to hold the charity harmless against the liability is, in effect, a non-deductible pledge.
- (k) *Other factors: repairs, insurance, taxes, and improvements* – Other factors to consider when making a gift of a remainder interest in real estate include arrangements for maintenance, insurance, repairs and improvements. Under state

laws, the life tenant is responsible for maintaining the property and for paying all current operating costs (utilities, taxes, and the like). To protect the value of the property, it is advisable for the donor to agree to keep the property insured with a policy that reflects the remainder interest of the charity and names the charity as an insured party. The tax clause in the donor's will should be reviewed and, if necessary, revised to ensure that death taxes will not be apportioned to the property. If the donor makes a capital improvement (as opposed to a repair) which increases the value of the property, the donor should be entitled to a further deduction based on the increased value of the property (*see* Priv. Ltr. Rul. 9329017 (ruling that the remainder interest in improvements made to real estate were considered a deductible charitable contribution, but providing no discussion as to how the deduction should be calculated)).

(1) Valuing improvements – The increase in value should be determined by an appraisal that compares the value of the property before and after the improvement. If the increase in value is greater than the cost of the improvement, the amount of the deduction should arguably be limited to cost on the theory that the donor has not “held” the improvements for the requisite long-term holding period. However, since the improvements become a part of the basic property which, if sold, would not produce any short-term capital gain, there is a strong case for the proposition that the reduction rule of § 170(e)(1) ought not to apply. Once the appropriate value of the improvement has been determined, the deductible portion is determined by applying the appropriate remainder and depreciation factors for the donor's age at the time the improvement is made.

(1) *Form of gift* – A simple deed of the property to charity reserving a life estate in the donor is sufficient; it is normally good practice, however, to cover the responsibilities for taxes, repairs and expenses in a separate letter agreement.

4. Partial Interest in Property if it is the Donor's Entire Interest in the Property: A deduction is allowed for a contribution of a partial interest in property if it is the donor's entire interest in the property (such as an income interest or a remainder interest) and the interest was not created for the purpose of making the gift (Treas. Reg. § 170A-7(a)(2)(i)).

(a) For example, if securities are given to A for life, with remainder to B, and B then transfers her remainder interest to charity, B is entitled to a charitable contribution deduction equal to the present value of her remainder interest.

(b) If, however, a donor transfers a remainder interest in property to his son and then immediately transfers the income interest to charity, the deduction will be denied because the income interest will be viewed as having been carved out specifically for the purpose of making the charitable gift (Treas. Reg. § 170A-7(a)(2)(i)).

5. Partial Interest that Represents an Undivided Portion of the Donor's Entire Interest in the Property: In addition, a partial interest that represents an undivided portion of the

donor's entire interest in the property is exempt from the partial-interest rules (§§ 170(f)(3)(B)(ii), 2055(e)(2), 2522(c)(2)). However, if the property in which the partial interest exists was divided in order to create the interest and avoid the partial interest rule, a deduction will *not* be permitted. Moreover, this undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property (*see* Treas. Reg. § 1.170A-7(b)(1)(i)). For these purposes, a gift is treated as an undivided portion of a donor's entire interest in the property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in the property (*id.*; *see also* Field Serv. Advice Ltr. Rul. 2001-49-007 (Dec. 7, 2001)).

(a) *Examples of what is and is not covered*

- (1) Donor gives Museum an undivided 25 percent interest in a sculpture valued at \$750,000. Provided Museum is entitled to the unrestricted use and possession of the sculpture for three months of the year, this gift will entitle the donor to a deduction equal in value to the 25 percent interest transferred.
- (2) Donor gives Charity an undivided 20 percent interest in a parcel of real estate each year for five years until the Donor has fully disposed of the real estate. Provided that Charity receives exclusive possession of the property each year for increasing periods commensurate with its increasing interest, each part of the installment contribution will be a deductible gift (Priv. Ltr. Rul. 8533006). This may be a useful technique for extending the five-year carryforward period for income tax deduction purposes.
- (3) However, if Donor makes a gift of real estate reserving the mineral rights, and the gift is not a qualified conservation contribution, the gift will not be deductible (Rev. Rul. 76-331, 1976-2 C.B. 52). Similarly, no deduction is allowed if a fee owner grants a charity a leasehold interest in an oil or gas well, or if the holder of a leasehold interest in a well grants the charity a working interest, or if the holder of a working interest grants a charity an overriding royalty or net-profits interest – in each case, the donor has not given the charity all her rights (Rev. Rul. 88-37, 1988-1 C.B. 97).

6. Fractional Interests in Tangible Personal Property: The 2006 PPA adopted significant changes in the law relating to gifts of fractional interests in tangible personal property, such as artwork, which can be summarized as follows:

- (a) *All interests must be owned either by the donor or the donee* – No income tax deduction is available for a contribution of an undivided interest in tangible personal property unless immediately before the contribution all interests in the property were owned by the donor or by the donor and the donee charity (§ 170(o)(1)(A)). This limitation on owners applies for gift as well as income tax purposes (§ 2522(e)(1)).

- (b) *Limit on deductions for additional gifts of undivided interest in the same property* – If the use of the property is related to the charity’s exempt purpose, and the deduction is based on the fair market value of the property, there is a special limit on the amount of deduction generated by gifts to the same charitable donee of additional undivided interests in the same property. In that situation, the fair market value of an additional contribution must be determined by using the lesser of (1) the property’s fair market value at the time of the initial fractional contribution or (2) the property’s fair market value at the time of the additional contribution (§ 170(o)(2)). Therefore, no deduction is allowed for increases in the fair market value of the entire property after the time of the initial fractional gift. (However, consistency is not an objective of the legislation since the deduction is adjusted downwards if the property goes down in value after the initial gift.)
- (1) This rule initially also applied for purposes of calculating the gift and estate tax charitable deduction for the transfer of a retained interest. This produced the untenable result that a subsequent gift of a partial interest in artwork could result in a taxable gift, measured by the difference in the market value of the gifted fractional interest and the amount of the deduction permitted under the special rule. Similarly, the bequest of the donor’s remaining fractional interest in an item of tangible personal property to charity could have led to estate tax liability on the difference between the fair market value of the fractional interest at the time of death and the amount of the estate tax deduction permitted under the special limitation. However, the Tax Technical Corrections Act of 2007 amended both sections 2055(a) and 2522(e) to delete the special limit for gift and estate tax purposes. As a consequence, the value of the gift or bequest will equal the amount of the permitted gift or estate tax charitable deduction.
- (c) *Recapture of deduction* – The PPA also provides in certain circumstances for the recapture of both the income and gift tax (but not estate tax) charitable deductions allowed with respect to earlier fractional interest gifts. First, if the donor makes an initial contribution and then fails to contribute all of the remaining interest in the property to the original charitable donee (or if the donee is no longer in existence, to another charitable organization) before the earlier of the 10th anniversary of the initial gift and the donor’s death, there is recapture of the deductions permitted for all of the prior charitable contributions. Secondly, there is also recapture where the charitable donee fails to take substantial physical possession of the property, or fails to use the property in a use related to the organization’s exempt function during the period beginning after the initial fractional contribution and ending on the earlier of the 10th anniversary of the initial contribution and the donor’s death (§§ 170(o)(3), 2522(e)(3)). The recapture takes the form of taxing the amount of the recaptured deductions in the year in which the recapture is triggered, and paying interest on any additional tax running from the due date of the tax that would have been paid earlier if the deduction had not been claimed. Furthermore, if a deduction is recaptured, there is an additional tax of 10 percent of the amount recaptured (§§ 170(o)(3)(B), 2522(e)(3)(B)).

7. Qualified Conservation Contributions: Partial-interest gifts of a qualified conservation contribution are allowed (§ 170(f)(3)(B)(iii)). As defined by section 170(h), there must be a contribution of a qualified real property interest made to a qualified organization exclusively for conservation purposes. Prior to the 2006 PPA, qualified conservation contributions of capital gain property were subject to modified versions of the same limitations and carryover rules applicable to charitable contributions of other capital gain property. However, since 2006, the rules (though technical) can be summarized as follows:
- (a) First, the 30 percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions (§ 170(b)(1)(E)).
 - (1) Farmers and ranchers may make a qualified conservation contribution up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.
 - (b) There must be a contribution of a *qualified real property interest*, which is defined as (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property (§ 170(h)(2); *see also* Treas. Reg. § 1.170A-14(b)).
 - (1) The most familiar of these is a so-called "conservation easement." This is not a traditional easement, but rather consists of a restriction (in perpetuity) on the use that may be made of the subject property.
 - (2) Minor interests, such as right-of-ways that will not interfere with the conservation purposes of the gift, may be transferred prior to the contribution without adversely affecting the qualification of the property (Treas. Reg. § 1.170A-14(b)(1)(ii)).
 - (c) The contribution must be made to a *qualified organization* (§ 170(h)(3)). A gift of an easement for conservation purposes is deductible only if it is given to a governmental unit, a publicly supported charitable organization, or an organization that supports a public charity (§ 170(h)(3)). The organization must have a commitment to protect the conservation purposes of the donation, and must have the resources to enforce restrictions (Treas. Reg. § 1.170A-14(c)(1)).
 - (d) The contribution must be made *exclusively for conservation purposes*, which include (1) the preservation of land for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants or a similar ecosystem; (3) the preservation of open space for the scenic enjoyment of the general public or pursuant to a clearly delineated

governmental policy; and (4) the preservation of an historically important land area or certified historic structure (§ 170(h)(4)(A); Treas. Reg. § 1.170A-14(d)).

(1) The conservation purpose must be protected in perpetuity. Hence, mortgage indebtedness must be subordinated to the rights of the donee organization (*Satulla v. Comm’r*, 66 T.C.M. 1697 (1994); Treas. Reg. § 1.170A-14(g)(2)).

(e) *Special estate tax exclusion* – Finally, the executor of a decedent’s estate may elect to exclude up to 40 percent of the value of land that is subject to a qualified conservation easement (§ 2031). The total amount that can be excluded is currently limited to \$500,000. The exclusion is reduced by the amount of any estate tax charitable deduction that may be taken with respect to the land. Numerous other rules must be satisfied before the exclusion may be claimed. However, the exclusion is available even for a post-mortem conservation easement; there is no requirement that it be in existence prior to the decedent’s death. A full discussion of this exclusion is beyond the scope of this outline.²

8. Special Rules that Broaden the Exceptions to the Partial Interest Rule for Transfer Tax Purposes: The partial interest rule applies with full force to estate and gift tax charitable deductions. Thus, a donor who makes a gift of a partial interest that is nondeductible for income tax purposes may also find that the gift is a taxable transfer for gift or estate tax purposes even though the gift is clearly made to charity (*see, e.g., Estate of Johnson v. United States*, 941 F.2d 1318 (5th Cir. 1991) (holding split interest trust where noncharitable beneficiary had partial interest ineligible for estate tax charitable deduction)). There are, however, certain rules that broaden these exceptions so that partial-interest gifts *are deductible* for transfer tax purposes:

(a) Special provisions work to “uncouple” the estate and gift tax deductions for gifts of conservation interests from some of the income tax restrictions on such deductions. In sections 2522(d) and 2055(f), gift and estate tax deductions are allowed for a “qualified real property interest (as defined in section 170(h)(2)(C)), which meets the requirements of section 170(h) (without regard to paragraph 4(A) thereof).” Under section 170(h), a gift must be made “for conservation purposes,” but section 170(h)(4)(A) – the provision disregarded by sections 2522(d) and 2055(f) – contains the definition of conservation purposes. The effect of these estate and gift tax provisions, therefore, is to leave in the requirement that the gift be made for conservation purposes but to eliminate the definition of that term. Thus, a donor who wishes to make a gift that is deductible for gift tax purposes without qualifying the gift for income tax purposes is left to her own devices to determine whether the gift is “for conservation purposes.”

² A great deal more could be said in general about the deduction for conservation easements, but that already has been done extraordinarily well by Stephen M. Small, Esq., in three works entitled *Preserving Family Lands* (3rd ed. 1998), *Preserving Family Lands: Book II* (1997), and *Preserving Family Lands: Book III* (2002). For more information, see www.stevesmall.com.

(b) A gift to a public charity or private operating foundation of a work of art is automatically treated as separate and apart from the copyright interest in the work (§§ 2055(e)(4)(A), 2522(c)(3)).

(1) However, artwork merely loaned by the owner to a charity is treated for federal gift tax purposes as remaining under the donor's full dominion and control as if the loan were not made (§ 2503(g)).

9. Special Income tax Rules in Section 170(a)(3) for *Remainder Interests in Tangible*

Personal Property: These rules predate the 1969 partial interest rules of section 170(f) and provide that no contribution of a future interest in tangible personal property will be considered to be made until the expiration of all intervening non-charitable interests, or until all intervening non-charitable interests are no longer held by the donor or a related person. This rule was intended to prevent donors from taking a deduction for a gift of a remainder interest in tangible personal property as long as the donor or a relative retains the right to possess and enjoy the property.

(a) Since the partial interest rules (see above) also prohibit a deduction for a gift of a remainder interest in tangible personal property (unless the remainder is in a CRT or pooled income fund), this provision would appear to be superfluous. However, it has not been repealed and continues to create problems.

(b) For example, if a donor contributes a remainder interest in a painting to charity subject to a reserved right to keep the painting in the donor's family for 10 years, both sections 170(a)(3) and 170(f) prohibit an income tax deduction until the 10-year period has expired or the donor relinquishes the right to keep the painting.

(1) Furthermore, since the section 170(f) (but *not* the section 170(a)(3)) rule is picked up by reference in the estate and gift tax provisions, the donor would be subject to gift tax on the value of the future interest contributed to the charity because the reserved interest is not in a pooled income fund or CRT.

(2) If the donor dies within the 10-year period without having relinquished the right to keep the painting, section 170(f) (but not section 170(a)(3)) would deny an estate tax deduction for the charity's remainder interest. This is obviously not a desirable form of gift from the donor's standpoint.

(c) However, if this same gift is contributed to a CRT, even though the requirements of section 170(f) would be satisfied and an income tax (and, by reference, an estate and gift tax) deduction would be permitted, *if the donor or a family member is a beneficiary of the trust* (and thus, through the trust, holds an "interest in the property"), section 170(a)(3) would postpone the income tax deduction until the donor and his family no longer hold an intervening interest (*see* Treas. Reg. § 1.170A-5(b), Example (6)).

(1) Note that the statute speaks in terms of an interest in the property, not the proceeds, so if the trust sells the property to an unrelated person and invests the proceeds in securities, the sale terminates any interest that the beneficiaries

of the trust might have had in the property. And, because the statute emphasizes an interest in the property as opposed to proceeds, the donor should be able to deduct the value of the remainder interest at the time the trust sells the property. The deduction will apparently be based on the donor's basis in the tangible personal property originally transferred (*see* Priv. Ltr. Rul. 9452026).

- (2) Note also, however, that while the plain language of section 170(a)(3) suggests that when a donor contributes tangible personal property to a charity and retains rights for himself, an income tax deduction eventually will arise on the donor's death (if the retained right then lapses), the regulations take a different tack. Treasury Regulation section 1.170A-5(b), Example (3), indicates that no such deduction arises. Apparently, the donor must relinquish his rights in the transferred property during his lifetime to secure a deduction.

E. Bargain Sales

1. **Definition:** A charitable bargain sale is a sale of property to a qualified charitable organization for less than the fair market value of the property. The donor is entitled to a charitable contribution deduction for the difference between the fair market value and the sales price. In this way, and in contrast to a gift of a partial interest in property, a bargain sale is partly a gift and partly a sale of property to a charity.
2. **In General:** Bargain sale rules can be triggered by gifts such as gifts of real estate subject to mortgages or liens or even by a small payment by a charity to the donor in conjunction with a charitable contribution (*see* Priv. Ltr. Rul. 9235033 (ruling that a charity's reimbursement of \$1,500 of environmental costs associated with the transfer of real property to the charity triggered bargain-sale rules)).
 - (a) **Appraisals** – The donor must obtain a careful appraisal by a qualified appraiser demonstrating a value in excess of the sale price. An appraisal is required for any property where the deduction claimed exceeds \$5,000 (\$10,000 in the case of closely held securities).
 - (1) Although the question is not addressed directly in the regulations governing appraisals, in the context of a bargain sale, it appears that the thresholds apply to the amount claimed as a deduction rather than to the value of the entire property (*see* Treas. Reg. § 1.170A-13(c)).
 - (2) Still, even where the amount claimed as a deduction is less than the applicable threshold, the donor should be prepared to support a value in excess of the sales price with an appraisal.
3. **Donative Intent Required:** In order for a bargain sale to produce a deduction, the donor must show that she intended to make a *gift* of the value in excess of the sales price. This becomes particularly important in the context of charitable gifts made by corporations. For example, in *Singer Co. v. United States*, a sewing machine manufacturer was not allowed a deduction for the gift element of sewing machines it

manufactured and sold at discount to public and parochial schools with the expectation of enlargement of its market, but a deduction was allowed for discounts given to governmental and religious organizations (449 F.2d 413 (Ct. Cl. 1971)). It is normally good form to recite the donor's donative intent in the documentation of the transaction.

4. Allocation of Basis: If there is a bargain sale to charity (or to a CRT) that results in a charitable deduction to the transferor, the donor will realize a taxable gain that is computed by allocating a portion of the adjusted basis of the transferred property to the sale in accordance with the ratio of the sales price to fair market value (Treas. Regs. §§ 1.170A-4(c)(2) (donee's basis), 1.1011-2(b) (donor's basis)).
 - (a) *Example* – Donor sells securities that he has held for more than one year to Charity for \$4,000. The securities have an adjusted basis of \$2,000 and a fair market value of \$10,000. Donor has made a deductible contribution to Charity of \$6,000 (\$10,000 value - \$4,000 sale price). His basis of \$2,000 is allocated to the sale in accordance with the ratio of the sale price to the fair market value: ($\$4,000 \text{ sale price} / \$10,000 \text{ fair market value}$) x \$2,000 adjusted basis = \$800. Thus, Donor has a recognized long term capital gain of \$3,200 ($\$4,000 \text{ sale price} - \800 basis) on the bargain sale. The balance of the basis of \$1,200 ($\$2,000 - \800) is allocated to the gift portion. This means that Donor is making a gift of appreciated property with a basis of \$1,200 and a fair market value of \$6,000.
 - (1) Donor is better off making a bargain sale than he would be if he were to sell the securities for \$10,000 and contribute \$6,000 of the proceeds.
 - The *sale* would generate a capital gains tax of \$1,200 ($15\% \times \$8,000 \text{ gain}$). Accordingly, Donor would be left with \$2,800 ($\$10,000 - \text{gift of } \$6,000 - \text{tax of } \$1,200$). In addition, Donor would have the benefit of the value of \$6,000 charitable contribution deduction (which will vary depending on Donor's tax bracket). If Donor is at the maximum 35 percent income tax bracket, the deduction would be worth \$2,100. As a consequence, Donor would retain \$4,900.
 - On the other hand, if the Donor enters into the *bargain sale*, he pays a tax of \$480 on the gain ($15\% \times \$3,200$) and is left with \$3,520 ($\$4,000 - \480), plus the value of a \$6,000 charitable contribution deduction (\$2,100), for a total of \$5,620. The increase in Donor's net retained interest results from the fact that the appreciation in the gift portion of the bargain sale (here, \$4,800) is not subject to income tax.
 - (b) If the transaction does *not* result in a charitable contribution deduction, the bargain-sale allocation rules are not applicable and it is not necessary to allocate the basis accordingly (Treas. Reg. § 1.1011-2(a)(1)).
 - (1) For example – Donor gives Charity a building with a fair market value of \$1,000,000. Donor's basis is \$400,000. The property is subject to a mortgage

of \$550,000 and depreciation recapture of \$600,000. The value of the contribution is \$450,000 (\$1,000,000 - \$550,000). However, since the amount of the contribution is less than the \$600,000 of depreciation recapture, which must be subtracted from the value of the gift for purposes of determining the amount deductible (Treas. Reg. § 1.170A-4A(a)), Donor does not receive any charitable income tax deduction. In this situation, Donor would be entitled to allocate his entire basis (\$400,000) to the amount deemed received (\$550,000) so that his taxable gain would be only \$150,000. While the transaction is a sale, there is no charitable deduction. Accordingly, all basis is allocable to the sale portion and none needs to be allocated to the gift portion.

5. Character of the Gain (Ordinary Income or Long-Term Capital Gain): The character of the gain realized as a result of the bargain sale depends on whether and to what extent the property transferred is a capital asset that, when sold, would generate a capital gain. Where a portion of the gain would be taxable as ordinary income and the balance as long-term capital gain, the computation is complicated because, in addition to allocating the basis, each type of gain must be allocated between the portion given to charity and the portion deemed sold.

(a) *Example* – Donor donates a building worth \$1,000,000, subject to a mortgage of \$250,000, with a cost basis of \$400,000 and with respect to which Donor has taken accelerated depreciation of \$300,000, all of which is subject to recapture as ordinary income if the property were sold. The transaction will be a bargain sale, pursuant to which Donor is deemed to have sold the property to charity for \$250,000 (the amount of the indebtedness) and made a gift of \$750,000, her equity.

(b) In determining the tax consequences, the first step is to allocate cost basis between the amount sold and the amount given. The basis allocated to the amount sold is $\$250,000/\$1,000,000 \times \$400,000 = \$100,000$, so that the gain on the bargain sale is $\$250,000 - \$100,000 = \$150,000$. The balance of the basis is allocated to the gift: $75/100 \times \$400,000 = \$300,000$.

(c) The next step is to allocate the recaptured depreciation between the sale and the gift using the same ratios. The depreciation allocated to the sale portion is $\$250,000/\$1,000,000 \times \$300,000$, or \$75,000, so that \$75,000 of the \$150,000 gain is taxed as ordinary income and the balance, \$75,000, is taxed as long-term capital gain. The remaining depreciation recapture is allocated to the gift: $\$75,000/\$100,000 \times \$300,000 = \$225,000$.

(d) The final step is to reduce the deduction for the amount given (\$750,000) by the ordinary-income element (recaptured depreciation) allocated to the gift (\$225,000). The net amount deductible is \$525,000.

6. Installment and Deferred Bargain Sales: Rather than paying the full purchase price when the sale is made, a charity could defer the payment of the price for a specified period and/or make the payment in installments. In such a case, the charity will be

required to pay interest on any deferred payment at a rate sufficient to avoid the imputation of interest under the imputed-interest rules (*see* § 7872; *but see* Temp. Treas. Reg. § 1.7872-5T(b)(9) (exempting loans to charitable organizations if the total loans by the lender to such an organization during the taxable year do not exceed \$250,000)).

- (a) Installment bargain sales can be useful in states where a gift annuity is subject to burdensome insurance regulations or where the charitable organization is not willing to assume the actuarial risk of the annuity.
- (b) Note, however, that a deferred or installment bargain sale will cause the property to be treated as “debt-financed property” in the charity’s hands. Therefore, unless the charity can put the property to a use that is related to its exempt purpose (other than merely producing income), a portion of any income realized from the property (including any gain arising from a sale of the property) will generate UBTI to the charity (§§ 511-514).

7. Types of Gifts that are Bargain Sales:

- (a) *Gift of mortgaged property* – For purposes of computing gain on the transfer of property, a transferor must include in the “amount realized” any liabilities from which she is discharged – such as a mortgage – as a result of the disposition of the property (Treas. Reg. § 1.1001-2). The fact that the transfer may be a gift or the fact that the liability is non-recourse to the transferor does not change this result (Treas. Reg. § 1.1001-2(a)(4)). Thus, when a donor gives mortgaged property to charity and is, by reason of the gift, discharged from the liability, the transaction is treated as though the donor had sold the property to the charity for the amount of the outstanding mortgage, even though the indebtedness is non-recourse to the donor and the charity does not agree to assume or pay the indebtedness (*Guest v. Comm’r*, 77 T.C. 9, 19-23 (1981); *see also Ebbsen v. Comm’r*, 783 F.2d 906, 913-15 (9th Cir. 1986)).
- (b) A donor should be able to avoid the bargain sale rule by agreeing to hold the charity harmless and paying off the mortgage as it comes due (Priv. Ltr. Ruls. 8536061, 8526015). In such circumstances, the donor should be entitled to a deduction equal to her equity in the property when it is given and additional deductions as the principal of the mortgage note is paid off.
 - (1) Alternatively, and where a property is about to be sold, the donor could retain a fractional interest in the property equal to the amount of the indebtedness and the capital gains tax that would be payable on sale of the retained portion, and make a gift to charity of the balance. When the property is later sold, the donor will receive a portion of the sale proceeds, which she could use to pay off the mortgage indebtedness and the capital gains tax on her portion of the sale proceeds. (Of course, payment of the mortgage note in these circumstances will not generate a further charitable income tax deduction, because the payment does not increase the charity’s interest).

(2) Finally, the bargain sale rule might be avoided by giving the charity an option to purchase the property at a below market price rather than the property itself. No deduction is available at the time the option is granted; the gift is treated as a pledge to make a gift in the future (Rev. Ruls. 82-197, 1982-2 C.B. 72; 78-181, 1978-1 C.B. 261; 75-348, 1975-2 C.B. 75). When the charity sells or exercises the option, however, the donor is entitled at that time to a deduction equal to the difference between the exercise price and the fair market value of the property. Since the option grant does not relieve the donor of liability, the bargain sale rule should not apply (*but see* Priv. Ltr. Rul. 9501004 (gift of option to CRT creates a partial interest that fails to qualify under IRC § 170(f))).

(c) *Gift of limited partnership interest* – A gift of a limited partnership interest will be treated as a bargain sale to the extent of the limited partner’s share of the liabilities of the partnership, even if the limited partner has no personal indebtedness with respect to the partnership interest transferred (Treas. Reg. § 1.1001-2(a)(4)(v); Rev. Rul. 75-194, 1975-1 C.B. 80).

F. Charitable Gift Annuities

1. CGAs in General: The Charitable Gift Annuity (“CGA”) is the oldest form of planned gift. Although it functions in much the same fashion as a CRT or pooled income fund, it is not technically a deferred gift. Instead, it is a type of bargain sale transaction in and of itself in which the donor transfers cash or other assets to a charitable organization in return for the charity’s promise, backed by its general assets, to make annuity payments to one or more individuals for their lifetimes.

(a) A CGA provides a charity with assets that it can use immediately; the charity is not waiting for the annuitant to die before any part of its interest falls into possession. This helps to make a CGA the preferred method for retaining an income interest where the donor is seeking a deduction based on fair market value for a gift of tangible personal property that the charity will use in carrying out its exempt function. Similarly, gift annuities are not subject to the prohibition on UBTI or to the private foundation self-dealing rules that apply to CRTs. CGAs may, therefore, be funded with assets otherwise inappropriate for planned gifts.

(b) *Payments and rates* – A CGA contract will generally provide for the annuity to be paid in monthly or quarterly installments. Most charities determine the annuity amount based on rates published by the American Council on Gift Annuities (“ACGA”). These rates in turn are based on the number and age of the annuitants and certain expectations with respect to expenses and the rate of return earned by the institution’s assets (or dedicated charitable gift annuity reserve fund) and are designed to produce an average “residuum” or gift to the organization at the expiration of the agreement of approximately 50 percent of the amount originally donated (based on present values as of the time of the gift). As a consequence, the rates are lower than, and are not in competition with, commercially offered rates. The ACGA typically conducts an annual review of rates and announces

adjustments effective as of July 1; however, in times of rapidly changing market conditions, the ACGA may publish rate tables more frequently.³

2. Income Tax Consequences to the Donor: The donor under a CGA contract is entitled to an income tax charitable deduction equal to the difference in value between the property transferred to the charity and the present value of the annuity to be paid back by the charity (Treas. Reg. § 1.170A-1(d)(1)).

(a) The present value of the annuity is based on the following factors:

- (1) The life expectancy of the annuitant or annuitants. Life expectancies are set forth in actuarial tables published by the IRS (Publication 1457, Table S). The most recent tables were issued in May 2009 and were effective for all gifts made after May 1, 2009. Note that, in order for the issuing charity to avoid potential UBTI issues and possible loss of tax-exempt status, CGAs may not be issued for a term of years or for the lives of more than two currently living annuitants.
- (2) The frequency (monthly, quarterly, semi-annually, or annually) and timing (beginning or end of installment period) of the annuity payments; and
- (3) The so-called section 7520 interest rate in effect for the month in which the contract is entered into or, at the election of the taxpayer, for either of the two immediately preceding months (§ 7520(a)). The section 7520 rate is 120 percent of the applicable federal mid-term rate, rounded to the nearest two-tenths of a percent (§ 7520(a)(2)). Note that annuity valuations are particularly sensitive to interest rate changes. All other things being equal, the higher the section 7520 rate, the lower the value of the annuity and the higher the income tax charitable deduction. Accordingly, in the current low interest rate environment, CGAs are not as tax efficient as in the past. (For example, at a 3.0 percent section 7520 rate, the value of a \$6,500 annuity paid in quarterly installments at the end of the quarter, for a 70-year-old annuitant is \$70,180; at a 7.0 percent section 7520 rate, the same annuity is worth \$52,912. If the CGA gift is \$100,000, the income tax charitable deduction is \$29,820 at a 3.0 percent rate and \$47,088 at a 7.0 percent rate.)

(b) The donor's income tax charitable deduction is subject to all the normal limitations applicable to charitable gifts. Deduction limits will, therefore, be affected by the type of property transferred to fund the CGA and the type of charity to which the gift was made. Substantiation requirements also apply.

- (1) If the donor funds a CGA with appreciated assets or encumbered property, the donor may realize capital gain income in connection with the transaction (Treas. Reg. § 1.1011-2(a)(4)).

³ Current ACGA suggested gift annuity rates can be found on the ACGA website at <http://www.acga-web.org/>.

3. Gift Tax Consequences to the Donor: The donor is entitled to a charitable gift tax deduction for the charitable gift portion of a CGA. If the charitable gift portion exceeds the annual exclusion (\$13,000 in 2009), it must be reported on a timely filed federal gift tax return, regardless of the other gift tax consequences of the CGA. The general exemption for charitable gifts from gift tax reporting requirements does not apply to partial-interest gifts, including CGAs (§ 6019(a)(3)). CGAs may have other gift tax consequences, depending on whether there is a sole annuitant or multiple annuitants and whether the annuitant(s) is the donor, a third party, or the donor's spouse:
- (a) If the donor is the only annuitant, there are no other gift tax considerations.
 - (b) If the sole annuitant is the donor's spouse, and the annuity begins immediately, the gift to the spouse will qualify for the gift tax marital deduction (Treas. Reg. § 25.2523(b)-1(b)(6), Example 3; Rev. Rul. 79-420, 1979-2 C.B. 335). If the donor's spouse is not a U.S. citizen, gift tax consequences can only be avoided if the annuity payments begin immediately and if the value of the spouse's annuity is within the special annual exclusion limit (\$133,000 in 2009) for gifts to non-citizen spouses (§ 2523(i)(2)). Whether or not the spouse is a U.S. citizen, the marital deduction may not be available for a deferred annuity. In this circumstance, the donor should first consider transferring the assets to fund the deferred CGA to the spouse (with no conditions so that the transfer qualifies for the marital deduction and in an amount no greater than the special annual exclusion limit if the spouse is not a U.S. citizen) and leaving it to the spouse in turn to establish the annuity contract.
 - (c) If the sole annuitant is a third party other than the donor's spouse, the donor will make a taxable gift to the third party equal to the value of the annuity. If the annuity is not deferred, the interest of the third party annuitant should constitute a present interest for purposes of the gift tax annual exclusion (§ 2503(b); *cf.* Priv. Ltr. Ruls. 8721023, 8637084). The donor can avoid making a taxable gift by retaining the right to revoke the annuity; such a right prevents the gift from being complete. In this circumstance, the donor is treated as making a completed gift each time the annuitant receives a payment under the contract. These gifts in turn will qualify for the gift tax annual exclusion. The downside to retaining a revocation right is that the donor's estate will include as an asset the value of the annuity remaining at the donor's death if the annuitant survives the donor.
 - (1) Contrast the above treatment – the ability to retain a lifetime revocation right over a CGA – with the inability to retain such a right over the interest granted to a third-party individual in a CRT. In the context of the latter, the donor can only retain a right to revoke the third party beneficiary's interest by will, meaning that there will be a completed gift of the annuity or unitrust payments for the period of the donor's life expectancy (Treas. Reg. §§ 1.664-2(a)(4), 1.664-3(a)(4), 25.2511-2(c); Priv. Ltr. Rul. 8430006). Some have questioned whether even such a testamentary right can be retained over an immediately effective third-party interest in a CRT, since the right could be construed to

make the beneficiary's interest one measured by the life of "another" in violation of core remainder trust rules.

- (d) If the donor establishes a two-life CGA, with the donor as the first annuitant and a third party other than the donor's spouse as the successor annuitant, the donor will be treated as making a taxable gift to the successor annuitant equal to the excess of the value of the joint annuity over the value of a single life annuity retained by the donor. This gift will not qualify for the federal gift tax annual exclusion because it is a future interest gift. The donor can avoid making a taxable gift by retaining the right to revoke the successor annuitant's interest. The retained right causes the gift to be incomplete, even if never exercised (Treas. Reg. § 25.2511-2(c)). Such a right can be exercisable both during lifetime and by will. Contrast again with retained revocation rights over CRT interests, which can only be exercised by will. Retention of such a right will, however, have estate tax consequences at the donor's death.
- (e) If the donor establishes a joint and survivor annuity for the donor and the donor's spouse, under which payments are made jointly to the donor and spouse while they are both alive and then all to the surviving individual, the spouse's interest qualifies for the gift tax marital deduction. Section 2523(f) treats the donee spouse's interest as a qualifying income interest for life, with respect to which the donor spouse is treated as having made a QTIP election ("qualified terminable interest property" is not included in the donor spouse's gross estate; if desired, the donor spouse may elect out of QTIP treatment). If, instead, the annuity is structured so that payments are made to the donor spouse as the primary annuitant and then to the other spouse, if he or she survives, as a secondary annuitant, the gift tax consequences are unclear and turn on whether or not such an arrangement is a joint and survivor annuity under section 2523(f)(b).⁴ If automatic QTIP treatment does not apply, potential gift tax liability can be avoided by having the donor reserve the right to revoke the interest of the other spouse; in that case, the annuity for the second spouse will not vest until the death of the donor, at which point it will qualify for the estate tax marital deduction (*see generally* § 2056(a)). If the donor's spouse is not a U.S. citizen, a gift tax marital deduction is permitted for a joint and survivor annuity under a special exception in section 2523(i) (which is not applicable to joint and survivor spousal interests in CRTs). At the donor spouse's death, however, the qualified domestic trust ("QDOT")

⁴ The scope of section 2523(f)(6) has not been elaborated in regulations or rulings, and the gift tax regulations do not define a joint and survivor annuity. Although an annuity paying the donor as primary annuitant and the spouse as secondary annuitant is the economic equivalent of the traditional joint and survivor annuity, it is unclear whether altering the structure of the payments is a change material enough to warrant different treatment. The definition of a joint and survivor annuity in section 417(b) (the only Code section that defines the term) seems to support an argument that such an annuity is a joint and survivor annuity. That Code section provides that a joint and survivor annuity is an annuity "(1) for the life of the participant with a survivor annuity for the life of the spouse which is not less than 50 percent of (and is not greater than 100 percent of) the amount of the annuity which is payable during the joint lives of the participant and the spouse, and (2) which is the actuarial equivalent of a single annuity for the life of the participant," or "*any annuity in a form having the effect of an annuity described in the preceding sentence*" (emphasis added) (*see also* Treas. Reg. § 1.401(a)-11(b)(2)).

requirements of section 2056A must be met in order for the estate of the donor spouse to receive an estate tax marital deduction for the value of the non-citizen donee spouse's annuity interest.

- (f) If spouses establish a CGA with joint property, the annuity should be structured as a classic joint and survivor annuity. Otherwise, one spouse may make a taxable gift to the other to the extent that the present value of that spouse's survivor annuity is less than the present value of the other spouse's survivor annuity. As before, such a gift can be avoided if both spouses retain the right to revoke the survivorship interest of the other (here to the extent of each spouse's contribution to the joint property).
4. Estate Tax Consequences to the Donor: The estate tax consequences at the donor's death of a CGA established during the donor's lifetime also will depend on the number and identity of the annuitants and the retention of any right to revoke annuity interests.
- (a) If the donor was the only annuitant, the donor's interest is extinguished at the donor's death and there is nothing to include in the donor's gross estate for federal estate tax purposes (other than a "stub" annuity installment payment to which the donor may be entitled under the contract).
 - (b) If the survivor annuitant is the donor's spouse, and no other person has an interest in the annuity arrangement, any amount includable in the donor's estate that is attributable to the CGA will qualify for the estate tax marital deduction as QTIP property (§ 2056(b)(7)(C)). A QTIP election is deemed made unless the donor's executor elects out. If the surviving spouse is not a U.S. citizen, there are two alternative arrangements available to qualify the annuity for the marital deduction (Treas. Reg. § 20.2056A-4(c)). Under the first, the surviving spouse must *inter alia* agree to pay the deferred estate tax due on the corpus portion of each annuity payment as it is received (Treas. Reg. § 20.2056A-4(c)(2)). Under the second, the surviving spouse must *inter alia* agree to transfer the corpus portion of each annuity payment to a QDOT that is established prior to the date that the estate tax return is filed (Treas. Reg. § 20.2056A-4(c)(3)).
 - (c) If a third party was the only annuitant and the third party survives the donor, no amount will be includable in the donor's estate unless the donor reserved the right to revoke the annuity interest. In that event, the value of the annuity at the donor's death will be includable in the donor's federal estate under section 2038.
 - (d) In the case of a two-life CGA where the donor had the initial annuity and retained a revocation right, the value of the survivor's annuity will be includable in the donor's estate under both sections 2038 and 2039. If the donor did not retain a revocation right, the value of the survivor's annuity will still be includable in the donor's estate, but under section 2039 only. Any estate tax attributable to the annuity will be allowed as an income tax deduction to the successor annuitant (amortized over the annuitant's life expectancy) (§ 691(c), (d)). Note that even if

the donor revokes the survivor annuity effective as of the donor's death, the value of the annuity will be includable in the donor's estate under section 2038, albeit that the donor's estate should be entitled to an offsetting estate tax charitable deduction.

- (e) In the case of a two-life annuity funded with joint property, at the death of the first donor, one half of the value of the survivor's annuity at that time will be includable in the deceased donor's estate (§ 2039). If the surviving joint annuitant is the deceased's spouse, a QTIP election will be deemed to have been made with respect to the value of the interest that is includable in the estate (unless the survivor is not a U.S. citizen in which case the QDOT rules described above must be complied with).
 - (f) A CGA may also be established by the donor to take effect at the donor's death under the terms of his or her estate planning documents. In this event, the donor's estate will be entitled to an estate tax charitable deduction for the difference between the amount transferred to the charity and the value of the annuity to be paid back to the individual annuitant, determined in the same manner as the income and gift tax deductions for lifetime CGAs. The deduction will only be available, however, if the amount of the annuity is ascertainable, which requires that the annuity starting date be stated clearly together with the amount of the annuity or the method of calculating the annuity. Reference to the ACGA rate in effect at the time of the donor's death for an annuitant of the same age as the specified beneficiary should adequately satisfy the certainty requirement. If the sole annuitant of the testamentary annuity is the decedent's surviving spouse, and the spouse is a U.S. citizen, and the annuity is not deferred, the spouse's interest will qualify as QTIP property for purposes of the estate tax marital deduction.
5. Generation-Skipping Transfer Tax ("GST Tax"): GST tax is only a concern if a skip person – a natural person assigned to a generation that is two or more generations below that of the donor (§ 2613(a)) – is named as an annuitant. The term includes a donor's grandchild, unless at the time of the transfer the grandchild's parent who is a child of the donor is deceased (§ 2651(e)). For purposes of the GST tax, a CGA is treated as if it were a trust; accordingly, trust rules determine the incidence of the tax and the method of allocating the GST tax exemption (§ 2652(b)(3)).
- (a) If the only annuitant is a skip person, the donor's transfer is a direct skip for GST tax purposes (§ 2612(c)). The donor will be liable for any GST tax liability (§ 2603(a)(3)). If the donor has available GST tax exemption, the GST tax can be avoided by allocating the exemption solely to the value of the annuity given to the skip person. The charitable component of the entire transfer will be subtracted out in determining the CGA's inclusion ratio (§ 2642(a)).
 - (b) If a two-life annuity is created and the second annuitant only is a skip person, there is no direct skip at the time of the donor's transfer. However, at the death of the first annuitant, there will be a taxable termination for GST tax purposes (§ 2612(a)). In this event, the Code appears to make the charity, in its functionally

equivalent role as trustee, liable to pay any GST tax liability (§§ 2603(a)(2), 2652(b)(2)). If the first annuitant is not the donor or the donor's spouse, such liability can be avoided if the donor allocates GST exemption at the time the annuity arrangement is established, albeit that the allocation would have to correspond to the entire value of the two-life annuity (including the initial annuity to the non-skip person) to avoid the tax entirely. For this reason, a donor may prefer to establish two different annuities, an immediate one for the non-skip person and a deferred contract for the skip person. The donor would then need only to allocate GST tax exemption to the second arrangement to avoid the GST tax.

- (c) In the case of a two-life annuity, if the first annuitant is the donor (and in some cases the donor's spouse) GST tax exemption cannot be allocated during the "estate tax inclusion period" (namely the period during which the donor is receiving annuity payments) (§ 2642(f)).

6. Tax Consequences to Annuitant – Annuities Funded with Cash: Under section 72, a portion of each annuity payment during the annuitant's life expectancy is excluded from gross income as a tax-free return of principal, whether the annuitant is the donor or a third party. Contrast this with the "worst-in, first-out" tiering system applicable to the taxation of annuity and unitrust distributions from a CRT (§ 664(b)). (For more information on CRTs, see the presentation by Lawrence P. Katzenstein.) To determine the excluded amount in the case of a one-life annuity, the amount of the annual payment is multiplied by an "exclusion ratio," the numerator of which is the investment in the contract (i.e., the non-charitable component of the gross transfer to the charity) and the denominator of which is the expected return (i.e., the annual payment multiplied by the annuitant's life expectancy and adjusted for timing and frequency of payment) (Treas. Reg. §§ 1.72-4, 1.72-5(a)).

- (a) *Example* – Mary Smith, life expectancy 20 years, purchases a \$1,000 lifetime annuity for \$15,000. The annuity is payable in a single annual installment at the end of each year. The expected return is \$1,000 x 20 years, or \$20,000. The exclusion ratio is her investment in the contract, divided by her expected return, or 15,000/20,000 – or 3/4. This means that three-quarters, or \$750, of each annual payment represents a tax-free return of principal. The remainder of each annual payment is taxable to Mary as ordinary income. If Mary lives out her life expectancy of 20 years, she will recover all of her \$15,000 investment in the contract.
- (b) The portion of each annuity payment excludable from gross income cannot exceed the "unrecovered investment" in the contract (§ 72(b)(2)). In other words, once the annuitant's life expectancy is reached (and the investment in the contract has been fully recovered), the entire amount of the annuity becomes includable in gross income.
- (c) If the annuitant dies prior to the expiration of her life expectancy and has unrecovered investment in her one-life annuity contract, the annuitant is,

however, entitled to deduct the amount of the unrecovered investment on her final income tax return (§ 72(b)(3)). This deduction is not a charitable gift and is not subject to the percentage and other limitations on charitable gifts imposed by section 170. The net effect of this rule is to ensure that the entire investment in the contract (but no more) will be recovered tax-free regardless of how long the annuitant lives.

(d) *Example.*- Before May 1, 2009, John Smith, age 72 (with a life expectancy of 14.5 years), gives \$50,000 in cash to charity in exchange for an annuity of 6.7% percent, or \$3,350 per year, paid quarterly in arrears at the end of each calendar quarter. Using the highest then available Section 7520 rate of 3.6 percent, John is entitled to a current income tax deduction of \$17,852; the present value of the annuity is \$32,148 and the expected return is \$3,350 x 14.5, or \$48,575. The exclusion ratio is thus \$32,148/\$48,575, or 66.2%. Accordingly, on a full-year basis, John is entitled to exclude \$2,218 as a tax-free return of principal and will be required to report ordinary income of \$1,132. If John lives for more than 14.5 years, he must begin to report the entire \$3,350 annuity as ordinary income once he has outlived his life expectancy. (The amount must be prorated in the 15th year.) If, on the other hand, John dies before 14.5 years expires, he is entitled to a deduction for the amount of unrecovered investment in his annuity contract (\$2,218 x the number of years or fraction thereof remaining of his life expectancy) in the year of his death.

(e) It should be noted there is a silver lining to the low interest rate “cloud.” While low interest rates reduce the donor’s immediate income tax deduction (all other things being equal), they correspondingly boost the donor’s “investment in the contract.” As a result, a larger amount of each annuity payment is treated as tax-free return of principal and a smaller amount is taxed as ordinary income.

7. Tax Consequences to Annuitant – Transfers of Appreciated Property: If a donor transfers appreciated property in exchange for an annuity paid by a charity, the transaction constitutes a bargain sale of the property under Treasury Regulation section 1.1011-2(a)(4). The bargain sale rules apply irrespective of the identity of the annuitant. As a consequence of the application of these rules, the donor may realize capital gain income when establishing a CGA. And, except as described below, the gain recognized on the sale is taxable to the donor at the time of the transfer as a long-term or short-term capital gain, depending on the nature of the property transferred and the donor’s holding period. Accordingly, if the donor transfers long-term capital gain property in return for an annuity to be paid to the donor’s son, the donor must pay a tax on the capital gain as determined under the bargain-sale rules in the year in which the initial transfer is made. The taxable gain equals the investment in the contract reduced by that portion of the donor’s basis in the assets transferred that is allocable to the investment in the contract.

(a) However, if the donor is the only annuitant or is the first annuitant and the CGA is non-assignable, the gain is reportable ratably over the donor’s life expectancy. This means that a portion of each annuity payment otherwise excludable as a

return of principal as described above is taxable as capital gain (*see* § 1011(b); Treas. Reg. § 1.1011-2(a)(4)). An annuity is considered to be non-assignable even though the donor retains the right to revoke any successor annuitant's interest and even though the donor may release his right to future annuity payments in favor of the donee charity (Treas. Reg. § 1.1011-2(a)(4)(ii)). If the donor dies before the expiration of his life expectancy, and there is no successor annuitant, the remaining gain is neither taxed on the donor's final income tax return nor taxed as income in respect of a decedent to the donor's estate.

- (b) *Example* – Assume that John Smith funds the annuity referred to in the previous example not with cash but with appreciated marketable securities having a fair market value of \$50,000 and a tax basis of \$10,000 at the time of the gift. In this case, John will have taxable gain that can be spread over his life expectancy. The gain is first allocated between the gift portion and the annuity portion in accordance with the bargain-sale rules; under those rules the total gain allocated to the annuity would be \$25,718 ($32,148 - [32,148/50,000 \times 10,000]$). Accordingly, he will have ordinary annuity income of \$1,132 each year, capital gain of \$1,774, and \$444 of tax free “income” for the duration of his life expectancy. The \$444 of tax free “income” is, in effect, a proration of the donor's basis allocated to the sale.

- (1) If John lives longer than his life expectancy, the entire amount of any annuity payment made after he surpasses that point will be taxable to him as ordinary income and no portion will be considered as capital gain. If he dies before the expiration of his life expectancy, he will have a deduction in his final income tax year for the unrecovered excludable portion of his basis ($\$444 \times$ the number of years or fraction thereof remaining of his life expectancy). Neither John (on his final income tax return) nor his estate will be taxable on any remaining amount of the gain portion.

8. Tax Consequences – Donee Charities:

- (a) *UBTI* – Even though an organization is recognized as exempt generally from federal income tax, it may still be liable for tax on its UBTI. One type of UBTI is income from debt-financed property. Debt-financed property is any property held by a charity with respect to which there is acquisition indebtedness (§ 514(b)). The obligation to pay an annuity is considered acquisition indebtedness and can cause a charity to have UBTI with respect to the assets received in consideration for a CGA unless four conditions are met:

- (1) The value of the annuity must be less than 90 percent of the contributed property, and no other consideration may be given by the charity;
- (2) The annuity must be payable over the lives of either one or two individuals in being at the time of the gift (in other words, annuities covering three or more lives will not qualify, nor will an annuity arrangement for an after-born grandchild, and nor will an annuity payable for a fixed term of years);

- (3) Neither a minimum nor a maximum number of annuity payments can be specified; and
 - (4) The annuity cannot provide for adjustment of the annuity amount by reference to the income received from the gift property or any other property (in other words, the annuity payout cannot be based on prevailing interest rates or on investment performance) (§ 514(c)(5)).
- (b) *Potential loss of tax-exempt status* – Under section 501(m), a charity loses its tax-exempt status if a substantial part of its activities consists of providing “commercial-type insurance.” The issuance of annuity contracts is specifically treated as providing insurance (§ 501(m)(4)). Even if a charity does not lose its tax-exempt status by providing annuities (because the activity is not substantial), it is taxed as if it were an insurance company upon issuing annuities (which is treated as an unrelated trade or business) unless the annuities qualify as “charitable gift annuities” (§ 501(m)(3)(E)). An annuity qualifies as a “charitable gift annuity” if a portion of the amount paid is deductible to the purchaser under section 170 or 2055 (no reference is made to the gift tax charitable deduction under section 2522) and if the annuity otherwise complies with the requirements of section 514(c)(5) (§ 501(m)(5)).
9. Deferred Gift Annuities: A deferred payment gift annuity (“DPGA”) is an arrangement under which the payment of the initial annuity is delayed for more than one year after the date of the gift to charity. Such an arrangement may be attractive to a donor who wants to support a charity currently, and who needs a current income tax deduction, but who does not need a current flow of income. In contrast, a CRAT must begin payments immediately and must pay the same annuity every year (§ 664(d)(1)(A)). (Deferral options with CRTs can only be achieved with CRUTs where the payment is defined as the lesser of the unitrust amount or the trust’s net income, and the investment policy is designed to minimize income in the initial years of the trust’s administration.)
10. Assigning an Existing CGA to Charity: While most donors will rely on receiving their charitable gift annuity payments until death, a change in circumstances may prompt consideration of assigning or relinquishing an annuity to the issuing charity. However, CGA payments generally cannot be assigned to other individuals or to non-issuing charities due to the requirements of section 1011.
- (a) While the IRS has concluded that a unitrust or annuity interest in a CRT is a capital asset and the donor thus may deduct the full fair market value of the assigned interest (*see, e.g.*, Rev. Rul. 86-60, 1986-1 C.B. 302), there has been no published or private ruling dealing with the nature of an annuity interest in a CGA. It would be tempting to conclude that it should be treated no differently from an annuity interest in a CRAT, so that a donor would be entitled to a fair market value deduction for a capital asset. The opposite conclusion may appear more appropriate, however. Under section 72(a), annuity payments other than the portion representing the investment in the contract are treated as ordinary income.

As a consequence, a donor who assigns his annuity to the issuing charity may only be entitled to an income tax charitable deduction equal to the lesser of the donor's unrecovered basis (plus any unrecognized capital gains if the annuity was funded with appreciated property) or the fair market value of the donor's annuity (see *First Nat'l Bank of Kansas v. Comm'r*, 309 F.2d 587 (8th Cir. 1962) (holding that a taxpayer cannot convert what otherwise would have been ordinary income under an annuity contract to capital gain by selling the annuity contract); *Roff v. Comm'r*, 304 F.2d 450 (3d Cir. 1962) (same); Treas. Reg. § 1.170A-1(c)(1)).

11. Converting Interests in CRTs to CGAs:

- (a) Donors who have created CRTs during their lifetime may find that they no longer need the income generated by the planned gift and may want to use the unneeded income stream to make a charitable gift. One possible option is to transfer part or all of the income interest in the CRT to the charitable remainder beneficiary. If structured correctly, such a transfer will provide the donor with an income and gift tax charitable deduction for the present value of the assigned income interest (see, e.g., Rev. Rul. 86-60, 1986 1 C.B. 302). Such a transfer from a CRT may also result in a partial or total termination of the trust and put part or all of the trust property immediately into the hands of the charitable remainder beneficiary.
- (b) Another option that will put assets into the hands of the charity but will leave something for the donor is a swap of the donor's remaining CRT interest for a CGA. Such a transaction was approved in Private Letter Ruling 200152018 and was held to have the following tax consequences:
 - (1) The donor is entitled to income and gift tax charitable deductions equal to the difference between the present value of the donor's CRT interest and the present value of the CGA. The income interest in the CRT is treated as a capital asset, and not ordinary income property, thereby permitting the income tax deduction to be calculated on the basis of the fair market value of that interest (see Treas. Reg. § 1.170A-4(a), (b)(1)). The partial interest rule is not violated, because the donor is giving away his entire interest in the property donated (assuming that there is no evidence that the interest in the CRT was created in order to effect an end run around the partial interest rule) (Treas. Reg. § 1.170A-7).
 - (2) The donor will not have to recognize any undistributed capital gains previously realized by the CRT.
 - (3) The donor will, however, realize capital gain in the entire amount of the present value of the annuity. This is because the donor is treated as having a zero basis in the interest contributed (§ 1001(e)(1)). That gain can be reported ratably over the donor/annuitant's life expectancy, assuming that the annuity is non-assignable other than to the charity issuing it.

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