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Imagine the Possibilities: Opportunities for Non-Cash Donors

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INTRODUCTION

For most Americans, charitable giving is an essential part of their lives. Over 80% of Americans give to charity annually. In 2010, religious organizations received an overwhelming majority of contributions, followed by educational organizations and gifts to foundations.[2]

Oftentimes, real estate, retirement accounts, tangible personal property, or closely held stock are the most significant assets for an individual or family. Despite this fact, many individuals have not typically viewed these assets as attractive alternatives to cash to accomplish charitable initiatives. Thus, cash donations generally make up the lion's share of total giving. However, a high percentage of donors, advisors, and charitable organizations are now exploring alternative methods to structure charitable gifts using assets other than cash, and charitable organizations are increasingly accepting these non-cash gifts.[3]

Charitable non-cash gifts can take many forms, but no matter the form, if structured properly, a non-cash charitable gift can create significant ''positives'' to the donor. On the other hand, non-cash charitable gifts are sophisticated transactions and, if not structured properly, can create unintended negative results, most often to the charity. This article explores some non-cash charitable gift alternatives and in each instance also provides some planning ideas and cautionary remarks associated with the non-cash gift.[4]

CHOOSING A CHARITABLE ORGANIZATION

With well over 1 million charitable organizations recognized as tax-exempt in the United States, it is essential for potential donors to understand that not all charitable organizations are created equal. To ensure maximum tax benefits, donors should be familiar with the different types of charitable organizations and their accompanying tax implications and should confirm an organization's tax status before attempting to take an income tax deduction in connection with a donation. The charitable contribution tax laws generally reflect the government's policy of favoring contributions to recognized public charities over contributions to private foundations. Accordingly, contribution limits are largely determined by whether a donor contributes to a public organization or a private organization.

50% Deduction Limitation

Each year, a donor may deduct up to 50% of his or her contribution base).[5] for cash contributions and non-cash contributions to public charities, if the donor

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[2] In 2010, charitable organizations received $290.89 billion in cash and non-cash charitable contributions. Donors contributed $100.63 billion to religious organizations. Educational organizations and foundations received $41.67 and $33 billion, respectively. Other organizations that received significant charitable contributions included human services, public-society benefit, health, international affairs, arts, culture and humanities, environment and animals, and foundation grants to individuals. National Park Service: Giving Statistics, http://www.nps.gov/partnerships/fundraising_individuals_statistics.htm.

[3] According to the IRS, for tax year 2008, 23.0 million individual taxpayers itemizing deductions reported $40.4 billion in deductions for noncash charitable contributions. The largest type of non-cash contribution is corporate stock. The IRS Spring 2010 Statistics of Income Bulletin stated that 44.9% of all non-cash donations were in the form of corporate stock. Other types of popular non-cash contributions include mutual funds, real estate, land, conservation easements, art and collectables, and various personal items, such as clothing and household items.

[4] For further information on financial, estate, and tax considerations for contributing non-cash assets, see the attached charts regarding donor and done issues provided by Charitable Solutions, LLC and Bryan Clontz, CFP®.

[5] The term ''contribution base'' means adjusted gross income (computed without regard to any net operating loss carryback to

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deducts his or her basis in the property.[6] A charity is deemed a public organization if it receives at least 33⅓% of its support directly or indirectly from the general public or the government.[7] Typically, churches, certain educational organizations, hospitals, medical research centers, governmental units, and publicly supported organizations, such as the American Red Cross, libraries, and community museums, qualify as public charities.

Although a majority of the 50% deduction organizations are public charities, the Internal Revenue Code has carved out an exception for certain private foundations. For instance, private operating foundations, pass-through foundations, donor advised funds (DAFs), and pooled-fund foundations are all subject to the 50% deduction ceiling despite their status as private organizations.[8]

Donor Advised Funds

DAFs provide donors with a unique opportunity to donate to charitable organizations and receive the maximum deduction limitation. Generally, a donor contributes an irrevocable donation to a qualified charitable organization, a tax-exempt §501(c)(3) organization, and the organization then creates and maintains a DAF. Although the organization maintains legal control over the contribution, the donor holds advisory privileges over the DAF, thus allowing the donor to recommend grants and contributions to other eligible charities through funds held in the DAF. Please note, however, that the DAF is not obligated to follow the donor's recommendations. Donors may contribute a wide range of assets to DAFs. Cash contributions to a DAF are subject to the maximum 50% deduction limitation. As discussed below, contributions of non-cash assets to a DAF are subject to a 30% deduction limitation if the donor deducts the fair market value of the property. Common DAF contributions include cash, appreciated stock, real estate, mutual funds, and limited partnership interests. DAFs do want an "exit strategy" for non-cash gifts including closely held interests.

DAFs provide donors with a multitude of tax benefits. Oftentimes, donors receive a current tax deduction for their charitable contributions even though the assets are not distributed in the same tax year by the DAF. Because DAFs are maintained by public charities, rather than private foundations, contributions to DAFs are typically subject to the maximum tax deduction limitation and donors may deduct the fair market value of the contributed non-cash assets. Additionally, DAFs allow donors to offer advice for distributions, while allowing the assets in the DAF to grow without the donor incurring a capital gains tax. For instance, a donor may engage in long-term or short-term charitable giving depending on the donor's charitable goals. Donors may also personalize their DAFs by naming them after family, or a company or foundation. To ensure a continuing legacy, donors may name successors to advise the account.

30% Deduction Limitation

Contributions of non-cash assets to a public charity are subject to a 30% deduction limitation if the donor deducts the fair market value of the property. However, the donor's deduction limitation may be increased to 50% if the donor elects to limit the deduction to his or her basis in the property, rather than the fair market value. Under this election, the donor's deduction for all contributed non-cash assets will be lowered to the donor's basis in the property and in turn the donor's deduction limitation will increase to the maximum 50% deduction limitation.[9]

Cash contributions and non-cash contributions, where the donor deducts the basis of the property, to an organization that does not qualify as a public charity are subject to a 30% deduction limitation. Accordingly, a donor may only deduct a maximum of 30% of his or her contribution base for cash contributions to private foundations.

20% Deduction Limitation

Alternatively, contributions of non-cash assets to organizations that do not qualify as public charities are subject to a 20% deduction limitation if the donor's deduction is based on the fair market value of the property. Where the donor elects to take a basis deduction for the property, the contribution is subject to a 30% deduction limitation.

The following chart illustrates the various deduction limitations:

Deduction Limitations for Charitable Contributions

	Public Charities	Private Foundations
Basis Deduction/ Cash	50%	30%
FMV Deduction	30%	20%

A donor may contribute to both public and private organizations within the same taxable year and a do-

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the taxable year under §172). §170(b)(1)(G). Note that the contribution base is calculated before any reductions for itemized deductions (such as the state income tax deduction and the mortgage interest deduction).

[6] §170(b)(1)(A).

[7] Regs. §1.170A-9(f)(2).

[8] §170(b)(1)(F).

[9] Whether this election is advantageous to the donor will depend on a number of factors, including how much the fair market value of the contributed non-cash assets exceeds the basis of such assets, whether the election will allow a greater current deduction because of the increased deduction limitation, the donor's current and anticipated future marginal tax rate, and the risk that the donor will die (which results in a loss of any remaining charitable deduction carryover).

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nor may contribute both cash and non-cash assets. Strategic tax planning is necessary to ensure that the donor maximizes his or her tax deduction. Regardless of what organizations a donor contributes to or whether the donor contributes cash or non-cash assets, he or she is subject to an overall 50% deduction ceiling for a taxable year. Contributions to public organizations are taken into account before contributions to private foundations. If a donor's contributions exceed the overall 50% limitation, or the 30% or 20% limitation in the event the donor only contributes to private foundations that do not qualify for the maximum deduction, the remaining deductions may be applied as carryover for five succeeding taxable years.

CHOOSING THE TYPE OF NON-CASH ASSET

In addition to the type of charitable organization a donor contributes to, the type of property a donor contributes plays a significant role in determining the donor's deduction limitation. Typically two types of non-cash assets are contributed to charities: capital gain property and ordinary income property (non-capital gain property). Generally, greater tax benefits stem from a contribution of capital gain property. Donors can potentially deduct the fair market value of the contributed property. Additionally, the charitable organization may generally sell the appreciated property without paying income tax on the gain if the organization is tax-exempt. Even if the charitable organization plans to sell the appreciated property immediately following the contribution, the gain from the sale will generally not be taxed to the donor.

However, this benefit is only applicable when a donor contributes property to a public charity or other organization treated as a public charity for purposes of this rule. When a donor contributes property to a private nonoperating foundation, the donor may deduct only the lesser of the donor's adjusted cost basis or the fair market value on the date of the contribution, unless the property is qualified appreciated stock.[10] In contrast, a donor may deduct only his or her adjusted cost basis in the property for contributions of ordinary income property, or non-capital gain property, regardless of whether the organization is public or private.[11]

DETERMINING THE VALUE OF PROPERTY

After deciding what charitable organization to contribute to and what type of property to contribute, the next issue is how does a donor determine the value of a piece of property. If the property qualifies as ordinary income property, the answer is fairly straight forward; the donor deducts his or her basis in the property. If the property qualifies as capital gain property, the donor can potentially deduct the fair market value of the property. Fair market value is defined as 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.[12]

While the term ''fair market value'' gives donors some guidance on how much they can deduct for property, the term also opens the door for a fair amount of subjectivity. In an attempt to avoid issues with overvaluation, the Internal Revenue Code and Treasury Regulations set forth substantive requirements to help donors determine the value of certain types of property. When determining the fair market value of an art object, a donor should consider the object's authenticity, physical condition, and extent of restoration. For example, a damaged antique vase will clearly be valued at less than an antique vase kept in prime condition. When evaluating the fair market value of non-publicly traded securities, a donor should evaluate the size of the contributed block of stock, whether the stock represents a minority interest, and any applicable buy/sell agreements. A donor attempting to determine the fair market value of real estate should consider whether the property is encumbered by a mortgage, the ease or difficulty a charitable organization would face when selling the property, and any relevant economic and environmental factors.

Similar to all other charitable contributions, the value of contributions of property must be verified before a donor can claim a deduction. If the claimed value of the property exceeds $250, the donor must substantiate the contribution with further information, such as written acknowledgement of the contribution by the donee, or a property description if the claimed value exceeds $500. If the claimed value of the property exceeds $5,000,[13] the object must be appraised by a qualified appraiser before the donor receives a tax deduction and the appraiser must sign a tax form before the return is filed. Additionally, for contributions of property with a claimed deduction of more than $500,000, the donor must attach a qualified appraisal of the contributed property to the return for the taxable year.[14] The Internal Revenue Code and Treasury Regulations set forth stringent standards for an appraisal, including requirements for a qualified appraiser, the time frame in which the appraisal must take place, and the information the appraisal must include.[15]

Although the Internal Revenue Code and Treasury Regulations set forth complex requirements for determining the value of contributed property, some case law indicates that substantial, rather than strict, compliance with these requirements may be sufficient to

[10] 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 does not include bonds or other debt instruments.

[11] §170(e)(1)(A).

[12] Regs. §1.170A-1(c)(2).

[13] The $5,000 threshold increases to $10,000 for gifts of ''non-publicly traded securities.'' Regs. §1.170A-13(c)(2)(ii)(B)(1).

[14] §170(f)(11).

[15] Regs. §170A-13(c).

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receive a charitable deduction.[16] However, case law also indicates that a donor must be cautious when relying on the substantial compliance theory.[17] Accordingly, a donor should comply with the appraisal requirements rather than rely on this theory to ensure he or she receives a full charitable deduction for a contribution.

PUBLICLY TRADED SECURITIES

Nearly 10 to 20 million households in the United States have the potential to reap significant additional tax savings by donating appreciated publicly traded securities to charity instead of cash. Securities can include stocks, bonds, or mutual funds. Although stocks and mutual funds have become a common investment vehicle for many individuals, generally speaking, most charitably inclined donors fail to factor in their investment gains for the purposes of charitable giving. This is important because the added tax savings from donating appreciated securities over cash can be significant. When individuals sell appreciated stock or shares in a mutual fund, they are required to pay tax on the capital gain. However, when individuals donate appreciated securities to charity, no federal or state income tax is due on the gain. This extra tax incentive for gifts of publicly listed securities makes appreciated stock one of the most cost-effective ways to donate to charity.

Donating Securities to Charity

For an illustration of the donation of publicly traded securities to charity, consider the following: An Illinois resident purchases $7,000 of publicly traded securities. Two years later, the publicly traded securities are valued at $10,000. Assuming a 35% personal income tax rate, a donation of $10,000, in either cash or appreciated securities, would result in a federal ordinary income tax savings of $3,500. However, in the case of appreciated securities, additional savings are realized by the avoidance of income taxes on the appreciation of the stock or mutual fund. For instance, an additional $600 savings would be realized by not having to pay the 15% federal capital gains tax and the 5% Illinois income tax on the $3,000 of appreciation. Accordingly, if the individual contributed the publicly traded securities to a charitable organization, he or she could avoid the federal and Illinois income taxes resulting from the sale while also receiving a charitable deduction for the contribution.

Publicly Traded Securities Held at a Loss

In today's market, many owners of publicly traded securities are holding their securities at a loss. The question in this situation is whether an outright gift of the security is appropriate.

If the security has decreased in value since it was acquired, it may be more beneficial for the donor is to sell the security and then make a charitable gift of the proceeds to charity. When the donor sells the security for less than basis, a capital loss is generated that the donor can use to offset any capital gain. Furthermore, by then making a charitable gift of the proceeds, the donor generates a charitable income deduction that can be used to further offset taxable income. Whereas, if the donor simply made an outright gift of the security to charity, the donor would not be able to take advantage of the capital loss and the charitable deduction may still be limited to the fair market value of the security.

CLOSELY HELD STOCK & OTHER BUSINESS INTERESTS

For many individuals, closely held stock and other business interests, such as limited liability company (LLC) or partnership interests, may be one of their most significant assets. As individuals reach the age of retirement, many business owners opt to sell the family business instead of passing the business to future generations. Rather than selling these business interests outright, individuals may be able to better satisfy both their personal charitable and financial goals by first contributing these interests to a charitable organization.

Contributing C-Corporation Stock

When a donor contributes closely held C-Corporation stock that he or she held for more than one year to a public charity, the donor may deduct the fair market value of the stock at the time of the contribution. If the donor contributes the stock to an organization that does not qualify as a public charity, the donor's deduction is limited to his or her basis in the property.

The business owner will also avoid any built-in capital gain on the gifted stock. The gifted stock can then later be purchased from the charity by the individual who purchased the ungifted portion of the business owner's stock (assuming no pre-arranged contract). Depending on the owner's tax bracket, the built-in capital gain and the calculated charitable deduction, the owner may end up financially in a similar position to that of one who had just sold all of his or her stock and his or her personal charitable goals will be realized.

Contributing S-Corporation Stock

When a donor contributes S-Corporation stock, the donor must reduce the deduction by the amount of re-

[16] *See Bond v. Comr.*, 100 T.C. 32 (1993).

[17] *See Hewitt v. Comr.*, 109 T.C. 258 (1997), *aff'd without published opinion*, 166 F.3d 332 (4th Cir. 1998). In *Hewitt*, the Tax Court rejected the donors' contention that they had substantially complied with the appraisal requirements, despite the IRS conceding that the value represented the fair market value of the property, because the donors never obtained a proper appraisal. *Id.*; *see also Friedman v. Comr.*, T.C. Memo 2010-45 (holding that an appraisal was insufficient because it did not mention the manner of acquisition or the cost basis of the donated item, and the donors' receipts omitted the required statement that "no goods or services were provided" by the charity).

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capture or other ordinary income the stock would have accumulated had the donor sold the stock at fair market value.[18] For contributions of S-Corporation stock to private foundations, a donor's deduction is limited to his or her basis in the stock. Contributions of S-Corporation stock may be less desirable to other charitable organizations as well. For instance, the tax burdens stemming from S-Corporation stock shift from the donor to the organization upon the contribution and the dividends, gains, and interest on dispositions of the stock are subject to unrelated business taxable income (UBTI) rules.[19] Thus, the organization must report its share of the corporation's income as UBTI daily and must pay the tax on the UBTI. Additionally, unlike other forms of stock, a charitable organization must pay tax on any gain when it sells the S-Corporation stock for a profit.[20] A charitable organization will likely balance these factors when deciding whether to accept a contribution of S-Corporation stock.

By contributing S-Corporation stock to a public charity organized as a trust, the UBTI burden may be lessened. UBTI of a corporation is taxed as corporate rates and UBTI of a trust is taxed at trust rates. The trust rates are beneficial because a trust can take advantage of the lower capital gains rate (the lower capital gains rate is not applicable to a corporation). The UBTI burden may be furthered lessened by the fact that a trust can take an income distribution deduction that can be further used to offset the UBTI.

Gifts of Assets Owned by an S-Corporation

Gifts of assets owned by an S-Corporation may be made by an S-Corporation to a charitable organization. For instance, a corporation may contribute corporate property such as real estate. The charitable deduction for gifts of corporate assets is limited to each shareholder's basis in his or her shares. Deductions that exceed the deduction limitation may be carried over indefinitely. Additionally, because such deductions are passed through to the shareholders on the K-1, the deductions are subject to the individual limits on the shareholders' returns rather than the 10% corporate entity limitation.[21] This alternative may likely be more beneficial for donors as gifts of assets owned by an S-corporation do not in and of themselves give rise to UBTI issues. Such gifts generally give rise to UBTI issues only if the contributed property qualifies as "debt-financed" property, for example if the contributed real estate is encumbered by a mortgage.[22]

Contributing LLC and Partnership Interests

A donor may contribute LLC or partnership interests to a charitable organization. Contributed LLC interests may be treated as corporate or partnership interests for tax purposes, although LLC interests will typically be treated as partnership interests. Donors may transfer partnership interests to a charitable organization through various methods: (1) an outright contribution; (2) a contribution of the proceeds following a sale of the interests; or (3) a partial gift/partial sale.

Strategic tax planning is necessary to determine the most advantageous time for a donor to contribute his or her partnership interest. For instance, a donor will receive a greater tax deduction for a contribution of a partnership interest when the entity is performing well because the deduction will include this higher value along with untaxed appreciation of the tangible assets.[23] Although donors may generally deduct the fair market value of contributions of LLC or partnership interests to a public charity, the donor must reduce his or her deduction by any gain that would not be treated as long-term capital gain had the interest been sold at fair market value rather than contributed. If the donor contributes his or her interest to an organization that does not qualify as a public charity, his or her deduction is limited to the lesser of the fair market value of the interest or the basis of the property.

A donor's deduction may also be reduced if the interest is subject to a liability. For instance, 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 partnerships, regardless of whether or not the partner has a personal indebtedness with respect to the transferred partnership interest.[24]

Valuation Planning Opportunities

While formula value clauses are not a charitable planning technique standing alone, formula value clauses can assist estate planners in guarding against valuation disputes with the IRS. The IRS has long opposed the use of defined value clauses to limit gift and estate taxes. Such clauses attempt to limit adjustments to the value of transferred property by assigning to charity any increased value imposed by the IRS.

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[18] §170(e)(1)(A).

[19] §512(e).

[20] §512(e)(1)(B).

[21] *See* McCoy, "Charitable Giving Techniques," SR050 *ALI-ABA Course of Study Materials* (2010).

[22] Additionally, an employee may choose to contribute stock acquired through an incentive stock option, or "ISO." Before completing the transfer, the employee must ensure that he or she has satisfied the various holdings periods. If the employee contributes the stock before these holding periods are satisfied, the contribution will be treated as a "disqualifying distribution." Accordingly, the donor will be required to include the difference between the exercise price and the fair market value of the stock on the day the option was exercised as ordinary income during the year of the transfer. *See* McCoy, "Charitable Giving Techniques," SR050 *ALI-ABA Course of Study Materials* (2010).

[23] *See* Walsh, "Navigating the Charitable Transfer of a Partnership Interest: A Primer," *Planned Giving Design Center Network* (Jan. 2001), *available at* http://www.pgdc.com/pgdc/navigating-charitable-transfer-partnership-interest-primer.

[24] Regs. §1.1001-2(a)(4)(v); Rev. Rul. 75-194, 1975-1 C.B. 80.

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For example, assume a taxpayer makes a gift of a fixed amount of shares in his closely held investment LLC. The assignment provides that shares with a fair market value of a fixed dollar value (i.e., $10,000,000) are to be distributed to a trust for the benefit of his family and any shares with a value in excess of the fixed dollar value are assigned to a specified charity. The charity should be actively involved in the appraisal process. Several courts have upheld defined value clauses over the IRS objections that the clauses do not result from arm's length transactions and are void as against public policy. The recent taxpayer victories using formula allocation clauses include *Petter Est. v. Comr.*,[25] *Hendrix v. Comr.*,[26] *Christiansen Est. v. Comr.*,[27] and *McCord v. Comr.*[28]

In *Hendrix*, the Tax Court upheld the validity of a defined value clause. Whether the charity is a public charity or a DAF, the result should be the same. If the charity is a private foundation, it is less certain that a court would reach the same conclusion.

REAL ESTATE

An outright gift of unencumbered real estate is a simple way to make a charitable gift. Many charitable organizations welcome outright gifts; however, before accepting the gift, the charitable organization will likely weigh such factors as the ease with which the real estate may be sold and any environmental concerns.

A donor making a charitable gift of unencumbered real estate to a public charity will receive a current income and gift tax deduction equal to the full fair market value of the real estate.[29] Gifts of real estate in excess of $5,000 require a qualified independent appraisal. The donor's fair market value income tax deduction for this gift to the public charity will be limited to 30% of the donor's contribution basis (with a five-year carry forward for any excess deduction).[30] If the donor cannot use the full deduction in the current year, the donor may instead want to consider gifts of partial interests of the real estate (absent valuation discounts) over a period of time, as discussed below, or reducing the fair market value of the gift by the amount of appreciation (i.e., a basis deduction), in which case the income tax deduction will be limited to 50% of the donor's contribution basis. Depending on the circumstances, these alternatives may result in a greater benefit to the donor.

Issues with timing often arise when contributing real estate to a charitable organization. Frequently, the question becomes: At what point in the sale process is it too late for the donor to avoid the realization of capital gain income by giving the asset to a charitable organization?[31] The anticipatory assignment of income doctrine holds that, if a taxpayer has the right to receive income or if, based on circumstances, the taxpayer is almost certain to receive the income, the taxpayer will be taxed on any gain, even if he or she transfers the right before actually receiving the income.[32]

Real Estate Encumbered by a Mortgage

The form of a gift of real estate to charity is not always simple. Real estate is often encumbered with a mortgage, or owned by a business entity (a partnership or LLC). Where contributed real estate is encumbered by a mortgage, the donor must reduce the amount of his or her contribution deduction by the mortgage on the property. Additionally, gifts of either debt-financed real estate or an interest in an entity that owns real estate require a ''plow-through,'' more sophisticated analysis — often centered around UBTI.

UBTI is defined as gross income from a regularly carried on unrelated trade or business. In general, the term ''debt-financed property'' means any property held to produce income (including gain from its disposition) for which there is an acquisition indebtedness at any time during the tax year (or during the 12-month period before the date of the property's disposal, if it was disposed of during the tax year). Acquisition indebtedness is generally defined as the unpaid amount of indebtedness incurred by the charitable organization in acquiring or improving debt-financed property.

Debt-financed property gifted to charity will often result in UBTI. However, an exception from UBTI does exist for certain debt-financed property contributed to a tax-exempt entity. Debt-financed property acquired by gift, bequest, or devise is not treated as acquisition indebtedness during the 10-year period following the date the tax-exempt entity receives the property if: (a) the debt was placed on the property more than five years before the date the tax-exempt entity received it; and (b) the donor held the property for more than five years before the date the tax-exempt entity received it.[33]

Contributing a Partial Interest in a Personal Residence

An individual may receive a current income and gift tax charitable deduction by retaining a life estate

[25] 653 F.3d 1012 (9th Cir. 2011), *aff'g* T.C. Memo 2009-280.

[26] T.C. Memo 2011-133.

[27] 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009).

[28] 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003).

[29] §§170, 2522.

[30] §170(b)(1)(C), (D)(ii).

[31] *See* McCoy, ''Charitable Giving Techniques,'' SR050 *ALI-ABA Course of Study Materials* (2010).

[32] *See Ferguson v. Comr.*, 174 F.3d 997 (9th Cir. 1999); *Lucus v. Earl*, 281 U.S. 111 (1930). Note that this issue arises not only with real estate, but with any non-cash gift donated to a charity where the asset is donated to charity after the sale process has begun.

[33] §514(b)(3).

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in his or her personal residence and gifting the remainder interest to a charitable organization.[34] A personal residence for this purpose includes the donor's primary residence, vacation home, condominium or stock in a cooperative apartment.[35] The donor will receive a current income and gift tax deduction equal to the full fair market value of the remainder interest in the personal residence, subject to applicable restrictions.[36] Generally speaking, the remainder value is determined using the value of the real estate reduced by an actuarial determination of the value of the life estate retained by the donor (and the donor's spouse, if a joint and survivor life estate is retained).

Keep in mind, however, in those instances where a sale of the personal residence is considered in the future, or may be necessary, caution should be taken prior to gifting the remainder interest. After the remainder interest is gifted, the donor retains only a life estate. Because of this, it is unlikely that the life tenant will be able to sell just that interest. Further, even if the life estate could be sold, it is unlikely that a buyer will pay full value because a buyer cannot be certain how long the life estate will last. Additionally, because the buyer will have the same difficulty selling the interest in the future, the buyer will likely request a further discount on the purchase price for lack of marketability. To sell the interest in the residence, the donor and the charity probably would both have to agree to the sale. However, it is important to note that the charity will likely desire to sell the remainder before the donor dies or sells the life estate.

In most states, neither a life tenant nor a remainder owner can compel the other to sell its interest. Therefore, it is common in these situations for the donor and the charity to enter into an arrangement for the property to be sold and each to take its present value interest of the sale proceeds. However, the donor should not always bank on the fact that the charity will agree to such scenario. Instead, a possible sale after the initial gift should be discussed in a well structured gift agreement between the donor and the charity. It is important to note, however, that while it is appropriate to address a subsequent sale in a gift agreement, any subsequent sale or transfer of the life estate should not be pre-planned prior to the donor's gift of the remainder interest for reasons mentioned above.

Conservation Easements

Another option for donating a partial interest in real estate is contributing a conservation easement to a charitable organization. A conservation easement is a legal agreement that permanently limits the use of the land to protect its conservation values. Although the donor relinquishes some of his or her rights to the property, the donor may still continue to own and use the land, and the donor maintains his or her right to sell the land or pass it on to heirs. For example, an easement on property containing rare wildlife may prohibit further development on the land; however, the donor may still use the land. To qualify for a charitable contribution, the donor must contribute the conservation easement to a qualified organization exclusively for conservation purposes.[37] The Internal Revenue Code sets forth four permissible conservation purposes: (1) the preservation of land areas for outdoor recreation or education of the general public; (2) the protection of a relatively natural habitat of fish, wildlife, plants, and similar ecosystem; (3) the preservation of open space (including farmland and forest land) for either the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental conservation policy, provided that the contribution yields a significant public benefit; or (4) the preservation of a historically important land area or a certified historic structure.[38]

While the value of an easement varies greatly depending on the type of restrictions placed on the land, a donor can typically deduct the fair market value of the easement. The fair market value of an easement is often determined by the decrease in the fair market value of the property because of the easement restrictions. When determining the value of an easement, a donor must consider any zoning, conservation, or historic preservation laws that may affect the property. Where the property is encumbered by a mortgage, a donor may not receive a charitable deduction unless the lender who holds the mortgage agrees to subordinate its rights to the property to the right of the charitable organization to enforce the conservation purposes in perpetuity.

ART OBJECTS AND OTHER COLLECTIBLES

Many individuals have collected certain items of tangible personal property that may be attractive for a charitable gift. One of the most common forms of charitable gifts of tangible personal property is the donation of art objects and other collectibles.

The term art objects encompasses many different items, including paintings, sculptures, photographs, prints, and drawings. An individual who makes a donation of an art object to a charitable organization will generally receive an income tax charitable deduction. A donor's income tax deduction for a charitable contribution of art is determined by the type of charity or foundation he or she contributes to and the type of contributed property.[39]

[34] §§170(f)(3)(B)(i), 2522(c)(2); Regs. §1.170A-7(b)(3).

[35] Regs. §1.170A-7(b)(3).

[36] §§170, 2522.

[37] §170(h).

[38] §170(h)(4).

[39] However, where the donor is also the creator of the art object, the donor's deduction is limited to the cost basis deduction. If the donor already deducted the costs attributable to the creative work as a business expense, the donor may not receive a charitable deduction for the contribution of his or her own art creation. Regs. §170A-1(c)(4). This limited deduction also applies where

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The Related Use Rule

In addition to determining the value of an art object, determining *how* the charitable organization will use the art object is one of the most common issues in contributing art. This determination is critical because it may alter a donor's potential deduction. The related use rule ensures that charitable organizations use the contributed property rather than selling it immediately after the contribution. The rule applies to all tangible personal property contributed to charitable organizations, including, but not limited to, book collections, jewelry, and most often, art objects.[40]

Where a donor contributes an art object to a public charity and that organization uses the art for a purpose or function related to its tax-exempt status, the related use rule is satisfied and the donor can deduct the fair market value of the art (assuming the art qualifies as capital gain property). The charitable organization's related use of the art does not have to be immediate to satisfy the related use rule. For instance, if a donor contributes a painting to a museum to put on display and the museum puts the painting in storage rather than immediately on display, the donor may still deduct the fair market value of the art because it was reasonable to anticipate at the time of the contribution that the property would eventually be displayed.[41] If the painting is of a type generally retained by museums for museum purposes, it is generally reasonable for the donor to anticipate that the painting will be put to a related use by the museum unless the donor had actual knowledge that the museum was not going to put the painting to a related use. This is the case even if the museum later sells or exchanges the object. In addition, because very few museums have sufficient space to exhibit all their art at one time, the fact that a donor can anticipate that the gift may be placed in storage part or even most of the time will not cause the value of the gift to be reduced.[42]

Alternatively, if the charitable organization does not use the art for a purpose related to its tax-exempt status, the donor's tax deduction will be reduced by the long-term capital gain acquired by the property. For example, if a donor contributed a painting to a hospital for display, rather than to a museum, the donor's deduction would most likely be reduced because the display of a painting is generally not related to a hospital's tax-exempt purpose.

Whether a charitable organization is using an art object in a manner related to its tax-exempt purpose is not always clear. For instance, if an art object is donated to a university and placed in a library for display and study by art students, the art is used for a related purpose and the donor may deduct the full fair market value of the object.[43] However, if that university sells the art object instead of placing it in the library for display and study, the use of the object is not related to the university's tax-exempt purpose and, accordingly, the donor's deduction is reduced. But what happens to the donor's tax deduction if the university places the art object outside of the library for artistic display? There are still many unanswered questions concerning what is a related use. Because of this ambiguity, a donor should determine a charitable organization's potential use of an art object prior to contribution to ensure the donor receives the maximum tax benefits.

A donor may also run afoul of the related use rule if the charitable organization sells, exchanges, or otherwise disposes of the art within three years of the contribution.[44] If this occurs, a donor may protect his or her full fair market value deduction by obtaining certification from the charitable organization stating that the use of the art object prior to sale or exchange was substantial and related to the organization's tax-exempt status. The certification must also specify how the organization used the property and how such use furthered the organization's purpose or function. Alternatively, if the charitable organization did not use the art object for a related use prior to sale or exchange, the donor must obtain certification from the organization stating its intended use of the property at the time of the contribution and why such use became infeasible. Under either circumstance, if the donor obtains the required certification, he or she may receive the maximum fair market value tax deduction for the contribution despite the subsequent sale or exchange.

Donating a Fractional Interest in Tangible Personal Property

Often an individual may want to contribute tangible personal property, such as an art object, but retain primary possession of the property for the near future.

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the donor received the property by inter vivos gift from the creator. In contrast, if the donor inherits the art object from the creator, the donor can deduct the full fair market value for a later charitable contribution. Similar rules apply to contributions of taxidermy property. Thus, when the creator of the taxidermy contributes the property, his or her deduction is limited to the lesser of basis or fair market value. Only the cost of preparing, stuffing, and mounting is considered when determining the basis of taxidermy property and the donor may not consider indirect costs, such as traveling. §170(e)(1)(B), (f)(15).

[40] A donor may also consider donating a boat, plane, or car as a form of tangible personal property. A donor's potential deduction for such contribution depends on whether the charitable organization retains or sells the property. If the organization retains the boat, plane, or car and uses it to further the organization's tax-exempt purpose, the donor may deduct the fair market value of the property. However, if the organization sells the property immediately after the contribution, deductions in excess of $500 are limited to the gross proceeds the organization receives upon the sale. §170(f)(12).

[41] Similarly, the fact that an art object is normally displayed but regularly undergoes time away for conservation or maintenance should not affect the fact that the art object is being used for a related use.

[42] Regs. §1.170A-4(b)(3)(ii).

[43] Regs. §1.170A-4(b)(3).

[44] §170(e)(7)(A).

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Generally, a donor must contribute his or her entire interest in the property to be eligible for a tax deduction; however, an exception applies where the donor contributes a ''fractional interest'' in the property. This exception requires a donor to contribute a portion of an undivided interest in the property to a charitable organization.[45] The remaining interest in the property must be contributed within 10 years of the initial contribution. Depending upon the circumstances, this may be a desirable option for many potential donors. For instance, a donor lives in Illinois and spends the summer in Michigan. The donor eventually wants to contribute a painting to the Art Institute of Chicago. However, for the immediate future, he would like to maintain possession of the painting when he is in Illinois. The donor may contribute a 25% fractional interest in the painting to the Art Institute. This allows the Art Institute to have unrestricted use and possession of the painting for three months every year, and the donor retains possession of the painting for the nine months he is in Illinois. The donor may deduct 25% of the fair market value of the art object for this contribution (assuming the art object qualifies as capital gain property).[46]

Although the fractional interest option may seem ideal to many potential donors, a donor should engage in careful planning prior to exercising this option because of the tax ramifications. Most significantly, when a donor contributes a fractional interest in tangible personal property, all subsequent contributions of interest in the property are limited to the lesser of its fair market value at the time of the initial contribution or its fair market value at the time of the additional contribution. Accordingly, a donor may not deduct for any appreciation in the property between the time of the initial contribution and the subsequent contribution. For instance, if the donor in the example above contributed a 25% fractional interest in a painting valued at $100,000, the donor may deduct 25% of the fair market value of the painting, or $25,000. Three years later, when the painting is worth $120,000, the donor wants to contribute the remaining 75% interest in the painting. Despite the painting's appreciation, the donor's deduction is limited to 75% of the painting's fair market value at the time of the initial contribution, or $75,000. Because of the inability to deduct for appreciation acquired after the initial contribution, fractional interest contributions require careful tax planning, especially if the art object has potential to appreciate.

Another consequence stemming from a fractional interest contribution is the possibility for recapture. If a donor fails to contribute the remaining interest in the partially contributed property to a charitable organization within 10 years of the initial contribution, the donor's previous tax deduction for the fractional interest contribution may be recaptured.[47] Additionally, if the charitable organization does not maintain substantial physical possession of the property in accordance with the fractional interest contribution or does not use the property for a purpose related to the organization's tax-exempt status, the donor's previous deduction, plus interest and a 10% tax penalty for the taxable year, may be recaptured.[48]

RETIREMENT ACCOUNTS

Over the past few decades, saving for retirement has become more of a priority for millions of individuals. Not only have life expectancies increased, but Congress has provided a number of incentives to encourage individuals to save for retirement. For individuals who enjoy making charitable gifts, the emphasis on saving for retirement often presents a conflict. Namely, how can one continue giving to charitable causes without sacrificing one's retirement security?

Although tax-qualified retirement plans and IRAs are important and effective vehicles for accumulating retirement savings, required minimum distributions increase each year. However, when the participant reaches the ''required beginning date,'' i.e., the age at which mandatory withdrawals must occur (April 1 of the year after the year in which the participant reaches age 70½), this forces the tax-advantaged retirement account to shrink and results in tax liabilities. The income taxes on distributions also continue for a spouse or heirs who inherit retirement accounts. Required distributions for heirs may be forced during their preretirement years, potentially causing heirs to pay taxes on distributions during the heirs' peak wage-earning years. Finally, retirement assets are subject to estate and generation-skipping transfer taxes for transfers to non-spousal heirs.

Tax law changes in the Pension Protection Act of 2006 provide donors over the age of 70½ (regardless of whether they have reached the ''required beginning date'') with a straightforward method for IRA funds to be directed to a qualified charitable organization.[49] The qualified donor can contribute up to $100,000 directly from an IRA to a charitable organization.[50] Although the donor may not claim a charitable deduction for the contribution, the donor may avoid ordinary income taxes on the funds through transferring the funds directly to the organization. This may even help the donor avoid being shifted into a higher income tax bracket.

It is essential to note, however, that only donors who have reached the age of 70½, contributing funds

[45] In such a case, the donor and the organization should be sure to establish who will be responsible for wear and tear at various times of possession, perhaps through a gift acceptance agreement as discussed below.

[46] The donor may also be able to get the reduced insurance rates available to museums on some or all of the property.

[47] §170(o).

[48] *Id.*

[49] §408(d)(8), added by P.L. 109-280, §1201, effective for distributions in tax years beginning after 2005, and as subsequently extended, before 2012. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, §725 (amending §408(d)(8)(F)).

[50] *See* IRS News Release IR-2006-192 (12/14/06).

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from IRAs, are eligible for this direct transfer method of contribution. Without the direct transfer option, such contribution may not be as beneficial for a donor. For instance, donors over the age of 59½ are permitted to make withdrawals from a retirement account without penalty. However, because withdrawals are generally taxed to the individual as ordinary income, the donor would have to pay taxes on the funds prior to the contribution, thereby potentially increasing the income tax bracket.

Designating a Charitable Organization as a Beneficiary

Instead of gifting retirement assets to a charity during lifetime, a donor may designate a charity as the beneficiary of the retirement account upon death. Under this option, the charity will be treated as receiving the *distribution* and any income tax on the built-in income (income in respect of a decedent) will be avoided. Further, while the retirement asset will be included in the donor's gross *estate*, the donor's estate will receive a corresponding estate tax deduction for the amount distributed to the charity, resulting in an offset of the *estate taxes*. The donor's assets that are not subject to income in respect of a decedent can then be left to the decedent's heirs without income tax consequences.

Designating Multiple Beneficiaries

If a donor designates both a charity and other individuals as beneficiaries of the retirement account, it may have a negative impact on the stretch options that are available to the individual beneficiaries. A charitable organization does not qualify as a ''designated beneficiary,'' because it does not have a life expectancy. For instance, if the donor should die before the beginning date for required distributions, the individual beneficiaries will generally be required to distribute the assets by December 31 of the fifth year following the year of the donor's death. This can be resolved by one of the following means: (a) establishing a separate retirement account for each beneficiary — thus, the charity's lack of life expectancy will not affect the individual beneficiaries; or (b) the charity cashing out its portion of the inherited assets by September 30 of the year following the decedent's death. Under this rule, beneficiaries that receive a full distribution of their portion by September 30 are likely disregarded for the purposes of determining the life expectancies that affect distribution options.

GIFT ACCEPTANCE AGREEMENTS

Oftentimes, a donor may not want to give an unconditional contribution to a charitable organization. Instead, it may be beneficial for the donor to attach strings to the contribution while also obtaining recognition for his or her generosity. However, charitable organizations often want as much flexibility as possible when determining how to utilize a contribution, and are hesitant about accepting a contribution encumbered with restrictions.[51] Many of the issues surrounding problem gifts may be avoided by utilizing a gift acceptance agreement between the donor and the charitable organization. This agreement can outline the terms of a contribution so that the donor and charitable organization may agree on how the contribution will be used. Additionally, these agreements may be used for both cash contributions and contributions of non-cash assets.[52] For instance, if a donor contributes an art object to an organization, a gift acceptance agreement can specify how the organization may use the contribution to ensure that the related use rule is satisfied and the donor may receive the maximum tax deduction.

The first step in avoiding litigation arising from a charitable contribution is to have a clear understanding of the donor's purpose and the charitable organization's requirements. The second step is to become familiar with the most common problem gifts and practical solutions to avoid potential litigation. Problem gifts often include ambiguous gifts, restrictive gifts, naming rights gifts, large gifts, and testamentary gifts.

An ambiguous gift may arise when the donor and charitable organization have different views on how the organization should utilize the contribution. For example, a college or university may agree to name a building after a donor in return for the donor's contribution. However, the university may plan on placing the donor's name on an older building while the donor assumed his or her name would be on a new building.[53] A gift acceptance agreement may prevent various ambiguities by outlining with specificity the terms of the gift's purposes, describing how to evaluate the effectiveness of the gift, and including a dispute resolution provision. Problems may also arise when donors place too many restrictions on a gift. For example, a donor contributes an art object to a charitable organization on the condition that the art object remain in the building where the object is currently housed and not be moved from the wall in the building where the object hangs at the time of the gift. Years after the contribution, if the building containing the contributed art object is torn down, what happens to the contribution?[54] Knowing the charitable organization and preparing for changing circumstances in

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[51] *See* Horwood & Wiktor, ''Accentuating the Positive With Gift Agreements,'' 6(3) *Family Foundation Advisor* 1 (Mar./Apr. 2007); *see also* Horwood & Wiktor, ''Gift Acceptance Agreements: Be Prepared When a Gift Comes with Strings,'' 1(5) *College & University Law Advisor* (May/June 2007).

[52] Some charitable organizations have gift acceptance policies. For example, this policy may provide that the charitable organization enters into such an agreement only where the gift is very desirable or if the charitable organization has great hopes for future gifts or bequests from that particular donor.

[53] *See* Phillips, ''Agganis Pulls $1M Gift Offer to Salem State College on Building Name,'' *Boston Globe* (Mar. 7, 2005).

[54] A similar situation happened to a contribution by Albert Barnes to the Barnes Foundation. Whittaker, ''The Barnes Foundation Petitions Court to Move Gallery into Philadelphia,'' *Kreisberg*

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the gift acceptance agreement may help to avoid these common problems.

Generally, donors contributing larger gifts may request recognition for their contribution. Recognition may include naming something after the donor. Such recognition is often beneficial to the charitable organization as well because it can serve as a method of attracting donations. However, issues with naming rights gifts may arise where the organization names something after the donor, such as a scholarship fund or building, and the donor is later convicted of a serious crime or alleged to have committed a serious crime.[55] Gift acceptance agreements may help charitable organizations avoid this situation by stating circumstances where the name may be removed and what happens to the contribution, while also preparing for changed circumstances, such as if the named building is sold or torn down. Large gifts may also lead to problems where there are more assets than necessary to fulfill the intended purpose.[56] Typically, this issue arises where the donor contributes non-cash assets, such as stock, art objects, or real estate, which have the potential to greatly increase in value after the contribution. Donors may plan for these issues by paying attention to the type of asset they are contributing, stating options for excess funds, and focusing on who the contribution is intended to benefit.

Additionally, gift acceptance agreements may be essential where a donor makes a testamentary gift to a charitable organization and seeks current recognition for the contribution. Without a contract stating otherwise, the donor can revoke the will and change or eliminate the contribution before death. Thus, most charitable organizations are hesitant to grant current recognition without a gift acceptance agreement. The agreement should enact a pre-emptive policy concerning the current recognition of promised gifts and determine how the gift will be evaluated upon contribution. Additionally, it may be beneficial for the charitable organization to obtain the testamentary instrument in advance and require copies of any future amendments.

CHARITABLE REMAINDER TRUSTS AND LIFE INSURANCE

A charitable remainder trust (CRT) and life insurance may be combined with any of the non-cash alternative assets discussed above to create a unique planning opportunity. This planning opportunity is especially effective when the donor has low basis in the non-cash asset or the non-cash asset is not producing any income.

A CRT is an irrevocable tax-exempt trust that pays an annual stream of income to a noncharitable beneficiary for one life, two lives, or a term of years with the assets remaining in the CRT at the end of the trust term passing to a charity or charities.[57] With respect to income taxes, a CRT is tax-exempt and pays no tax when it sells assets or earns income.[58]

A charitable remainder annuity trust (CRAT) is structured to pay an annuity to the income beneficiary that is calculated based upon a fixed percentage of the fair market value of the CRAT's assets determined on the date the assets are contributed to the trust.[59] Thus, the annuity amount will not change from year to year.[60] Accordingly, a CRAT may provide an excellent planning opportunity for a non-income-producing asset and life insurance.

Balancing Charitable Goals and Heirs' Inheritance

Often donors are faced with an interesting problem: They want to benefit their favorite charity yet are concerned that the transfer of assets will deprive descendants of a portion of their inheritance. Further, when a low-basis, non-income-producing asset is involved, often the donor also may want to create cash flow without incurring the corresponding capital gain associated with a sale. The combination of a CRAT with an irrevocable life insurance trust (ILIT) can provide for the donor and his or her heirs, as well as the charitable beneficiary.

In this scenario, the donor establishes a CRAT and retains an annuity stream during the term. The donor gifts the low-basis real estate to the CRAT. The CRAT can then sell the real estate without incurring capital gain. The proceeds from the sale provide cash flow to pay the annuity, thus accomplishing the donor's cash flow objectives.

Additionally, the donor (or his or her heirs) may be concerned that, by giving away the low-basis asset, the donor has significantly reduced the size of his or her eventual estate to be transferred to descendants upon death. An effective way to then replace the gifted assets is to also establish an ILIT.

Each year, the donor gifts all or a portion of the annuity stream to the ILIT. The CRAT is the preferred planning tool because the annual annuity payment is set and does not vary regardless of fluctuations in the value of the assets held in the CRT. The ILIT then uses the income to purchase a life insurance policy on the donor's life and pay the ongoing premiums. If established correctly, the death benefit from the life insurance policy will not be included in the donor's estate upon his or her death. Further, the insurance policy proceeds will replace the assets that were given to charity through the CRAT and will be distributed to

Group Ltd. (Sept. 24, 2002). A court eventually allowed the art to be moved after long and expensive litigation. *In re Barnes Foundation*, 672 A.2d 1364 (Pa. Super. Ct. 1996).

[55] *See* Scherer, "Buildings Donated by 'Corrupt' CEOs Face Name Shame," *Christian Science Monitor* (Oct. 9, 2002).

[56] *See, e.g.,* Fimrite, "S.F. Supervisors Lack Faith in Trust. Buck Fund Attacked for Restructuring Aid to Poor in Marin," *San Francisco Chronicle* (Mar. 5, 2002).

[57] §664.

[58] §664(c)(1).

[59] §664(d)(1).

[60] *Id.*

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the donor's family beneficiaries with no estate taxes or probate costs.

To receive maximum tax benefits for a contribution of a life insurance policy, a donor must contribute the entire policy (i.e., complete a transfer of ownership). Mere payment of premiums attached to a policy payable to a charitable organization is not allowable as a charitable deduction where the donor still maintains the ability to borrow against the policy or change the beneficiaries.[61]

Charitable Gift Annuities

A charitable gift annuity (CGA) is a transaction where the donor transfers assets to a charitable organization and, in return, the organization makes the annuity payment to one or more individuals for their lifetimes. Because the charitable organization may utilize the transferred assets immediately, rather than upon the death of the donor, this method of transfer allows the donor to retain an income interest while also deducting the fair market value of the contribution. Additionally, CGA contributions are generally not subject to the prohibition on UBTI or private foundation self-dealing rules that apply to CRTs.[62]

Four conditions must be met to ensure that a charitable organization does not incur UBTI for assets received in consideration for a CGA: (1) the value of the annuity must be less than 90% 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; (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.[63]

Gift acceptance agreements commonly limit the type of CGAs an organization may accept. Because CGAs require an organization to make annuity payments to an individual and to back up the annuity obligation in the event the donated property is exhausted, the organization must ensure that it is not subjecting itself to negative cash flow over the life of the donor.[64] Accordingly, gift acceptance agreements may limit the size of the CGA, the age of the annuitants, and the type of property accepted in exchange for CGAs.[65]

[61] *See* McCoy, ''Charitable Giving Techniques,'' SR050 *ALI-ABA Course of Study Materials* (2010).

[62] *Id.*

[63] §514(c)(5).

[64] The charitable organization will have to use its general assets to pay the annuity to the extent that the assets contributed by the donor are exhausted.

[65] *See* Miree, ''Understanding and Drafting Nonprofit Gift Acceptance,'' *Planned Giving Design Center Network* (Aug. 2000), *available at* http://www.pgdc.com/pgdc/understanding-and-drafting-nonprofit-gift-acceptance-policies.

ESTATE TAX CHARITABLE DEDUCTION

A testamentary disposition of property to charity may serve as a beneficial alternative for a donor who has not previously made a lifetime gift or installment sale on the property. A donor can eliminate all or a portion of the estate tax by bequeathing his or her property to a charitable organization. To qualify for an estate tax deduction, the contributed property must be included in the donor's gross estate.[66]

In contrast to a lifetime contribution of property, a testamentary disposition of property is not subject to a percentage deduction limitation.[67] However, the amount a donor deducts may not exceed the value of the property a charitable organization receives. Accordingly, the deduction value may be reduced by any estate, succession, legacy, or inheritance taxes payable in whole or in part out of the charitable bequests, legacies, or devises.[68] To avoid these deductions, tax planning is necessary to determine the amount of federal and state death taxes that will be due and the extent to which death-related costs can be satisfied with assets other than the contributed property before a donor creates a testamentary disposition of the property. If the donor does not want his or her charitable contribution reduced by death taxes or administrative expenses, the will or other testamentary documents should include language setting forth such desire and clearly providing that no charitable disposition is to bear any share of taxes or expenses.[69]

Identifying a Qualified Recipient

A valid and effectual transfer of property before or at death to or for a qualified recipient or purpose is essential to receive an estate tax charitable deduction. First, a donor must identify a qualified recipient or purpose to receive his or her property contribution. Donors can bequeath property to four general classes of recipients: (1) governmental entities; (2) charitable corporations; (3) qualified trusts; and (4) veterans' organizations. To receive an estate tax deduction for contributions to a governmental entity, the entity must use the contribution for an exclusively public purpose.[70] Similarly, qualified charitable corporations must be organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes for the donor to receive a tax deduction.[71] To qualify as a charitable corporation for purposes of estate tax deductions, no part of the organization's net earning can inure to any private stockholder or individual. Additionally, the organization may not engage

[66] §2055(d).

[67] §2055.

[68] §2055(c).

[69] Many state apportionment statutes cover this issue, unless the will is ambiguous and can be read to override the state apportionment default.

[70] §2055(a).

[71] *Id.*

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in lobbying activities or participate or intervene in any political campaign on behalf of any candidate for public office. Churches, schools, and publicly supported charitable organizations typically meet the requirements for a qualified charitable corporation.

Donors may also receive a tax deduction for contributions to qualified trusts and fraternal organizations if the contribution is used exclusively for charitable and related purposes. A donor must be cautious when selecting a trustee to manage his or her property to prevent a conflict of interest. For instance, when contributing an art collection, a conflict may arise between the estate and the prospective purchaser of an art collection where the trustee is an art dealer with motives counter to that of the estate.[72] Donors may also receive a tax deduction for contributions to veterans' organizations. Unlike transfers to charitable organizations, a donor may receive an estate tax deduction for transfers to a veterans' organization regardless of the organization's participation in lobbying activities or political campaigns.

[72] For instance, in *In re Rothko*, 379 N.Y.S.2d 923 (Sur. Ct. 1975), *modified*, 392 N.Y.S.2d 870 (Sup. Ct. 1977), *aff'd*, 401 N.Y.S.2d 449 (1977), a conflict of interest arose between the executors of the donor's estate. One executor was a director and salaried officer of the gallery that had entered into consignment to sell 698 paintings for up to a 50% commission. Another executor was an artist who entered into an agreement with the same gallery to sell his paintings on more favorable terms than those secured for Rothko's estate. Because of the Rothko estate's agreements to sell the donor's paintings at unreasonably low prices, the court removed all three executors and held them liable for damages ranging from $6.4 million to $9.2 million.

How to Transfer Property

After choosing a qualified organization, the donor must make certain that the property reaches the organization by way of a bequest, legacy, devise, trust distribution, assignment, or other transfer to effectuate a valid transfer of property. The best method of making a testamentary charitable transfer is through a direct outright bequest of the property. The bequest should clearly identify the items bequeathed as well as the specific charitable organization, rather than granting the executor of the estate sole discretion in such determinations.[73] While some jurisdictions permit a donor to grant an executor discretion to designate the charitable organization, a donor should be specific in stating his or her intentions to ensure an estate tax deduction.[74] Additionally, if possible, the donor should discuss the potential bequest with the charitable organization in advance to verify that the organization will not renounce the bequest. If the donor is unable to secure acceptance in advance, the donor should include a contingent charitable bequest in his or her will.

CONCLUSION

When properly structured, a charitable gift of publicly traded securities, real estate, artwork, closely held stock, or retirement assets can be an attractive alternative to cash gifts and also will provide substantial benefits to both the donor and the charitable organization. With this in mind, donors, advisors, and charitable organizations should all continue to consider these alternative assets as prime assets for meeting their charitable goals.

[73] Rev. Rul. 55-335, 1955-1 C.B. 455.

[74] Rev. Rul. 69-285, 1969-1 C.B. 222.

Table A

Asset Type	Liability/Cost Exposure	Risk Management/ Due Diligence	Acceptance Issues	Staff Role	Disposition Alternatives
Real Estate	Environmental, UBTI, liens, IRS penalties, accident claims, up-front due diligence expense, on-going holding costs, remediation or improvement cost, time-to-reward ratio, fiduciary risk	Indemnification letter, environmental audit, survey, broker price opinion or appraisal, insurance, site inspection with pictures, determine property's history, develop sales plan — review all deeds, lease agreements, rental agreements, inspection reports, donor should complete disclosure checklist citing any known issues, outsource to another charity	Conflicts of interest, valuation, self-dealing, implied or expressed restrictions	Tax substantiation — Form 8283/ 8282, due diligence, change insurance/utilities, execute transfer documents, donor communication, audit preparation, manage disposition *Note: One person should manage all illiquid assets*	1. Hold (not usually recommended) 2. Sell to private buyer (unrelated party) 3. List with broker

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Privately-Held Stock/LLC/ Partnerships	Capital calls, indemnification clauses, lack of control with minority gifts, UBTI and specific issues related to underlying property	Indemnification letter, independent appraisal, review financials if appropriate, develop sales plan, review all entity documents	Thin to non-existent market, difficult valuation, self-dealing without independent appraisal, S-Corp UBTI issues	Tax substantiation — Form 8283/ 8282, due diligence, execute transfer documents, donor communication, audit preparation, put stock certificate or assignment document in safe, check in with company annually to see if there has been any material change	1. Sell back to entity 2. Sell in open market transaction 3. Sell to private unrelated buyer
Life Insurance/ Annuities	Virtually none except as it relates to complex foundation-owned, charity-owned and investor-owned contracts — so split-interest gifts are allowed	IRS has listed number of reportable transactions — be cautious to comply with reporting requirements; also review illustration or policy being considered and have memo outlining donor's premium paying responsibilities and charity's options for non-compliance	Work with agent to illustrate any non-paid-up (universal or variable) life policies at 2% under current crediting rate	Tax substantiation — Form 8283/ 8282, due diligence, execute transfer documents, donor communication, audit preparation, manage policies annually to determine health, put donor in contact with qualified insurance appraiser	1. Usually held to death 2. Cash surrender to company 3. Reduce paid-up 4. Sell to life settlement companies
Mineral Interests/ Intellectual Property	None other than potential capital calls	More than any other asset, having well-designed sales plan prior to acceptance is critical	Marketability, appraisals	Tax substantiation — Form 8283/ 8282, due diligence, execute transfer documents, donor communication, audit preparation	1. Hold (not recommended unless strong income payments) 2. Sell via broker 3. Sell privately
Restricted Stock/ Stock Options	Post-contribution loss possibilities during restricted or holding period	Review all restrictions and option agreements	None	Tax substantiation — Form 8283/ 8282, due diligence, execute transfer documents, donor communication, audit preparation	Sell with broker as soon as restriction is lifted
Collectibles/Art	None other than post-contribution holding expenses	Review history of collection, document with pictures	Work with broker/ appraiser to assess value prior to acceptance	Tax substantiation — Form 8283/ 8282, due diligence, execute transfer documents, donor communication, audit preparation, insurance, storage	1. Auction sale 2. Private buyer 3. Broker

This table has general information and should not be relied upon as tax, legal or financial advice.

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Table B

Asset Type	Various Forms	Unique Issues and Potential Traps	Planned Gift Issues	Additional Comments
Real Estate *Deduction: FMV*	Residential, commercial, domestic or foreign, leasehold/life or remainder interest	Environmental liability, holding period management, accelerated depreciation, negative basis, debt (note ''5-and-5 UBTI exception''), pre-arranged sale	Ideal for family limited partnership/ charitable remainder unitrust, difficult for charitable remainder annuity trust and charitable gift annuity because of marketability	Real estate represents nearly 50% of privately held wealth, estimated at twice entire stock market; yet only 2% of all charitable gifts are real estate
Closely Held Stock *Deduction: FMV*	C-Corp or S-Corp	Thin to non-existent market, difficult valuation, self-dealing without independent appraisal, pre-arranged sale, S-Corp UBTI issues	Ideal for family limited partnership/ charitable remainder unitrust with no known liquidation event — other vehicles work for corporate redemption or market sale	Private company contributions are very popular prior to market sale; S-Corp gifts to trust are tax-effective prior to sale or to corporation if held
LLC Interests *Deduction: FMV*	Tax status may be corporate or partnership	Same as closely held and characteristics of underlying assets and potential capital calls, multiple shareholders/ assets difficult	Same as closely held	Charities usually want LLC interest for liability protection; multiple shareholders make this option difficult
Partnerships *Deduction: FMV*	General, limited or operating	May be difficult or expensive to appraise, characteristics of underlying assets, general partnerships have full liability, partnerships with negative basis	Limited partnerships are particularly good funding assets for charitable lead trusts	For LLCs and partnerships, appraisal discounting may apply
Life Insurance/ Annuities *Deduction: Lesser of adjusted cost basis or FMV*	Paid-up and non-paid-up life insurance — variable or fixed deferred annuities	Non-paid-up policies, ''stranger-owned'' or premium financed, or gifts with policy loans are more difficult; paid-up whole life policies work well; annuities trigger gain upon transfer	Life insurance is excellent life-time or testamentary gift (through beneficiary designation); annuities are only attractive as testamentary gifts because of income in respect of decedent	Life insurance can be excellent wealth replacement tool for any planned or outright gift; premiums can be paid with appreciated property
Mineral Interests *Deduction: Varies*	Oil/gas working or non-working interests, timber, other minerals	Valuation difficult, tax law very complex and state rules may govern (e.g., timber)	Very difficult but possible	These assets are typically held in partnerships or LLCs so those rules apply as well
Restricted Stock *Deduction: FMV*	SEC rule 144 or 145	Appraisal requirement, lock-up period	Restricted stock can easily be used for just about every planned gift	Restricted stock should be coordinated with experienced broker
Stock Options *Deduction: Varies*	Qualified (ISOs) or non-qualified	''In-the-money'' option transfers trigger gain to donor at ordinary income rates at time of gift	ISOs can be excellent funding assets provided they are exercised and then held for over year	Qualified replacement stock from employer retirement plan/ employee stock ownership plan can work well for both outright and planned gifts

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Collectibles/Art *Deduction: Basis for non-related use/FMV for related use*	Art, coins, antiques	Valuation, insurance, storage, transaction costs, complex structures like private operating foundations are sometimes used	Tangible property works fairly well for nearly all forms of planned gifts — cost basis deduction is issue, however; testamentary gifts are ideal	Post-August 17, 2006 rules severely tightened partial-interest art gifts; capital gains taxes remain at 28% federal so there is extra tax benefit in tangible property donations
Intellectual Property *Deduction: Varies*	Patents, royalties, copyrights; revenue or non-revenue producing	Valuation cost, disposition process	Work best as testamentary gifts to receive step up in basis	Post-June 3, 2004 rules reduced attractiveness of patent/royalty gift (lesser of basis or FMV)

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