What Can Clients Donate to Charity?

At some point, many wealthy clients will think about contributing something other than cash to charity. This report examines some of the noncash assets donors may want to consider. We've highlighted the main issues, including tax implications, special private foundation considerations, and operational questions.

We will look at six categories of noncash assets: publicly traded securities, nonpublicly traded business interests, tangible personal property, intangible personal property, qualified retirement plans, and real estate.

Publicly Traded Securities

As a rule, publicly traded securities that have been held for at least one year can be contributed to a private foundation or public charity, giving the donor a deduction for the fair market value. If the property has appreciated, the donor does not realize the gain. Generally, appreciated publicly traded securities are an excellent asset to contribute to a private foundation or a public charity.

Conversely, if the property has lost value, the donor does not realize a loss. Therefore, it makes sense to give appreciated property, but not depreciated property. In virtually every case involving depreciated property, the donor would achieve better results by first selling the property and using the cash proceeds to make the gift.

The deduction the donor may take in a given year is limited to 20 percent of the donor's contribution base (in most cases, his adjusted gross income) for gifts to private foundations and 30 percent of his contribution base for gifts to public charities.

If the donor has not held the stock for at least a year, the deduction will be limited to the lower of two figures: the fair market value of the stock or the donor's basis. In this case, the property is treated like cash for the purposes of determining which deduction limitations apply. So a donor contributing short-term-gain property will be limited to a deduction of 30 percent of contribution base for gifts to a private foundation and 50 percent of contribution base for gifts to a public charity. The donor does not recognize a gain or loss on the disposition.

Types of Securities

Common and preferred stock that are traded on an exchange, open-end mutual funds, closed-end investment funds that are traded on an exchange, U.S. government bonds, and some exchange-traded corporate bonds are considered publicly traded securities for purposes of the charitable contribution rules. Given the right economics, all these are appropriate securities for charitable gifts.

Other publicly traded securities may not be appropriate for donations. This list includes certain zero-coupon bonds as well as Section 1256 contracts such as commodity futures and options to which the mark-to-market rules apply. The mark-to-market rules state that, for securities to which they apply, the owner must treat the securities, for income tax purposes, as though they were sold at the end of each tax year. The contribution of such property to charity will be deemed to be a sale, so a donor cannot avoid recognition of appreciation in such property. Therefore, such property is rarely, if ever, appropriate for a charitable contribution. (Note that this doesn't mean these aren't good investments for a foundation.)

Valuation

A donor of publicly traded stock is generally not required to obtain an independent appraisal of value. Instead, the donor may use the average of the high and low prices quoted on the exchange on the day of the gift. For mutual funds, the price is the closing net asset value on the date of the gift. If no such quote exists, it may be an indication to look more closely into the question of whether the property qualifies as a publicly traded security.

Date of the Gift

For a donor to receive a tax deduction in a given year, a gift must be completed in that year. For publicly traded securities, that means the security must be delivered into the recipient's account by year end.

Donors should not wait until the last minute. For operational reasons, many brokerage firms and other custodians take what may seem like an inordinate amount of time to transfer securities, even within the same firm. When a delivery to another firm is involved, even more time can be required. For year-end security donations, we generally recommend allowing a minimum of two weeks, and preferably a month, for the custodian to actually get the securities delivered.

Nonpublicly Traded Business Interests

Nonpublicly traded business interests generally include limited partnerships, closely held C corporations and S corporations, and limited liability companies. There are a number of considerations involved, and a donor should seek specialized counsel. That said, here are some of the general considerations.

Deduction Rules

For the most part, if an interest in a privately held business is donated to a public charity, it can be deducted at its fair market value, provided the interest has been held for at least one year. If the contribution is to a private foundation, it will be deductible only at the lesser of basis or fair market value. Keep in mind that privately held businesses, depending on their capital structure and the specific nature of the donor's interest, may be considered debt-financed property and subject to bargain-sale rules.

Valuation

Any deduction for nonpublicly traded business interests valued at more than $5,000 must be substantiated by a qualified appraiser. Such valuation issues are a study unto themselves, and a detailed discussion of the issues would easily fill a book. Suffice it to say that anyone considering a gift of nonpublicly traded business interests to charity should consider the valuation question early on. The valuation itself can be a time-consuming and expensive process.

Private Foundation Considerations

Contributions of nonpublicly traded business interests to a private foundation will not be deductible at fair market value. Furthermore, any gift of such an interest must be reviewed carefully in light of rules against prohibited transactions, self-dealing, and excess business holding. These rules do not mean that such gifts are never allowed. Sometimes they are. And it is not uncommon to have such nonpublicly traded business interests held by the private foundation of a disqualified person.

Gifts of nonpublicly traded business interests are perhaps the most complex and hardest to analyze of any charitable gifts. They should be considered only when the size of the gift justifies a considerable expenditure on professional analysis of tax and other issues. In those cases, if the analysis shows it to be feasible, such gifts can be highly beneficial for recipient and donor alike.

Tangible Personal Property

Donors can also make gifts of items such as cars, jewelry, art, collectibles, gemstones, books, maps, and rugs. This category excludes real estate but includes items that may not immediately seem “personal”: livestock, agricultural products, lumber (but not uncut marketable timber, called stumpage), harvested crops, and certain items of business inventory. In general, such property may be donated to charity with a tax deduction. However, there are a number of special cases (dealt with later in this section).

The general rule is that a donor may contribute tangible personal property and take a deduction for the fair market value at the time of the gift or for the donor’s basis in the property, whichever is lower. For example, if a donor paid $100,000 for a ring, and it is now worth $150,000, if he gives it to charity he can deduct only $100,000. If it has fallen in value to $50,000, he could deduct only $50,000.

Related Use

The tax rules are different if the property is of a type normally used by the charity in its tax-exempt function. Then, if the donor has held the property for investment purposes for at least one year, the donation may qualify for a fair market value deduction. One example: an art investor who donates a painting to an art museum with the reasonable expectation that the museum will display the painting in the normal course of its business.

Deduction Limitations

For gifts of nonrelated-use property to public charities, the donor’s deduction is limited to 50 percent of his contribution base. For such gifts to a private foundation, the limit is 30 percent. For gifts of related-use property that qualify for consideration as appreciated capital-gain property, the limits are 30 percent for gifts to a public charity and 20 percent for gifts to a private foundation.

Issues for Specific Assets

- **Art.** We often receive inquiries about artwork and how it should be treated as a gift. For art to be deductible at its appreciated fair market value, it must meet two tests. It must be held by a donor for investment purposes for at least one year. And it must be donated to a charity that expects to use it in a manner related to its charitable purpose. So, for example, a gift of art that the charity is expected to sell immediately will not qualify. Furthermore, an artist himself cannot get a fair market value deduction because he is deemed to be a dealer, and dealers are by definition not investors. An artist who donates his own art may deduct it only to the extent of his basis in the art. His time in creating it is not included in this basis. Finally, an artist who donates an original physical work but retains the copyright receives no deduction because this is a gift of a partial interest (that is, a gift of less than the donor's full rights in the property), and as a general rule, gifts of partial interests do not qualify for any deduction.

- **Timber.** Similarly, the treatment of timber depends on a number of factors. If the donor owns land with standing trees for investment, has held that property for at least one year, and contributes it to charity, the donation is not considered tangible personal property, and the gift is deductible at fair market value. If the same owner cuts the trees, the resulting cut timber will be deemed tangible personal property. Whether the gift is deductible at basis or at fair market value depends now on whether the recipient is expected to put the timber to a related use. If so, the donor may still deduct it at fair market value. However, if the recipient is expected to sell the timber (or put it to some other nonrelated-use), the donation deduction is limited to the donor's basis.

- **Agricultural crops.** As with timber, the tax treatment of crops depends on several factors: whether the crops are sold with the land or are first harvested; whether the donor holds the cropland for investment purposes; how long the donor holds the land (but not the crops, which typically have a growing season of less than one year); and sometimes, whether the recipient puts the donated crops to a related use. To get a fair market value deduction, a donor must contribute land held for more than a year (with or without crops growing on it). If these conditions prevail and there are crops growing, the value of the land and crops is deductible at fair market value. If the crops are cut, they become tangible personal property and are then deductible at fair market value only if given to a charity that uses them for a related purpose. That might be the case, for example, if the crops were donated to supply meals for homeless people.

- **Livestock.** Certain types of livestock can qualify for long-term-gain treatment, if they are held for breeding, dairy, or sporting purposes. Such livestock can be donated to charity for a fair market value deduction, even if the charity does not have a related use for the property. This area is quite complex, down to rules on which kind of animals are considered livestock; mink may be, turkeys and chickens are not. So donors and advisers should tread carefully in making any decision.

Valuation

Tangible personal property may be difficult to value. All gifts of such property worth more than $5,000 must be substantiated with a qualified appraisal. For some kinds of property—art is one example—it is advisable to use an appraiser who specializes in that kind of property.

Gifts to Private Foundations

In general, gifts of tangible personal property to a private foundation are permitted and are deductible at the lower of basis or fair market value, subject to the 30 percent limit. However, make sure that no such property will produce unrelated business income in the hands of the foundation. The better course for such assets may be first to sell them, then to contribute the proceeds. On the other hand, it may make sense to contribute appreciated tangible personal property to a foundation, because the unrealized gain may be realized in the tax-exempt foundation, avoiding income tax on the gain.

Intangible Personal Property

Intangible personal property is just what it says—and a bit more. The list includes copyrights, trademarks, patents, and other forms of intellectual property; as well as business assets such as databases, customer lists, formulas, royalties, or brand names; and contracts such as life insurance contracts, annuity contracts, and personal service contracts. Obviously, intangibles can be extremely valuable. It is difficult to generalize about the deductibility of intangibles, so we will review some of the more common types.

Copyrights

Donation to a public charity of a copyright that has been held for at least one year will qualify as long-term capital gain property, deductible at fair market value by the donor. As with art, this rule does not apply if the donor is the creator of the copyright. It also does not apply if the donor's normal business includes the buying and selling of copyrights. A copyright donated to a private foundation will be deductible at basis.

Patents

Generally, donations of a patent to a public charity will qualify for a deduction at fair market value regardless of the holding period. This exception regarding the holding period arises because IRS code section 1235 allows for this exception regarding the holding period. For patents that have been depreciated, the donor may face recapture of depreciation; that is, he will have to take as income some depreciation. This will reduce the donor's deduction by the amount of the recapture.

Unlike the case with copyrights, the creator of a patent is entitled to a fair market value deduction for a contribution to a public charity.

Royalties

Royalties for such things as copyrights, patents, and brand names are considered ordinary income assets, and as such are not deductible as capital-gain assets at fair market value, but instead at the donor's basis.

A gift of royalties without a gift of the property (such as a copyright) that produces them will be considered an assignment of income. When income is assigned, it is still taxable to the donor, even if it is received by a charity. For example, if a writer assigns the royalties from a book, but does not assign the copyright, the tax treatment for the donor is the same as if he was collecting the royalties and then giving them to charity. The donor should receive an income tax deduction for the amount donated. However, this deduction would be subject to the limitations applicable (30 percent of gross income for a private foundation, 50 percent for a public charity). Note that the donor in most cases will gain no tax benefit and may be worse off after making such a gift.

Oil royalties have different rules, relating to "working interests" and to "operating interests." A working interest is an interest in oil and gas in place (i.e., not exploration) that bears the cost of development and operation of the property. Operating interests are generally considered to be real property interests, and as such can be long-term capital gain property if held for one year. Royalties from such interests will also generally be considered long-term gain property, unless the donor uses the property in a trade or business. Donations of long-term gain property to a public charity are deductible at fair market value. Note that there are a number of variations in mineral interests, and any possible donation should be carefully examined.

Personal Service Contracts

Generally, a gift of a personal service contract will be considered an anticipatory assignment of income. The result is that the donor will be deemed to have received the income paid on the contract as it is paid, even though the donor does not get the cash. The donor should get a charitable deduction for the amounts as they are paid but, as previously noted, these deductions will be subject to the normal limits. For example, assume a donor has $1 million of income a year from a contract and assigns that contract to a public charity. The donor will be treated as if he has received income of $1 million and then made a gift of $1 million. The 50 percent deduction limit will apply, and the donor will only be able to deduct $500,000 that year, with the other $500,000 carried forward.

Installment Notes

When someone sells property on an installment basis, an "installment note" is created. Contributing such a note to charity is considered a taxable sale, and the donor will be deemed to have received all the remaining unrealized gain in the note. The donor will receive a tax deduction for the fair market value of the note.

Life Insurance and Annuity Contracts

A donor may contribute a cash-value life insurance contract to charity. The donor is entitled to a deduction equal to the lesser of his basis in the contract and the contract's fair market value, which will usually approximate its cash value. The calculation of fair market value depends on several factors, and for large donations a qualified appraisal may be required.

Note that if a contract has any outstanding loan against it, it may be considered debt-financed property, and donation of debt-financed property will subject the transaction to the bargain-sale rules.

The gift of an annuity contract issued after April 22, 1987, will be considered a sale and will result in the owner being deemed to receive ordinary income equal to the fair market value of the annuity, less his basis in it. The gift would be deductible at fair market value. Thus, it will rarely be beneficial for a donor to make a gift of an annuity contract. For contracts issued before April 22, 1987, the donor may be limited to a deduction only for his basis, which is an even worse outcome.

Employee Stock Options

Frequently, donors who hold large positions of employee stock options wish to donate these to charity. Unfortunately, this is not possible in most instances because of contractual prohibitions. Even when it is possible, it will generally have no tax advantage because the donor will be deemed to receive income for the value of the option.

Qualified Retirement Plans

Qualified retirement plans, such as IRAs, 401(k)s, and Keogh plans are powerful wealth accumulation tools due to their tax-deferred status. So it is not uncommon for donors to have large qualified plans and to seek to give all or part of such plans to charity. Under the current law, it rarely makes sense for a donor to give a plan to charity during his life. Conversely, upon death such assets are often excellent choices. Let’s look at these in more depth.

Congress has been changing the rules regarding contributions from IRAs to charity on a very frequent basis. As of this moment, it is generally possible for donors over age 70$^1/_2$ to contribute up to $100,000 from their IRA without adverse tax consequences. If this might appeal to you, ask your tax adviser about your specific situation.

Lifetime Contributions

During a donor's lifetime, to contribute plan assets to charity a donor generally must first receive the money from the plan as income. For example, if a donor wants to give $50,000 from his IRA, he must first take the $50,000 out of the IRA, and it will be considered taxable income. The donation will be a charitable contribution and deductible subject to the limitations. Currently, contributions directly from an IRA to charity are only allowed under limited circumstances pursuant to section 408(d)(8) of the Internal Revenue Code. While that provision expired on December 31, 2009, section 725 of the 2010 Act passed in December 2010, extended the provision to December 31, 2011, so contributions directly from an IRA to a charity are allowed in the limited circumstances previously allowed. The taxpayer must have attained the age of 70$^1/_2$ years, the amount is limited to $100,000 per taxpayer per year, the amount counts toward the required minimum distribution (which was usually the hook for making the contribution, especially if the distribution was not needed), and a charitable contribution deduction can't be claimed. There was also a special rule that the taxpayer could elect that distributions directly from an IRA to charity in January 2011, would be treated has having been made in 2010.

There are a few situations in which it might make sense to take distributions from a qualified plan to contribute them to charity. We'll consider distributions of employer stock (as from an ESOP), a lump-sum distribution that qualifies for 10-year forward averaging, and distributions taken as part of a "wealth replacement" plan involving life insurance.

Lump-sum distributions of employer stock from a company retirement plan may qualify for long-term capital gain treatment in the hands of the employee. Unlike most distributions from retirement plans, this distribution isn't automatically deemed income and taxed. The employee receiving the stock does not have to hold it for a year to qualify for long-term capital gains. So the stock, when received, can be contributed to charity for a fair-market value deduction.

A somewhat similar situation may arise when a retirement plan beneficiary receives a lump-sum distribution that qualifies for 10-year forward averaging. This is special tax treatment that results in plan distributions being taxed at between 15 percent and 22 percent. A donor could take these distributions, pay tax at the lower rates, and then donate the proceeds to charity. The charitable deduction would be usable by the donor against his highest marginal tax rate, which is around 45 percent for top-bracket donors in high-tax states.

The third situation involves life insurance planning designed to eliminate the estate tax on a large qualified plan. The donor purchases life insurance in a life insurance trust outside his estate. The death benefit on the life insurance is designed to equal the amount in the qualified plan. Because qualified plan assets can be left to charity upon death without income tax or estate tax (see the following section), the donor plans to leave the qualified plan to a private foundation. To help pay the life insurance premium, the donor withdraws an amount each year from the retirement plan, gives part of it to the foundation, and uses part to pay the premium. At death, the qualified plan goes to the private foundation, completely tax free, and the heirs get the life insurance death benefit, also completely tax free.

Testamentary Gifts of Qualified Plans

While lifetime gifts of qualified plans seldom make sense, testamentary gifts (gifts made upon death) often do. One of the major benefits of qualified plans is that they offer tax deferral. However, the death of an owner of such a plan often triggers income tax on the amount of income that has been deferred. If the amounts involved are large, this income tax will be at high marginal rates, and combined state and federal rates may approach 50 percent in some states.

In addition to income taxes, the plan value may be subject to estate tax, which is also on the order of 50 percent. Fortunately, these two taxes are not quite additive, or the plans would be completely wiped out. However, the combined effect of income taxes and estate taxes can still devastate the value of such plans. The combined tax bite can be upwards of 75 percent of the predeath value of the plan.

When a donor gives a qualified plan to charity, both the income tax and the estate tax are avoided. This allows 100 percent of the plan value to go to charity. If the donor contributes the plan to a private foundation, his heirs can continue to control 100 percent of the plan value. Often the best way to make sure that a charity, such as the foundation, receives the assets without tax is to name the charity as the beneficiary of the plan.

If less than the whole plan is to be contributed to charity, care must be taken to address issues of minimum distributions required from the plan, as well as to provide for the payment of the taxes that may result.

Real Estate

Gifts of real estate to charity are filled with opportunity and fraught with complexity. The complexity arises from the bewildering array of ownership structures, the variety of tax rules, and the bedeviling bargain-sale rules, which apply, perforce, to gifts of debt-financed real estate. Nevertheless, we will summarize some of the key issues and highlight the key opportunities and pitfalls.

Basic Rules

Contributions of real estate to public charities are deductible up to 50 percent of contribution base for contributions valued at basis, and up to 30 percent if contributions are of appreciated long-term gain property held for at least one year. If the contribution is to a private foundation, the deduction will be limited to the donor's basis and will be deductible up to 30 percent of contribution basis. These are the basic rules. However, there are a number of potential complications.

Ordinary Income Traps

As noted, contributions of appreciated property to public charities normally qualify for deduction at fair market value. But there are several important exceptions. They include donor's dealer status, a donor's short-term holding period (i.e., less than one year), or a depreciation recapture situation. If one of these applies, the deduction will be for the lesser of basis or fair market value.

A donor will have "dealer status" if his business is buying and selling real estate. For example, if a home builder who donates a house to charity is in the business of buying lots, building homes, and selling them, it is likely that he will be considered a dealer. Dealer status can have important tax consequences for reasons other than deductions, so it is likely that a donor will be aware of this issue if it applies to him. A donor will have a short holding period if he has not held the property in question for at least one year. Depreciation recapture is a potentially hidden trap. Because the rules for depreciating real estate have always been complicated and have changed over the years, any given real estate holding may or may not be subject to depreciation recapture upon disposition. If it is, the deduction will be reduced by the amount of the recapture.

Debt-Financed Property

We have already discussed the potential pitfalls involved in contributing debt-financed property to charity. At best, it triggers the bargain-sale rules. Note that the debt-financed property rules will complicate or scuttle most contemplated contributions of partnership interests in real estate.

Partnerships

Often donors own real estate limited partnership interests that they consider contributing to charity. Proceed carefully. Partnerships often have debt financing on their property. Because partnerships are pass-through entities for tax purposes, the limited partner in such a case is considered to own a debt-financed interest in the property. This means that a contribution will trigger the bargain-sale rules. In addition, limited partners may have very complicated basis situations that include some amount of potential basis recapture.

Partial Interests

In general, the donation of partial interests to charity are not deductible. However, there are several exceptions, two of which apply to real estate: contributions for qualified conservation easements and so-called life estate gifts.

A qualified conservation easement consists of a perpetual easement on property for purposes of conservation. Such an easement must be granted on suitable property to an appropriate agency; for example, a governmental unit or a qualified land trust. A typical easement may prohibit a parcel of land from ever being developed, while still allowing a donor to continue living in an existing house and sell the property in the future. However, the easement will continue to go with the property, and a future purchaser must abide by its terms.

Life estate agreements are also permitted contributions, as discussed above. While such agreements may permit a deduction for a gift of a future interest, we would counsel great caution for donors who are considering making a gift of a future interest in their principal residence. Such gifts are irrevocable and may significantly limit the flexibility of the donor to deal with unforeseen developments.

Conclusion

In this report we have touched on the more common types of property that donors consider giving to charity. For the most part, only gifts of cash and publicly traded stock can be considered "simple." Donors considering any other type of gift, if the amount is significant, would be well advised to consult with an expert before committing to such a gift.

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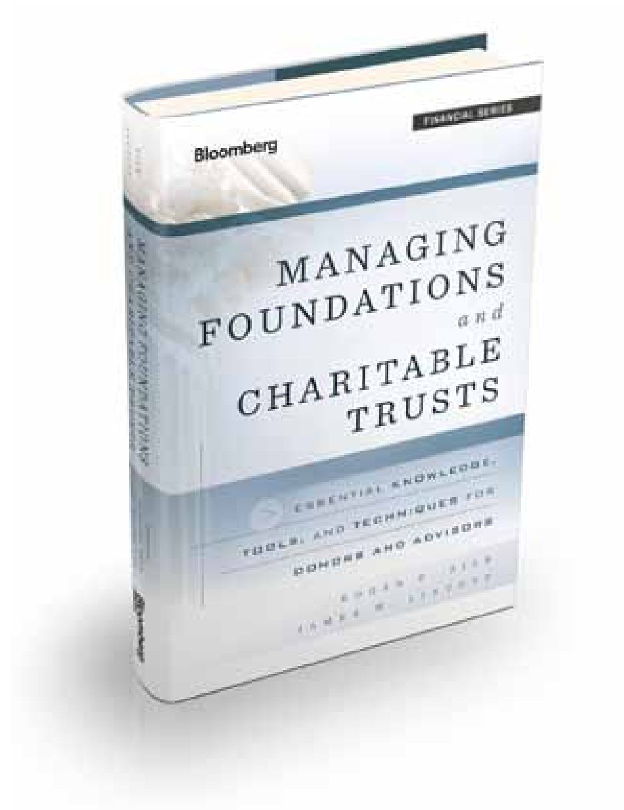

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