A PRIMER ON THE DEDUCTION, VALUATION, AND SUBSTANTIATION OF CHARITABLE CONTRIBUTIONS

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Multiple tax and non-tax factors become intertwined in evaluating a potential gift to a charitable organization. These factors include the donor's benevolent motives, psychic income, and attainment of tax or estate planning benefits.[1] As important as these motives and consequences are, this article does not seek to focus on all of them. Instead, the spotlight here is on the formidable rules that the donor and the donor's advisor must navigate for the donor to obtain federal income and transfer tax deductions.[2] This article provides an introductory guide to a complex thicket of categories, exceptions, and limitations. The information within this article will arm the advisor with substantial knowledge and will suffice for most planning situations. In other circumstances, the advisor may need to consult additional resources.[3]

Preliminary—but necessary—assumptions undergird planning for a donation to a charity. The recipient of a deductible contribution must exist for a charitable purpose, and the Internal Revenue Service must have determined that the recipient satisfies the tax law definition.[4] In addition to the donee being organized and operating for a charitable purpose, it is equally important that the donor must be charitable—at least in desire and inclination.[5] A qualified contribution saves income tax at the donor's marginal rate bracket.[6] In some instances the deduction may offset tax liability at less than a taxpayer's marginal rate due to the overall limitation in section 68 of the Internal Revenue Code on itemized deductions of certain higher income taxpayers.[7] Because marginal income tax rates are not 100%, the donor does not receive a dollar-for-dollar offset in tax liability in return for a contribution.[8] Thus, a lifetime gift to charity results in a reduction in net income or wealth.[9] Charitable deductions under transfer taxes produce a similar result.[10] Although the value of a lifetime or

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1. A charitable gift produces a benefit to all or to a segment of society. *See* I.R.C. § 170 (West 2012). Donors are motivated to initiate, continue, or complete some worthwhile program. A tangential—but significant—consequence for the donor of a lifetime gift is the ability to evaluate the use of the gift so the donor can determine whether to make additional contributions. The donor may also seek and receive community adulation and prestige for making the gift.

2. *See id.* (stating rules governing deductibility of charitable contributions in the computation of an individual's income tax); I.R.C. §§ 2055, 2522 (West 2012) (governing deductibility under federal estate tax and gift tax, respectively).

3. *See generally* JOSEPH P. TOCE JR. ET AL., TAX ECONOMICS OF CHARITABLE GIVING (2010–2011 ed. 2010); BARBARA L. KIRSCHTEN & CARLA NEELEY FREITAG, CHARITABLE CONTRIBUTIONS: INCOME TAX ASPECTS (Tax Mgmt. Inc. 2008).

4. *See generally* § 170(c) (defining charitable organization); § 2055(a) (defining charitable organization for estate tax purposes); § 2522(a) (defining charitable organization for gift tax purposes).

5. *See* I.R.C. §§ 501(c)(3), 508(a) (West 2012).

6. *See* I.R.C. §§ 63(a), 161. (West 2012). The charitable deduction allowed by section 170 is an itemized deduction that is subtracted from taxpayer's adjusted gross income to compute taxable income. *See* § 170.

7. *See* I.R.C. § 68 (West 2012).

8. I.R.C. § 3 (West 2012) (stating marginal income tax rates).

9. *See* § 170(a).

10. *See* Treas. Reg. § 20.2055-1 (2012).

testamentary gift to a qualified charity is deductible in full for gift and estate taxes without any ceiling on the deductible amount, marginal transfer tax rates are also considerably less than 100%.[11] Consequently, the donor or the donor's heirs or beneficiaries suffer a diminution in what would be the donor's or the donor's heirs' or beneficiaries' in absence of the contribution.[12]

Even a donor who possesses the requisite philanthropic spirit and understands the net cost of charitable gifts wants to reap all benefits the tax law confers.[13] If a deduction is available, the typical donor wants to qualify for it. Thus, the advisor needs to possess an understanding of the multiple requirements for obtaining, valuing, and substantiating charitable deductions.[14] This article intends to provide a basic understanding of those requirements.

Federal gift and estate tax laws contain relatively few restrictions on outright contributions to charitable entities.[15] Under income tax laws, however, charitable deductions are subject to numerous restrictions. Ceilings cap a taxpayer's aggregate annual deduction.[16] Valuation rules govern the calculation of and may limit deductible amounts.[17] Parts I and II of this article primarily focus on those ceilings and value limitations.[18] Both income tax and transfer tax laws limit charitable deductions for contributions of partial interests to gifts made within a fixed number of highly restrictive formats.[19] Accordingly, after ceilings and value reductions, Part III shifts to focus on the constraints peculiar to gifts of partial interests.[20] Part IV addresses contributions that are accompanied by a return economic benefit to the donor.[21] Finally, Part V describes the

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11. *See* I.R.C. §§ 2055(a), 2522(a) (West 2012) (allowing deduction of a charitable bequest and gift without limitation other than the limitation in section 2055(d), which restricts the deduction to the value of property included in a decedent's gross estate); I.R.C. § 2001(c) (West 2012) (stating the marginal federal estate tax rates); I.R.C. § 2502(a)(1) (West 2012) (applying the same rate schedule for federal gift tax).

12. *See supra* note 11.

13. *The Tax Perks of Charitable Giving—Portland, Oregon*, EST. PLAN. BLOG (Feb. 24, 2012), http://www.naylaw.com/blog/the-tax-perks-of-charitable-giving-portland-oregon.html.

14. *See* Carrie Sowders, *Contemporaneous Documentation of Charitable Contributions*, AM. INST. CPAS (Dec. 1, 2012), http://www.aicpa.org/publications/taxadviser/2012/december/pages/clinic-story-02.aspx.

15. *See* §§ 2522(a), 2055(a) (stating a gift or bequest by a citizen or resident is fully deductible at its fair market value if made to an organization described in either section 2522(a) or section 2055(a)). If the donor or decedent is a nonresident alien, the recipient must be a domestic corporation or the donated asset must be for use within the United States for a permitted charitable purpose. *See* Treas. Reg. § 25.2522(b)-1. S*ee also* Treas. Reg. § 20.2055(1)(a) (West 2012).

16. I.R.C. § 170(b) (West 2012).

17. § 170(e); Treas. Reg. § 1.170A-1(c) (2012).

18. *See infra* Parts I–II.

19. *See* § 170(f) (stating the income tax restrictions on gifts of partial interests); § 2055(e) (stating the estate tax limits). *See also* § 2522(c) (stating the gift tax limits).

20. *See infra* Part III.

21. *See infra* Part IV.

burden placed on the donor to substantiate a claimed contribution deduction.[22]

I. DEDUCTION CEILINGS

A. Income Tax

A typical contribution is a direct, outright gift of cash or a specific asset to a charitable organization.[23] The recipient obtains full title and has immediate ability to exercise all rights of ownership.[24] No trustee holds the property, no intervening interest in a third party exists, and no other party is designated to receive the property after charity enjoys it.[25] The primary charitable deduction issues are (1) whether the donor will be able to deduct the entire value of the contribution in the year of gift or be limited by a ceiling, and (2) whether the value of the contribution is its full fair market value.[26] This part discusses the first issue, and Part II addresses the second.[27]

Annual income tax charitable deductions may not exceed stipulated percentages of the taxpayer's contribution base for the applicable year.[28] A taxpayer's contribution base is the taxpayer's adjusted gross income without regard to any net operating loss carryback.[29] Few taxpayers have a net operating loss carryback.[30] As a result, the contribution base for most taxpayers is the taxpayer's adjusted gross income.[31]

Deduction ceilings vary with the character of the contribution.[32] Cash contributions enjoy higher ceilings, while in-kind donations of assets may bump into lower ceilings.[33] The ceilings are also higher for gifts to so-called public charities than for contributions to those commonly known as private foundations.[34] To appreciate these differences, section one discusses

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22. *See infra* Part V.
23. JOSEPH P. TOCE JR. ET AL., TAX ECONOMICS OF CHARITABLE GIVING § 4.02 (2010–2011 ed. 2010).
24. *Id.* § 5.02.
25. *Id.* § 5.01.
26. *Id.* § 7.02.
27. *See infra* Part II.
28. I.R.C. § 170(b)(1) (West 2012).
29. § 170(b)(1)(G).
30. *See generally Net Operating Losses (NOLs) for Individuals, Estates and Trusts*, IRS (Jan. 28, 2013, 7:15 AM), http://www.irs.gov/pub/irs-pdf/p536.pdf (describing the author's experience with individual taxpayers regarding net operating losses).
31. *See* TOCE, *supra* note 23, § 7.02.
32. *Id.* § 4.02(2).
33. *Id.*
34. § 170 (b)(1)(A).

classification of charitable organizations.[35] Then, with the classifications in mind, section two examines specific deduction ceilings.[36]

1. Classification of Charitable Entities

Charitable organizations fall into two categories.[37] Included in the most favored category for deductibility of contributions are "public charities."[38] The term "public charities" is partially misleading inasmuch as contributions to pass through and common fund private foundations, as well as private operating foundations, qualify for deductibility as public charities.[39] Additionally, a public charity does not necessarily receive support from the general public.[40] Despite the risk of inaccuracy, this article still labels the entities in this favored category as public charities because of the common usage of that term for this purpose.

Public charities are identified in subsections 509(a)(1)–(4) of the Internal Revenue Code.[41] Those described in section 509(a)(1) fall within one of five different purpose categories or meet a test of broad public support. These include:

(1) Churches and conventions or associations of churches;
(2) Educational institutions with a regular faculty, curriculum, and enrolled students in attendance at a particular location;
(3) Certain hospitals and medical-research organizations affiliated with a hospital;
(4) Certain college and university endowment funds;
(5) Governmental units (if the contribution is used for exclusively public purposes); and
(6) Organizations with a charitable purpose who also satisfy a public support test articulated in the regulations to this section.[42]

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35. *See infra* Part I.A.1.

36. *See infra* Part I.A.2.

37. *See* TOCE, *supra* note 23, § 3.01.

38. *See generally* I.R.C. § 509(a) (West 2012). The term "public charity" is used here to denote organizations in the favored category. As commonly used, the term refers to entities described in subsections 509(a)(1)–(4). The term "public charity," however, is not defined in the Internal Revenue Code. But, under common usage, the term refers to organizations described in section 509(a), being organizations excluded from the term "private foundation."

39. § 170(b)(1)(F). Those entities, however, are private foundations and are not described in any of subsections 509(a)(1)–(4). *See generally* § 509(a)(1)–(4).

40. *See generally* § 170(b)(1)(A)(i)–(vi). Organizations described in section 170(b)(1)(A)(i)–(v) are within the term "public charities" because of the character of their activities, not due to their sources of support. *See generally id.* An entity described in section 170(b)(1)(A)(i)–(iii) could be supported by a single private individual. *See* § 170(b)(1)(A)(i)–(iii).

41. § 509(a)(1)–(4).

42. §§ 170(b)(1)(A), 509(a)(1).

Section 509(a)(2) of the Code articulates a different public support test for organizations that derive much of their support from gross receipts from admission charges, merchandise sales, and service fees.[43] Supporting organizations (described in section 509(a)(3)) are unusual public charities.[44] Supporting organizations often are not supported by the general public, but they obtain public charity status because they support, to a significant extent, an organization that is a public charity under section 509(a)(1) or (a)(2).[45]

The other, less favored category for deductibility of contributions includes all charitable entities that remain private foundations because they are not described in one of subsections 509(a)(1)–(4).[46] This article will refer to these entities as private foundations, like they are referred to in the Internal Revenue Code.[47] However, such labeling is slightly misleading because, as previously noted, contributions to some private foundations qualify for deductibility under higher ceilings.[48]

2. *Ceiling Limitations*

When a taxpayer makes gifts directly to public charities, the taxpayer can deduct the gifts in an aggregate amount up to 50% of the taxpayer's contribution base in the year of payment.[49] If the taxpayer's qualifying contributions exceed this 50% ceiling, the excess may be carried over and used as a charitable deduction in up to five subsequent years.[50]

Excluded from qualifying for the 50% ceiling, however, are contributions of long-term capital gain property.[51] Long-term capital gain property includes any capital asset—such as real estate, securities, or tangible personal property—that would produce long-term capital gain if a taxpayer sold the asset rather than donated it.[52] For contribution purposes, capital gain property consists of both capital assets and section 1231 property (assets used in a trade or business).[53] Most gifts to public charities that are long term capital gain property are subject to a ceiling of 30% of a donor's contribution base.[54] In two instances, however, gifts of long term capital gain property that a taxpayer donates to a public charity qualify for a

43. § 509(a)(2).
44. § 509(a)(3).
45. § 509(a)(1)–(3).
46. § 509(a)(1)–(4).
47. *See* § 509(a) (defining private foundation, which includes all organizations not referenced in section 170(b)(1)(A)(i)–(vi) or described in section 509(a)(2)–(4)). *See id.*
48. *See supra* Part I.A.1.
49. *See* § 170(b)(1)(A).
50. *See* § 170(d)(1)(A).
51. § 170(b)(1)(C)(i).
52. *See* § 170 (b)(1)(C)(iv).
53. *See id.*
54. *See* § 170(b)(1)(C)(i).

deduction up to the 50% ceiling.[55] One instance is when a taxpayer donates tangible personal property but its use is unrelated to the recipient's exempt purpose or function.[56] In that situation, the donor benefits from the higher 50% ceiling but suffers from a reduced value deduction.[57]

The other instance in which a 50% ceiling is available for a gift of capital gain property to a public charity is when a donor makes an election to value the donated property at its cost basis.[58] Without this election, the donor may deduct the full fair market value of the donated asset up to 30% of the donor's contribution base.[59] Under this special election, the donor may opt to reduce the value of long term capital gain property by the amount that would be long term capital gain if the donor sold the property instead of donating it.[60] The reduced value may then be deducted up to 50%, rather than 30%, of the taxpayer's contribution base.[61] If the donor makes such an election, it applies to all long term capital gain property given to public charities in that tax year.[62] As suggested in the following examples, this election should be considered in several factual settings.

Contributions for the use of (i.e., in trust for, rather than outright to) public charities or directly to, or in trust for the use of, private foundations are deductible, with one exception, in an aggregate amount up to 30% of the taxpayer's contribution base.[63] Gifts that do not qualify for this 30% ceiling are gifts of long term capital gain property to or for the benefit of a private foundation.[64] Those gifts are subject to an even lower ceiling of 20% of taxpayer's contribution base.[65]

Hypothetical fact situations can aid advisors in understanding difficult rules. To achieve initial understanding and sustain retention of these rules, reference will be made to Ralph and Ruby, a married couple who makes or proposes to make a number of different donations. Ralph and Ruby are

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55. *See id.*

56. *See id.* Section 170(e)(1)(B) requires for contribution deduction purposes that the value of donated tangible personal property be reduced by the amount that would have been long term capital gain on a sale when the use of the donated asset is unrelated to the donee's exempt purpose or function. *See* § 170(e)(1)(B). Section 170(b)(1)(C)(i) excludes property to which section 170(e)(1)(B) applies. *See* § 170(b)(1)(C)(i). This exclusion leaves such property subject to the 50% ceiling of section 170(b)(1)(A). *See id.*

57. *See* § 170(b)(1)(C)(i).

58. *See id.* This election is stated in section 170(b)(1)(C)(iii). *See* § 170(b)(1)(C)(iii).

59. *See* § 170(b)(1)(C)(i).

60. *See* § 170(b)(1)(C)(iii).

61. *See id.*

62. *See id.*

63. *See* § 170(b)(1)(B). The distinction between *to* or *for the use of* is drawn by the definition in section 170(c) of a "charitable contribution," which uses both terms, and the language of section 170(b)(1)(A) describing only gifts *to* organizations that qualify for the higher deduction ceiling. *See* § 170(c).

64. *See* §170(b)(1)(D) (addressing contributions of capital gain property to which section 170(b)(1)(A) does not apply). While section 170(b)(1)(A) applies to gifts to public charities, subparagraph (D) covers gifts to private foundations. *See id.*

65. *See id.*

assumed to have a contribution base (which is also their adjusted gross income) on their joint federal tax return of $150,000 in the year that the donation occurs or is to occur. The initial set of examples illustrates application of deduction ceilings.

> *Example:*
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> (1) For the couple's only contribution of the year, Ruby gives $100,000 in cash to Famous Technological University. Famous Tech is an educational institution described in section 170(b)(1)(A)(ii), making it a public charity under section 509(a)(1).

The deduction for the year of contribution is capped at $75,000, which is 50% of Ralph and Ruby's contribution base.[66] The excess $25,000 constitutes a carryover that Ralph and Ruby may deduct in the following tax year up to a maximum amount that represents 50% of Ralph and Ruby's contribution base in that first carryover year.[67]

> *Example:*
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> (2) Ruby contributes $100,000 to a perpetual trust whose terms require distribution of $5,000, a fixed amount, each year to Famous Tech.

Although this contribution benefits a public charity, the contribution is placed in trust, making it a gift for the use of, rather than to, the recipient.[68] Accordingly, the deduction ceiling is 30% of Ralph and Ruby's $150,000 contribution base.[69] Thus, the deduction for the year the gift is made is a maximum of $45,000.[70] The remaining amount may be carried to and be used in the next year. If the remaining amount is not absorbed within a year, the donor may carry it into as many as four more years.[71]

> *Example:*
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> (3) In a different year, Ralph and Ruby establish the Ralph and Ruby Family Foundation, a grant-making private

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66. *See* § 170(b)(1)(G). If Ralph and Ruby file a joint return, they share a contribution base, which is their joint adjusted gross income (without regard to any net operating loss carryback). *See id.*

67. *See* § 170(d)(1)(A). The carryovers are deductible only after deduction of contributions to public charities (section 170(b)(1)(A) organizations) made in the carryover year. *See id.*

68. *See id.*

69. *See* § 170(b)(1)(B).

70. *See id.*

71. *Id.* Contributions made in the carryover year, however, are deductible prior to deduction of carryover amounts. *See* § 170(d)(1).

> foundation.[72] They contribute $100,000 to this Foundation as their only charitable contribution that year.

Ralph and Ruby make this contribution to an entity that is subject to a lower contribution ceiling.[73] If, as before, Ralph and Ruby have an adjusted gross income of $150,000, the applicable ceiling, 30% of their adjusted gross income, limits their deduction to only $45,000 in the year of donation.[74] The excess $55,000 is a carryover that Ralph and Ruby may deduct in the following year.[75] If their adjusted gross income in that first carryover year remains at $150,000, the 30% limitation again is $45,000. In a second carryover year, Ralph and Ruby may deduct the $10,000 that remains after taking maximum deductions in each of the year of gift, and the first carryover year.[76]

Example:

> (4) In still another year and as the couple's sole gift to charity, Ruby donates Blackacre, a 40-acre parcel in northern Wisconsin, which has a fair market value of $100,000, to Famous Technological University. In 1987, Ruby purchased Blackacre as an investment for $10,000.

Blackacre is long term capital gain property in Ruby's hands. Accordingly, Ruby may deduct the value of this gift at its full, fair market value up to 30% of her $150,000 contribution base.[77] Although this is a donation to a public charity, the deduction ceiling is 30%, not 50%, because the donated asset is long term capital gain property.[78] Thirty percent of the $150,000 adjusted gross income is $45,000, making that amount the maximum deduction in the year of the gift. The balance of the value of this gift ($55,000) is a carryover to the following year and to as many as four years beyond the next year.[79] In each carryover year, this contribution retains its character as a gift of long term capital gain property to a public charity.[80] In other words, the deduction remains subject to a ceiling of 30% of adjusted gross income in each carryover year.[81]

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72. *See generally* § 170(b)(1)(A)(vii). A grant-making private foundation is not described in section 170(b)(1)(A)(vii). *See* § 170(b)(1)(F)(i)–(iii). Accordingly, it is not a public charity but is a private foundation for contribution deduction purposes. *See id.*

73. See § 170(b)(1)(B).

74. *See* § 170(b)(1)(B)(i).

75. *See* § 170(b)(1)(B)(ii).

76. *See id.*

77. *See* § 170(b)(1)(C).

78. *See* § 170(b)(1)(C)(i).

79. *See* § 170(b)(1)(C)(ii).

80. *See id.*

81. *See id.*

Example:

> (5) Instead of donating Blackacre, Ruby gives Whiteacre, a different parcel of real estate, to Famous Tech. The fair market value of Whiteacre is $100,000. Two years ago, Ruby purchased it for investment purposes at a cost of $90,000.

The general rule allows Ruby to deduct this gift at its full value up to 30% of her adjusted gross income or up to $45,000 assuming a contribution base of $150,000.[82] However, Ruby should consider making an election that will enable her to deduct a larger amount of her gift in the year of contribution. She may opt to subtract the appreciation element, which is the amount that would be long term capital gain if she sold the property and value the gift at its cost basis rather than at its fair market value.[83] If Ruby makes this election, Ruby is allowed to deduct the reduced value of the gift up to 50% of her contribution base rather than 30%.[84] With the election in place, Ruby's donation is valued at $90,000.[85] She is eligible to take a deduction of $75,000 (being one-half of her contribution base) in the year of the contribution and to carry over the remaining $15,000 to the following tax year.[86]

In Example (5), the difference between Ruby's cost basis and the fair market value of the donated property was relatively small. In Example (4), Ruby only had a $10,000 basis in Blackacre. The disparity in the amount of appreciation in the two donated assets is crucial. If the donor has a large built-in appreciation, the election to reduce the deduction amount to cost basis is likely not attractive. It is not sensible for Ruby to value the gift of Blackacre in Example (4) at her cost of $10,000 and only receive a $10,000 deduction with no carryover. But in Example (5), when the cost is $90,000 and present value is $100,000, the election to reduce the total deduction to $90,000 may confer a substantial benefit. The increased deduction of $75,000 in the year of the contribution may offset tax at higher than normal marginal rates, for example.

Other circumstances may give a donor an incentive to elect to reduce the value of donated capital gain property and take a higher deduction in the contribution year.[87] A donor with poor health and a short life expectancy may foresee insufficient carryover years to absorb the full deduction.[88] Any

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82. *See id.*

83. *See* § 170(b)(1)(C)(iii).

84. *See id.* The election under section 170(b)(1)(C)(iii) negates application of the 30% ceiling prescribed by section 170(b)(1)(C)(i) and (ii), leaving the gift subject to the 50% ceiling of section 170(b)(1)(A). *See id.*

85. *See supra* text accompanying notes 82–84.

86. *See* § 170(d)(1)(A). *See also supra* note 67 and accompanying text.

87. *See generally* Treas. Reg. § 1.170A-10(d)(4)(iii) (2013).

88. *See id.*

unused charitable deduction dies with the donor and cannot be used by the donor's estate or beneficiaries.[89] A donor who has made or who routinely makes large cash contributions may also benefit from the election to reduce the value of the contribution to cost basis and receive a higher contribution ceiling.[90] Cash gifts and donations of long term capital gain property in the same year, combined with the operation of the priority rules discussed next, may make deduction within the 30% limit of the full fair market value of donated property unlikely, even given the availability of five carryover years.[91]

3. Priority Rules

Priority rules govern the sequence of deductions within the percentage limitations for a taxpayer's gifts.[92] The priority rules apply when a taxpayer makes contributions in the same year to both public charities and private foundations,[93] or gives both long term capital gain property and cash or other assets in the same year.[94] Priority rules also apply in carryover years when a donor makes or has made current year or carryover gifts to both public and private entities or gifts that consist of different classes of assets.[95]

Under the priority rules, the first permissible deductions are qualifying gifts directly to public charities, up to the ceiling of 50% of the donor's contribution base.[96] Qualifying gifts generally exclude contributions of long term capital gain property.[97] However, the reduced value of donations of tangible personal property, whose use is unrelated to the exempt purpose of the donee, remains eligible for deduction up to the 50% ceiling.[98] Transfers of long term capital gain property, with a special election to deduct only the value that remains after subtracting the appreciation that would be long term capital gain upon a sale, also qualify for the favored 50% deduction ceiling.[99]

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89. *See id.* There are no provisions for carryover of individual income tax deductions to a decedent's successors, including the decedent's estate. If the decedent was married, the existing excess charitable deduction may be used in the decedent's separate return for the year of death or on a joint return filed for the year of death. *See id.*

90. *See* § 170(d)(1). Gifts made by taxpayer in a carryover year are deductible before the carryover amounts. *Id.*

91. *See* § 170(b)(1)(C).

92. *See* § 170(b)(1)(B)–(D) (stating the percentage limitations of allowable deductions and their priority).

93. *See, e.g.*, § 170(b)(1)(B) (stating such a priority rule).

94. See § 170(b)(1)(C)(i). A donor can deduct contributions of capital gain only after deducting contributions of cash and other property. *See id.*

95. *See* § 170(d)(1).

96. *See* § 170(b)(1)(A).

97. *See* § 170(b)(1)(C).

98. *See supra* note 54. *See also supra* text accompanying note 95.

99. *See* § 170(b)(1)(C)(i). *See also supra* note 94 and accompanying text.

After deducting contributions that qualify for inclusion within the 50% ceiling, a taxpayer may deduct donations to private foundations and gifts in trust for both public and private entities,[100] except for gifts of long term capital gain assets.[101] With these second category gifts, a donor may deduct up to 30% of the donor's contribution base.[102] The actual limit, however, is the lesser of either 30% of the taxpayer's contribution base or the percentage remaining after subtracting qualifying contributions to public charities from 50% of the donor's contribution base.[103]

The third deduction in line is contributions of long term capital gain property a donor gives to public charities.[104] The normal but also nominal ceiling for these contributions is 30% of the donor's contribution base.[105] Gifts of long term capital gain property to private foundations are the lowest priority deduction.[106] Not only are they last in sequence, but they are also subject to a ceiling of 20% of taxpayer's contribution base.[107]

Advisors and donors can learn important lessons from operation of the priority rules. If contributions qualifying for the 50% ceiling are substantial in value, then contributions to private foundations or in trust for public or private entities and gifts of long term capital gain property may be deductible at far less than their stated deduction ceilings.[108] Indeed, in the year of contribution, a donor may not be able to deduct any gifts at the lower priority levels if large cash gifts are made to public charities the same year.[109] Moreover, when a donor carries over unused deductions in each category to a succeeding year, the donor can only deduct them after deducting current year contributions.[110] Additionally, carryovers retain their status as subject to a 50%, 30%, or 20% ceiling, and a donor must claim them in that sequence.[111]

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100. § 170(b)(1)(B).
101. *See* § 170(b)(1)(C)(i).
102. § 170(b)(1)(B)(i).
103. § 170(b)(1)(B)(ii).
104. *See* § 170(b)(1)(C)(i). A donor may deduct contributions of capital gain property described in section 170(b)(1)(C)(i) after the donor deducts all other charitable contributions excepting only gifts of capital assets to private foundations. § 170(b)(1)(C)(i), (D).
105. § 170(b)(1)(C)(i). The 30% ceiling is the largest amount that a donor can deduct. *Id.* When a donor makes other gifts to a section 170(b)(1)(A) organization and those gifts are significant in value, a lower ceiling may apply. § 170(b)(1)(C)(ii).
106. § 170(b)(1)(C)(i), (D).
107. § 170(b)(1)(D)(i).
108. *See* § 170(b)(1)(B).
109. *See* § 170(b)(1)(B)–(D).
110. *See* § 170(b)(1)(B), (C)(ii), (D)(ii).
111. § 170(d)(1)(A).

Example:

> (6) Ralph and Ruby make two gifts this year: $35,000 to Famous Tech, a public charity, and $75,000 to the Ralph and Ruby Family Foundation, a grant-making private foundation.

The 50%, 30%, and 20% ceilings are not cumulative.[112] They operate on separate tracks, and gifts that qualify for higher ceilings have the right of way.[113] Applied to this example, the priority rules first permit the donors to deduct the cash gift they made directly to Famous Tech.[114] Then the donors can deduct the contribution to the private foundation eligible for deduction within the 30% ceiling.[115] Under the priority rules, however, the ceiling on gifts qualifying for the 30% ceiling is the lesser of 30% of adjusted gross income or the percentage remaining after a donor deducts gifts to public charities.[116] In Example (6), the donors can deduct the gift to the university up to 50% of the taxpayers' $150,000 contribution base, or $75,000. Thus, in the year of the gift, the donors can deduct fully the $35,000 gift to the university.[117] Thirty percent of their contribution base, which is the ceiling on contributions of cash to a private foundation, is $45,000. After the donors subtract cash contributions to public charities from 50% of their contribution base ($75,000 minus $35,000), $40,000 remains. Ruby and Ralph can deduct only the lesser of those two amounts.[118] Ruby and Ralph can deduct only $40,000 of the amount they gave to the family foundation.

Example:

> (7) In another year, Ralph and Ruby again make two gifts: $75,000 to Famous Tech and $50,000 to the Ralph and Ruby Family Foundation.

The taxpayers can deduct the entire $75,000 gift to the university because it is not more than the $75,000 amount that represents 50% of their contribution base.[119] The lesser of 30% of their contribution base ($45,000) or the amount left after they deduct gifts to public charities ($75,000 contribution base minus $75,000 used) means that they can not deduct any of the gift to the family foundation.[120] The entire contribution to the family

112. *See* § 170(b)(1)(B)–(D).
113. *See* § 170(b)(1)(B).
114. § 170(b)(1)(A).
115. § 170(b)(1)(B).
116. *Id.*
117. § 170(b)(1)(A).
118. § 170(b)(1)(B)(ii).
119. *Id.*
120. § 170(b)(1)(A).

foundation is available as a carryover.[121] When the donors carry that contribution over to the next year, however, it retains its character as a gift to a private foundation.[122] First, the donors must deduct contributions they make in that carryover year.[123] Therefore, if Ralph and Ruby make donations to public charities in that carryover year or if they possess public charity carryovers from a prior year, they must take those new contributions and carryovers into account in that carryover year before considering the deductibility of the carryover amount for the prior gift to the private foundation.[124]

B. Transfer Taxes

A donor's eligible contribution to charity receives a full deduction at fair market value under both federal gift and estate taxes.[125] There is no ceiling on the deductible amount.[126] Unlike the income tax rules, the character of the asset—as cash, other property, or as long term capital gain property—is irrelevant.[127] The donor's wealth, lack of wealth, and position in the income tax realm are all irrelevant.[128] As long as the taxpayer relinquishes dominion and control over the taxpayer's entire interest and is a citizen or resident, 100% of the value of a direct contribution to charity is a charitable deduction for gift or estate tax purposes.[129]

II. VALUATION OF CHARITABLE CONTRIBUTIONS

A. Datum: Fair Market Value

Valuation of a gift to charity starts with the fair market value of the contributed item.[130] Cash in United States currency is valued at its stated amount.[131] If a donor contributes an asset to charity, the fair value of the asset on an open market is the proper beginning point.[132] The common definition of fair market value is familiar; it is the price at which a sale would occur between a willing buyer and a willing seller, neither party

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121. § 170(d)(1)(A).
122. *Id.*
123. *Id.*
124. § 170(d)(1).
125. I.R.C. §§ 2522(a), 2055(a) (West 2012).
126. *See* §§ 2522(a), 2055(a).
127. *See* §§ 2522(a), 2055(a).
128. §§ 2522(a), 2055(a).
129. §§ 2522(c)(2), 2055(e)(2).
130. Treas. Reg. § 1.170A-1(c)(1) (2013).
131. This is unstated and obvious inasmuch as all amounts and values for contributions are stated in equivalent United States dollar value.
132. § 1.170A-1(c)(1).

being under compulsion to engage in the transaction and both having knowledge of the relevant facts.[133]

To ascertain the deductible value of gifts in kind, a donor may need to make downward adjustments from fair market value.[134] The Code requires that a donor make a reduction when a sale of the asset—rather than a donation—would produce ordinary income.[135] The Code may also require that a donor make a reduction when the contributed item is capital gain property in the donor's hands and the recipient is a private foundation.[136] Finally, the Code requires a third curtailment when a donor donates tangible personal property to a charity, but the use of the contributed item is unrelated to the recipient's exempt purpose.[137] Examination of each of these valuation adjustment rules is next.

B. Ordinary Income Element

In determining the deductible amount, a donor must subtract from the fair market value any value that would be realized as ordinary income upon a sale of the donated asset.[138] This applies to all in kind contributions.[139] The donor must reduce by the ordinary income element the value of any asset contributed to any charitable entity.[140] To ascertain the deductible value, a donor must subtract short term capital gain that would result from a sale.[141] Similarly, a donor would subtract any amount realized upon a sale that would have been recaptured and treated as ordinary income.[142] Likewise, a donor must value at cost basis an item the donor classifies as inventory.[143]

An asset could be inventory to one taxpayer but a capital asset to another.[144] For instance, a developer of (dealer in) real estate might classify Blackacre as inventory, but a casual purchaser who intends to build her dream home on the property might classify it as a capital asset.[145] Accordingly, the status of the asset in the hands of the donor is a crucial

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133. § 1.170A-1(c)(2).
134. *See* § 1.170A-1(c).
135. *See* I.R.C. § 170(e)(1)(A) (West 2012).
136. *See* § 170(e)(1)(B)(ii).
137. *See* § 170(e)(1)(B)(i)(I).
138. *See* § 170(e)(1)(A). *See also* Treas. Reg. § 1.170A-4.
139. *See* § 170(e)(1)(A).
140. § 1.170A-4(a)–(b).
141. *See* § 1.170A-4(a)(1).
142. *See* §1.170A-4A(d).
143. *See* § 1.170A-4A(c)(2).
144. *See* I.R.C. § 1221(a) (West 2012). The capital asset is property held by a taxpayer but the Code excludes several types of property, among them inventory. *See id.*
145. *See id.*

fact in determining whether there is an ordinary income element to subtract.[146]

Example:

> (8) Ralph, sole proprietor of a paint store, donates paint and supplies with a retail value of $800 to the high school drama club.

Ralph's donation consists of items that are inventory to him, so their sale would have produced ordinary income. In calculating his charitable deduction, Ralph must reduce the retail value of the paint and supplies by this ordinary income element.[147] The result is a deduction equal to his cost basis.[148] An ordinary income element could be present even in capital gain property.[149] Ralph and Ruby might own and donate an apartment building. They may have taken accelerated depreciation that would be recaptured as ordinary income on a sale of the building.[150] If so, for contribution deduction purposes, the donor must reduce the value by the ordinary income element even though the building is a capital asset and a sale primarily would produce long term capital gain.[151]

C. Capital Gain Property Given to Private Foundation

Donations in kind to most private foundations encounter another valuation rule with potentially severe consequences.[152] The rule requires the donor to reduce the asset's fair market value by the amount that would be long term capital gain if the donor sold the property.[153] Thus, if a donor gives a painting to a grant-making private foundation, for deduction purposes the donor's cost basis is the value of the gift.[154]

An important exception to this value reduction rule applies to contributions of "qualified appreciated stock."[155] Stock that a donor contributes to a private foundation falls within this exception and escapes value reduction if the market quotation is readily available for the contributed stock on "an established securities market"; the property is capital gain property in the hands of the donor; and the donor does not

146. *See* § 1221.
147. *See* I.R.C. § 170(e)(1)(A) (West 2012).
148. *See* § 1.170A-4A(c)(2).
149. *See* I.R.C. § 1231 (West 2012).
150. *See* I.R.C. § 1250 (West 2012).
151. *See* § 1.170A-4A(d).
152. *See* § 170(e)(1)(B)(ii). This rule does not apply to operating, pass-through, or common fund private foundations described in section 170(b)(1)(F). *See* § 170(b)(1)(F).
153. § 170(e)(1)(B)(ii).
154. *See id.*
155. § 170(e)(5).

contribute, in the aggregate, more than 10% of the outstanding stock of the corporation.[156]

Example:

> (9) Ruby gives to the Ralph and Ruby Family Foundation shares of Exxon stock that she purchased five years ago for $85,000 that today are worth $100,000.

Ruby may deduct the full $100,000 because the Exxon stock is qualified appreciated stock.[157] Because the donee is a private foundation, Ruby's deduction ceiling is 20% of her adjusted gross income in the year of the contribution.[158] Therefore, if Ruby's adjusted gross income is $150,000, Ruby may deduct only $30,000.[159] Ruby may carry over her $70,000 balance and use it as a charitable deduction in up to five succeeding years.[160] In those carryover years, the priority rules dictate that the carryover amount retains its classification and its rank order.[161] Thus, the carryover amount remains subject to the 20% ceiling and is only deductible after gifts to public charities and gifts to private foundations other than capital gain property.[162]

Example:

> (10) Same facts as Example (4), except the gift is made to the Ralph and Ruby Family Foundation.

This problem returns to Ruby's ownership of Blackacre, the northwoods parcel Ruby bought for investment years ago for $10,000 that now has a fair market value of $100,000. If Ruby donates Blackacre to the Ralph and Ruby Family Foundation, she runs into the draconian value reduction rule.[163] Blackacre is not qualified appreciated stock.[164] Accordingly, Ruby must subtract all of the long term capital gain element.[165] Ruby is limited to her cost basis of $10,000 as the maximum contribution deduction.[166]

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156. § 170(e)(5)(B)–(C).
157. *See id.*
158. § 170(b)(1)(D)(i).
159. *Id.*
160. § 170(b)(1)(D)(ii).
161. § 170(d)(1).
162. *Id.*
163. *See* § 170(e)(1)(B)(i)(1).
164. *See* § 170(e)(5).
165. *See id.*
166. *See id.*

D. Tangible Personalty Unrelated to Exempt Purpose

To permit a donor to deduct the full value of a contribution, the charitable recipient's use of the tangible personal property the donor contributed must be related to the recipient's exempt purpose or function.[167] If the use is not related, the donor must subtract the entire appreciation element from the asset's fair market value.[168] This rule applies to all contributions of tangible personal property whether to public charities or to private foundations.[169] For example, this rule mandates a reduction in value of a stamp collection donated to a local hospital.[170]

Even when the use of the donated asset relates to the donee's exempt purpose, the donee's disposition of the item of tangible personal property before the end of the contribution year may trigger elimination of the long term capital gain element.[171] Moreover, disposition of any donated property other than publically traded securities before the third anniversary of the gift,[172] for which a deduction of more than $5,000 is claimed,[173] may trigger recapture as ordinary income of the value that exceeds a donor's basis.[174] However, the donee may avoid recapture if the donee certifies that use of the donated property was substantial and relates to its exempt purpose, describes the use, and states how the use furthers its purposes.[175] In the alternative, the recipient may avoid recapture if the recipient states the intended use of the donated item and certifies that the intended use became impossible or infeasible to implement.[176]

Example:

> (11) Ruby gives an Alexander Calder print worth $100,000 to the Hometown Symphony. Ruby bought the print for $20,000 many years ago.

Ruby's gift is a donation of capital gain property to a public charity.[177] Normally, a gift of capital gain property to a public charity is deductible at

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167. *See* § 170(e)(1)(B)(i)(I).
168. *Id.*
169. *Id.*
170. *See id.*
171. *See* § 170(e)(B)(i)(II). If the claimed deduction exceeds $5,000 per section 6050L(a)(2)(A) of the Code and disposition occurs before the end of the contribution year, section 170(e)(1)(B)(i)(II) requires subtraction of the long term capital gain element unless the charity provides certification of related use and permissible frustration of intent as described in section 170(e)(7)(D). *Id.*
172. § 170(e)(7)(B).
173. *Id.*; I.R.C. § 6050L(a)(2) (West 2012).
174. § 170(e)(7)(A).
175. *Id. See also* § 170(e)(7)(D)(i).
176. § 170(e)(7)(D)(ii).
177. § 170(b)(1)(C)(ii).

fair market value subject to a ceiling of 30% of donor's contribution base.[178] This gift, however, is tangible personal property whose use is unrelated to the donee's exempt purposes. The special value reduction rule allows only a deduction of the donor's cost basis.[179] Because Ruby purchased the print for $20,000, Ruby's deduction is limited to that amount, notwithstanding the fact that the print now has a market value of $100,000.[180] As some solace, she may deduct up to 50% of her contribution base because the print is characterized as a gift of tangible personal property given to a public charity, which is unrelated to the donee's exempt purpose.[181] But, as the required valuation of the donated property is at a low cost basis compared to fair market value, a larger deduction ceiling may be neither comforting nor helpful.[182]

If Ruby contributed the print to the regional art museum rather than to the symphony, it would appear that Ruby would be able to deduct the full fair market value.[183] Nevertheless, if the museum sells the print within three years to purchase a different item for its collection, Ruby may need to include the amount the prior deduction exceeded the cost basis in determining her gross income for the year of disposition.[184]

III. CONTRIBUTIONS OF PARTIAL INTERESTS

A donor who gives a charity less than donor's entire interest in the contributed asset faces the prospect of no tax deduction.[185] Income tax and transfer tax statutes contain parallel provisions that deny any contribution deduction, unless the partial interest given to charity is in one of very few statutorily prescribed forms.[186] When a donor gives part of the entire interest, it is often called a split-interest gift because the transfer splits the property between a charity and a non-charitable recipient.

A. Transfers in Trust

A split-interest gift creates a charitable remainder trust when a donor transfers cash or assets into a trust and gives a charity the future interest

178. § 170(b)(1)(C)(i). *See also supra* note 105 and accompanying text.

179. § 170(e)(1)(B)(i)(1).

180. *See id.*

181. *See* § 170(b)(1)(A). The special 30% ceiling of section 170(b)(1)(C)(i) does not apply to capital gain property to which section 170(e)(1)(B) applies. *See* § 170(b)(1)(C)(i). Therefore, if the donee is a public charity, as described in section 170(b)(1)(A), a 50% ceiling is applicable. *See* § 170(b)(1)(A).

182. *See generally* § 170(f)(1).

183. *See, e.g.*, § 170(b)(1)(A).

184. *See supra* text accompanying notes 171–76.

185. *See, e.g.*, § 170(e)(2).

186. *See* § 170(f)(2)–(3) (containing the pertinent income tax provisions); § 2522(c), (e) (containing the relevant gift tax provisions); § 2055(e) (containing the applicable estate tax provisions).

while the donor either retains the current beneficial ownership or donates the current benefits to another individual or non-charitable entity.[187] On the other hand, when a donor gives a charity the current benefits from the donated property but the donor retains the future benefits or gives them to another, the result is a charitable lead trust.[188]

Rules regarding split-interest gifts are rules of form.[189] In the case of gifts made during donor's lifetime, they are in addition to the income tax contribution provisions that turn on the character of the transferred asset, the classification of the recipient, and the value reduction rules.[190]

1. Future Interests Given to Charity

If a donor gives a charity a future interest in trust, the future interest, to be deductible, must be one of three varieties: a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund.[191] A charitable remainder annuity trust pays annually, or more frequently, to the current, non-charitable beneficiary, a fixed annuity that, at inception, "is not less than 5 percent, nor more than 50 percent, of the . . . fair market value of" the trust assets.[192] The current, non-charitable payment must also be sufficiently small, such that the actuarial value of the remainder interest given to charity is at least 10% of the initial fair market value of the property placed in trust.[193] The payment period may not exceed either twenty years or the life or lives of the named, non-charitable recipient(s).[194] As the term annuity suggests, the distribution amount usually remains fixed throughout the term of the trust.[195]

A charitable remainder unitrust is a similar but distinctly different arrangement. A charitable remainder unitrust distributes annually, or more frequently, to one or more non-charitable recipients, a payment that is "a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of [the property held in trust], valued

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187. *See* Treas. Reg. § 1.664-1(a)(1)(i) (2012).

188. *See* Jonathan Gudema, *Which Planned Gift Gives Money To Charity Now?*, PLANNED GIVING BLOG (Apr. 25, 2008), http://theplannedgivingblog.files.wordpress.com/2011/03/understanding-charitable-lead-trusts.pdf (defining a charitable lead trust).

189. *See infra* text accompanying note 190.

190. *See* Part I.A.2. Ceilings on income tax contribution deductions vary with the type of asset donated to charity and the classification of the charitable recipient. *See* § 170(b)(1).

191. *See* § 170(f)(2)(A); I.R.C. § 664(d)(1) (West 2012) (defining a charitable remainder annuity trust); § 664(d)(2) (defining a charitable remainder unitrust); § 642(c)(5) (defining a pooled income fund).

192. § 664(d)(1)(A).

193. § 664(d)(1)(D).

194. § 664(d)(1)(A).

195. *See id.* *But see* I.R.S. Priv. Ltr. Rul. 2012-16-045 (Apr. 20, 2012) (allowing a variable, ascending annuity for a charitable lead trust in which each year's annuity amount is 120% of the prior year's amount).

annually."[196] A fixed percentage applied yearly to a fluctuating fair market value yields an annual distribution amount that varies with the investment performance of the unitrust.[197] The payment period of a charitable remainder unitrust is also limited to a fixed term of years or the life or lives of named, individual beneficiaries.[198]

The third type of deductible future interest that a donor may give to charity is a remainder interest in a pooled income fund.[199] A pooled income fund may be characterized as a mutual fund operated by a charitable organization.[200] Contributions of numerous donors are commingled for investment.[201] At least annually each donor receives a share of the current income of the fund. Each donor's share is proportionate to the donor's contribution.[202] Accordingly, the donor enjoys a payout that varies with the investment performance of the pooled income fund.[203] The charity receives a remainder interest in each donor's contribution.[204] When the donor dies, the charity that sponsors and operates the pooled income fund withdraws as its own property the donor's pro rata share of the fund.[205]

a. Valuation

The fixed annuity or the unitrust payment that is distributed from a remainder trust to the donor or third party is valued in a prescribed fashion.[206] The Internal Revenue Service translates life expectancies into actuarial factors for life interests, remainders, and annuities and provides fixed term factors.[207] Each month the Service publishes interest rates, known as section 7520 rates, which express the anticipated earnings of a hypothetical fund projected into the future based upon then existing

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196. § 664(d)(2)(A).

197. *See id.*

198. *Id.*

199. I.R.C. § 170(f)(2)(A) (West 2012).

200. *See* I.R.C. § 642(c)(5) (West 2012). *See generally* A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal & Economic Analysis*, 33 J. CORP. L. 745, 748 (2008) (describing "mutual fund" as a legal entity that "raises money by issuing shares and invest the pooled proceeds in securities").

201. § 642(c)(5). The pooling of contributions from multiple donors for investment purposes reduces administrative costs. *See id.* In turn, this permits the charitable organization to solicit smaller contributions. *See generally id.*

202. § 642(c)(5)(F).

203. *See* § 642(c)(5).

204. § 642(c)(5)(A).

205. *See* § 642(c)(5).

206. I.R.C. § 7520 (West 2012) (requiring an annuity life interest or interest for a term of years to be valued under tables reflecting mortality experience and interest rates determined monthly).

207. *Id. See* Treas. Reg. §§ 1.664-2(c), 20.2031-7(d) (2012) (giving directions and factors for calculating the value of the remainder interest in a charitable remainder annuity trust); Treas. Reg. § 1.664-4 (2012) (stating how to calculate the remainder of a charitable remainder trust).

economic conditions.[208] The actuarial factors and section 7520 rates must be used for valuing the payout from a charitable remainder trust.[209] The donor is permitted to use the section 7520 rate that is in effect for the month in which the gift is made or, alternatively, the donor may elect to use the rate that was in effect in either of the two preceding months.[210] The value of the future interest is the total value of the property placed into the remainder trust minus the value of the present payments to the non-charitable beneficiary.[211] The value of the future interest, of course, is the charitable deduction.[212]

b. Deduction Ceilings

The ceilings on donor's aggregate income tax charitable deductions apply to split-interest gifts.[213] As previously noted, the applicable ceiling depends on the classification of the charitable beneficiary.[214] Ceilings also vary with the kind of assets the donor contributes.[215] Moreover, those ceilings distinguish between gifts directly to an organization and gifts in trust for the benefit of an organization.[216] The ultimate disposition of the charitable remainder interest determines whether a split-interest gift is to or for the benefit of an organization.[217]

If a donor puts cash or property other than long term capital gain property into a charitable remainder trust and the remainder will be distributable outright to a public charity when the prior estate ends, the donor is eligible for a deduction up to 50% of the donor's contribution base.[218] On the other hand, the lower 30% contribution ceiling applies if the same assets are contributed, but the remainder will be held in further trust for the public charity when the non-charitable payout ends.[219] If a donor puts long term capital gain property into a charitable remainder trust to benefit a public charity and the remainder is either to be distributed outright or continue in trust for the benefit of charity, the contribution ceiling is 30% of the contribution base.[220] The same ceiling applies when the donor makes

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208. § 7520(a)(2) (stating that the rate is 120% of the federal midterm rate under section 1274(d)(1) rounded to the nearest 2/10 of 1%).
209. § 7520(a).
210. *Id.*
211. Treas. Reg. §§ 1.664-2(c), 1.170A-6(c)(3)(ii) (2012).
212. §§ 1.664-2(d), -3(d).
213. *See* I.R.C. § 170(b) (West 2012) (stating that the limitations therein apply to all charitable gifts).
214. *See supra* text accompanying notes 28–48.
215. *See supra* text accompanying notes 49–62.
216. *See supra* text accompanying notes 49, 63–65.
217. Treas. Reg. § 1.170A-8(a)(2) (2012).
218. *See* § 170(b)(1)(A)(c); § 1.170A-8(a)(2).
219. § 170(b)(1)(B); § 1.170A-8(a)(2).
220. *See* § 1.170A-8(d); § 170(b)(1)(B).

a contribution consisting of cash or assets other than capital gain property and a private foundation is the ultimate beneficiary of either an outright distribution or a further trust.[221] A 20% ceiling applies, however, if the donor makes a contribution with long term capital gain property and the trust assets ultimately will benefit a private foundation either through outright distribution or continuation in trust following termination of the non-charitable interest.[222]

Example:

> (12) Ruby cannot afford the loss of income that would result from an outright gift to charity. Ruby decides to create a trust this year and fund it with $100,000. She wants the trust to pay her income for life and, at her death, to distribute the remainder to Famous Tech.

Ruby wants to give a remainder to the university while keeping the right to income for life. If the transaction is implemented exactly as Ruby has requested, Ruby receives no charitable deduction. No charitable deduction is available for the gift in trust of an income interest for the life of an individual followed by a remainder to charity.[223]

Example:

> (13) Ruby creates a trust and funds it with $100,000. The trustee is to pay her $5,000 per year for her life and then distribute the remainder to Famous Tech.

Example (13) describes a trust designed as a charitable remainder annuity trust.[224] The value of this remainder interest is deductible.[225] The $5,000 annuity is a fixed payment that is not dependent upon the income of the trust. Among other statutory requirements, the annuity must be payable for a set number of years, not more than twenty, or it may be payable for the life or lives of named, living individuals.[226] Ruby could retain the right to an annuity for her life or she could direct the annuity be paid for the joint lives of herself and her husband Ralph.[227] Alternatively, she could name a

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221. *See* § 1.170A-8(d); § 170(b)(1)(B).

222. § 170(b)(1)(D).

223. *See* § 170(f)(2)(A) (limiting a deduction for the contribution to charity of a remainder interest to the charity's interest in a charitable remainder annuity trust, a charitable remainder unitrust, and a pooled income fund).

224. *See generally* I.R.C. § 664(d)(1) (West 2012); Treas. Reg. § 1.664-2 (2012). The statement assumes the trust also contains all provisions to satisfy section 664(d)(1) and regulation 1.664-2. *See id.*

225. *See* § 170(f)(2)(A).

226. *See* § 664(d)(1)(A).

227. *Id.*

third person or persons (e.g., her daughter or her daughter and son-in-law) as payee(s).[228]

Example:

(14) Ruby creates a trust similar to the one in Example (13), except the trustee is to pay Ruby each year an amount that is 5% of the fair market value of the trust assets as determined on the first business day of each year.

Under these facts, Ruby has retained the right to receive a variable payment rather than a fixed amount.[229] Thus, Example (14) describes a distribution from a charitable remainder unitrust.[230] It is a fixed percentage of the trust's annual fair market value. Accordingly, the payout will rise or fall as the fair market value of the trust fund increases or decreases yearly.[231] Ruby may retain a unitrust payment for her life, for the joint lives of Ruby and Ralph, for the life of another, or for a fixed term of up to twenty years.[232]

2. Present Interests Given to Charity

The temporal positions of non-charitable and charitable beneficiaries in a remainder trust may be reversed.[233] If that is done, giving a current trust interest to a charitable entity or entities and the future interest to an individual or other noncharitable recipient creates a lead trust.[234] As with remainder trusts, both income and transfer tax deductions for the charitable portion are available only when this is done in a particular format.[235] Under the statutory prescriptions, the current (or lead) interest that is given to charity must be in the form of either a fixed annuity or a payout that represents a fixed percentage of the annual fair market value of the trust property.[236] If a fixed annuity is currently payable to charity, the trust is commonly known as a charitable lead annuity trust.[237] When the payment

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228. *Id.*

229. § 664(d)(2)(A).

230. *See generally* § 664(d)(2)–(3); Treas. Reg. § 1.664-3. This statement assumes the trust also contains all provisions to satisfy section 664(d)(2) and (3), and regulation 1.664-3. *See id.*

231. *See* § 664(d)(2)(A).

232. *Id.*

233. *See* I.R.C. § 2055(e)(3)(B) (West 2012).

234. *See Establishing a Lead Trust*, OFF. MED. DEV. & ALUMNI REL., www.medicineatmichigan.org/WaysofGiving/Lead-Trusts.asp (last visited Mar. 19, 2013).

235. I.R.C. §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B) (West 2012).

236. §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B).

237. *See generally* §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B). The label "lead trust" is not used in the Code or its regulations. *See* §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B).

to charity is a fluctuating amount calculated yearly as a fixed percentage of the value of the trust assets, the trust is labeled a charitable lead unitrust.[238]

A charitable lead payment is not restricted to a minimum of 5% of the initial value or to a maximum of 50% of that value.[239] Also, unlike current payments from charitable remainder trusts,[240] lead trust payments for a fixed term are not limited to twenty years.[241] If distributions are payable to the charitable recipient for the lifetime of an individual or individuals, the designated persons must be living at the inception of the unitrust and must be one or more of the following: the donor, donor's spouse, ancestor, or spouse of an ancestor of all remainder beneficiaries.[242]

To obtain an income tax deduction for a contribution to a charitable lead trust, a donor must remain taxable on the trust income.[243] This means the donor must structure the trust as a grantor trust under the rules of sections 671 to 678.[244] As the trust income is taxed to the donor in future years, the government seriatim recaptures the benefit of an immediate income tax deduction as the trust income is taxed to the donor.[245] If the trust ceases to be a grantor trust before its scheduled termination, the donor is deemed to receive income equal to the deduction received that has not been recaptured.[246]

A non-grantor lead trust is commonly used as an alternative to the grantor lead trust.[247] Under the non-grantor alternative, the donor escapes taxation on the trust income that is paid to charity.[248] The donor, however, forgoes an immediate income tax deduction.[249] Nevertheless, the trust should be able to take an income tax deduction on its fiduciary return as income is paid to charity.[250] The present value of the charitable portion of the trust qualifies for a gift tax charitable deduction when the non-grantor trust is established even though an income tax deduction is unavailable.[251]

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238. *See supra* text accompanying notes 229–30; I.R.C. § 664(d)(2)(A) (West 2012).

239. *See* Treas. Reg. § 1.170A-6(c)(2)(i)(A), -6(c)(2)(ii)(A) (2012).

240. *See* § 664(d)(1)(A).

241. *See* Treas. Reg. § 1.170A-6(c)(2)(i)(A), -6(c)(2)(ii)(A) (2012).

242. § 1.170A-6(c)(2)(i)(A), -6(c)(2)(ii)(A).

243. I.R.C. § 170(f)(2)(B) (West 2012).

244. *Id.*

245. *Id.*

246. *Id.*

247. *See generally id.* The non-grantor alternative is not specifically described in the Code. *Id.* By failing to be a grantor trust, the non-grantor alternative fails the tests of section 170(f)(2)(B) for income tax deductibility of the contribution to the trust. *Id.*

248. The income is allocable to the trust as there is no grantor trust provision that allocates it to the grantor.

249. I.R.C. § 170(f)(2)(B).

250. I.R.C. § 642(c)(1) (West 2012) (allowing a deduction for payments to charitable organizations paid pursuant to the terms of the trust agreement).

251. I.R.C. § 2522(c)(2)(B) (West 2012) (does not require donor to remain taxable on the trust income).

Charitable lead trusts often have generation skipping implications.[252] If the remainder beneficiaries of a charitable lead trust are skip persons,[253] the distribution of the remainder interest during the lifetime or at death of the donor will be a transfer subject to the tax on generation skipping transfers.[254]

Example:

> (15) Ruby creates a trust, funds it with $100,000, and stipulates that the trustee is to pay from the trust $5,000 per year for twenty-five years to Famous Tech. At the end of twenty-five years, the trust will terminate and its remaining assets will be distributed by representation to the then-living descendants of Ralph and Ruby.

Example (15) is a simple illustration of a charitable lead annuity trust.[255] If the payment to Famous Tech were a fixed percentage of the annual fair market value, the arrangement would be a lead unitrust.[256] Under either form, the charity receives payments presently and at least annually.[257] Hence, the charitable interest is called a lead interest. Non-charitable beneficiaries, such as the donor's children or grandchildren, receive the remainder when the lead charitable interest terminates. If the donor's grandchildren or more remote descendants are to receive—or do receive—the remainder interest, the distribution to them at the end of the charitable lead interest is a taxable termination[258] (if distribution is outright) or a taxable distribution[259] (if the assets continue in further trust) under the tax on generation skipping transfers.

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252. I.R.C. § 2601(a) (West 2012). "A tax is hereby imposed on every generation-skipping transfer . . . ." *Id.*

253. *See* I.R.C. § 2613(a) (West 2012). Skip persons are individuals who are two or more generations below the transferor, a trust in which all beneficial interests are held by skip persons, or a trust that has no individual beneficiary but at no time may a distribution be made to one who is not a skip person. *Id.*

254. *See* § 2601(a). The tax on generation skipping transfers is imposed by sections 2601 to 2663. *See generally* I.R.C. §§ 2601–63 (West 2012). If upon termination a lead annuity trust will distribute assets to skip persons, settlor may allocate generation skipping transfer exemption to the trust, but the exemption amount allocated will be increased by compound annual interest at the same rate used to value the charitable interest for estate or gift tax purposes. *See* § 2642(e). The increased exemption amount is used to determine the applicable fraction and inclusion ratio for imposition of generation skipping transfer tax. *Id.* This adjustment of the exemption amount applies only to lead annuity trusts. *Id.*

255. *See* § 2522(c)(2)(b). This statement assumes the provisions of the entire trust satisfy the requirements of regulation 1.170A-6(c)(2)(i). *Id.*

256. § 2522(c)(2)(b). The provisions of the entire trust are assumed to satisfy the requirements of regulation 1.170A-6(c)(2)(ii). *See* Treas. Reg. § 1.170A-6(c)(2)(ii).

257. § 2522(c)(2)(b).

258. § 2612(a).

259. § 2612(b).

B. Outright Gifts

1. General Disallowance Rule

Disallowance rules for split-interest gifts are not limited to transfers in trust.[260] Outright gifts of partial interests to charitable entities are subject to the same form restrictions as are gifts in trust.[261] If the donor gives the charity a remainder interest, the present interest the donor retains or gives to another non-charitable beneficiary must be in the form of an annuity interest or a unitrust interest.[262] If the donor gives the charity the present or lead interest and the donor or other non-charitable beneficiary receives the future interest, the present interest given to charity must be either a fixed payment or a fixed percentage of a fluctuating fair market value.[263] Standing alone, these limitations virtually eliminate outright donations of partial interests in property.[264] However, three significant exceptions exist with parallel provisions under both income tax and gift tax laws.[265]

2. Limited Exceptions

One exception to the general disallowance of a deduction for an outright split-interest gift permits a donor to transfer the remainder interest in the donor's personal residence or farm to a charitable entity while simultaneously qualifying for a charitable deduction.[266] The interest retained by the donor is not an annuity payment. Nor is it a unitrust payment. Instead, the retained interest is a plain vanilla life estate. Nevertheless, and despite the basic split-interest rules, the actuarial present value of the remainder interest in a personal residence or a farm qualifies as a charitable contribution deduction.[267] In calculating the deductible value, the donor must take into account depreciation of improvements.[268] The identity of the charitable organization as a public charity or a private foundation determines whether the ceiling on the donor's maximum income tax deduction is 30% or 20% of the taxpayer's contribution base.[269]

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260. *See infra* text accompanying note 261.

261. I.R.C. § 170(f)(3)(A) (West 2012).

262. *Id.*; § 170(f)(2)(A).

263. § 170(f)(3)(A), (f)(2)(B).

264. § 170(f)(3)(A), (f)(2)(B). The creation of legal interests that mimic the operational features and requirements of charitable remainder trusts or charitable lead trusts would be difficult, awkward, impractical, and nearly impossible. *See* § 170(f)(2)(A)–(B), (f)(3)(A).

265. § 170(f)(3)(B)(i–iii).

266. § 170(f)(3)(B)(i).

267. *Id.*

268. § 170(f)(4); Treas. Reg. § 1.170A-12 (2012).

269. *See supra* Part I.A.2. The residence or farm would be a capital asset. *See* I.R.C. § 1221(a). Under section 170(b)(1)(C), the ceiling on a taxpayer's contribution is 30% (or 50% if the election of § 170(b)(1)(C)(iii) is made) of a taxpayer's contribution base if the recipient is a public charity. *See*

For a gift of a remainder interest in a donor's residence to qualify for this exception, the donated property need only be a personal residence, not necessarily the donor's principal residence.[270] Therefore, the property could be a second residence or a vacation home.[271] A farm also qualifies for the exception.[272] A farm is property used by the donor or his tenant "for the production of crops, fruits, or other agricultural products or for the sustenance of livestock."[273] This definition suggests that a farm is a somewhat expansive term and includes ranches where livestock graze, orange groves, and presumably includes a fish farm.[274]

A second exception to the prohibition against a contribution deduction for an outright gift of a partial interest is a gift of an undivided portion of the donor's interest in any asset.[275] An undivided portion is a fractional share of present and future interests.[276] Present and future fractional rights are given to charity.[277] Accordingly, this exception does not contradict the statutory prohibition against a deduction for a gift of a future interest in tangible personal property.[278] However, relatively new income and gift tax provisions adopt significant limitations and restrictions on gifts of undivided interests in tangible personal property.[279]

A third exception for an outright gift of a partial interest in property is a qualified conservation contribution.[280] In the most general of statements, to receive a deduction for a qualified conservation contribution, a donor must contribute "(A) a qualified real property interest, (B) to a qualified organization, (C) exclusively for conservation purposes."[281] A qualified real property interest is a perpetual restriction on the use of real property, a remainder interest in real estate, or a donor's entire interest in real property other than a qualified mineral interest.[282] Each of these interests clearly is less than full ownership. Thus, transferring any of them to charity will not

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§ 170(b)(1)(C). The ceiling is 20% of a taxpayer's contribution base when the remainder beneficiary is a private foundation. § 170(b)(1)(D). *See supra* Part I.A.2.

270. Treas. Reg. § 1.170A-7(b)(3) (2012).

271. *See id.*

272. § 170(f)(3)(B)(i).

273. Treas. Reg. § 1.170A-7(b)(4).

274. *See id.*

275. § 170(f)(3)(B)(ii).

276. § 1.170A-7(b)(1)(i).

277. *Id.*

278. § 170(a)(3); Treas. Reg. § 1.170A-5(a)(2) (2012).

279. § 170(o); I.R.C. § 2522(e) (West 2012). The new provisions deny a deduction "unless all interests in the property are held immediately before" the contribution by taxpayer or taxpayer and the charitable recipient (with potential exceptions by regulation). §§ 170(o), 2522(e). These new income and tax provisions also provide for recapture of the contribution deduction if the taxpayer's remaining interest in the property is not given to donee before the earlier of donee's death or expiration of ten years from the first contribution of a partial interest. §§ 170(o), 2522(e).

280. § 170(f)(3)(B)(iii).

281. § 170(h)(1).

282. § 170(h)(2).

garner a charitable deduction unless the terms of the transfer come within the special provisions that allow deductions for conservation contributions.[283] If the donor satisfies these special provisions, the donor may deduct the fair market value of the donated interest.[284] The value of a perpetual usage restriction is the difference between the fair market value of the property absent the property's restriction and the property's value when subjected to the restriction.[285] The present value of a remainder interest must reflect depreciation and depletion.[286] The value of real property absent the mineral interests is the value of the surface rights.[287]

Only certain types of charitable organizations are eligible to receive conservation contributions.[288] They include governmental units,[289] certain public charities,[290] and certain supporting organizations controlled by a public charity.[291] A conservation purpose includes preservation of land areas for public recreation or education, protection of natural habitats, preservation of open space that will yield a significant public benefit, and preservation of a historic area or structure.[292]

Example:

> (16) Ralph and Ruby convey a remainder interest in their vacation home to Famous Tech. They retain the right to full use of the home for their joint lives and for the life of the survivor.[293]

This is a simple illustration of a gift of a remainder interest to charity accompanied by retention of common law life estates. The donation of the remainder in this personal residence generates both income and gift tax charitable contribution deductions.[294]

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283. *See* § 170(h); Treas. Reg. § 1.170A-14 (2012) (setting forth special provisions).

284. *See* § 170(h); § 1.170A-14.

285. § 1.170A-14(h)(3).

286. § 1.170A-14(h)(2).

287. § 1.170A-14(h)(1).

288. § 170(h)(1)(B), (h)(3).

289. § 170(h)(3)(A), (b)(1)(A)(v), (c)(1). Those governmental units are a state, United States possession, subdivision of a state or United States possession, the United States, or the District of Columbia. § 170(h)(3)(A), (b)(1)(A)(v), (c)(1).

290. § 170(h)(3)(A). The eligible public charities are those that satisfy the public support test of § 170(b)(1)(A)(vi). *Id.*

291. I.R.C. § 509(a)(3)(B)(i) (West 2012). Those supporting organizations are so-called Type I supporting organizations described in § 509(a)(3)(B)(i) controlled by either a governmental unit or a public charity described in section 170(h)(3)(A). *See id.*

292. § 170(h)(4).

293. Treas. Reg. § 1.170A-7(b)(3) (2012). The remainder interest may be retained for donor's life or for a term of years. *Id.*

294. I.R.C. §§ 170(f)(3)(B)(i), 2522(c)(2) (West 2012).

Example:

> (17) Ruby conveys an undivided one-half interest in Blackacre to Famous Tech. She retains the other one-half interest.

Ruby gave the university only part of her interest in Blackacre. The interest she retained is neither a fixed payment nor one based on a fixed percentage of a fluctuating fair market value.[295] Nevertheless, Ruby is entitled to an income tax and gift tax deduction for the interest she transferred to charity.[296] As this is a gift of only a fractional interest, normal valuation principles apply to determine her deduction, including consideration of depreciation, depletion, and discounts for lack of control and lack of marketability.[297] When the donor ascertains the value of the undivided interest, the recipient's status as a public charity or private foundation dictates the ceiling on the donor's aggregate deductions.[298] If an ordinary income element exists in the property's value or if the recipient is a private foundation, valuation reduction rules would become pertinent.[299]

Example:

> (18) Ruby enters into an agreement with the Freesoil Conservancy, a publically supported regional land conservancy. Under the agreement, Ruby binds herself and her successors never to develop Blackacre, but to keep its fields, streams, and woodlands in their pristine condition, although she keeps the right to build a vacation cabin at a specified location if the conservancy approves her plans.

Example (18) illustrates a qualified conservation contribution. The land conservancy must be a qualified organization, and the terms of the agreement need to satisfy the definition of a conservation purpose.[300]

IV. CONTRIBUTIONS WITH RETURN ECONOMIC BENEFIT

A. Valuation Reduction Required

The donor who receives an economic benefit in exchange for a charitable contribution must reduce the value of the donation by the value

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295. *See supra* text accompanying notes 263–75.
296. §§ 170(f)(3)(B)(ii), 2522(c)(2).
297. § 170(f)(4); Treas. Reg. § 1.170A-12.
298. *See supra* text accompanying notes 49–65.
299. *See supra* text accompanying notes 152–62.
300. *See* § 170(h)(3)(A). The publically supported land conservancy is most likely an organization described in section 170(b)(1)(A)(vi) and therefore is a qualified recipient of a qualified conservation contribution. *Id.* *See also* § 170(h)(4).

of the benefit.[301] Only the net amount qualifies for a potential tax deduction.[302] Thus, the charitable donation portion of the $100 admission to the annual gala party for the community symphony is the excess over the $35 dinner served at the black tie event.[303] However, a donor need not subtract the nominal value of items the recipient organization gives in appreciation for the generosity of its donors.[304]

B. Bargain Sales

A bargain sale is a sale of property to a charitable organization at less than fair market value with intent to donate the excess value.[305] If a donor sells an item at a bargain price, the charitable deduction rules are applied to the excess of fair market value over consideration received—the contribution portion.[306] This net contribution amount is subject to the percentage limitations on deductions and the value reduction rules.[307]

For income tax purposes, a bargain sale is treated as two transactions: a sale or exchange and a charitable contribution.[308] If a contribution deduction is allowable, the taxpayer's basis in the property sold is allocated pro rata between the two transactions.[309] The basis assigned to the charitable portion is irrelevant because there is no recognition of gain or loss on a gift of property to a charity.[310] On the other hand, the basis assigned to the sale portion likely will generate or increase taxable gain on the transaction.[311]

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301. Treas. Reg. § 1.170A-1(h) (2012).

302. *Id.*

303. *See id.*

304. *See* Treas. Reg. § 1.170A-13(f)(8) (2012) (permitting certain goods or services having insubstantial value to be disregarded by the donee when providing the donor with an acknowledgement to substantiate the gift so the donor can deduct the full amount of the contribution). *See* Rev. Proc. 90-12, 1990-1 C.B. 471 (as amplified by Rev. Proc. 92-49, 1992-1 C.B. 987).

305. Treas. Reg. § 1.170A-4(c)(2)(ii) (2012).

306. § 1.170A-4(c)(2)(i).

307. *See generally* § 1.170A-4(c) (explaining percentage limitations on deductions); § 1.170A-4(c)(2)(i) (explaining value reduction rules).

308. § 1.170A-4(c)(2).

309. *Id.*; I.R.C. § 1011(b) (West 2012); Treas. Reg. § 1.1011-2 (2012). Allocation of basis is not required if the transferor cannot claim a charitable deduction (1) because the transferor had no donative intent, (2) because of the percentage limitations, or (3) because of the value reduction rules. *See* discussion and authorities cited *supra* notes 47–86; discussion and authorities cited *supra* notes 131–75; § 1.1011-2(a)(1).

310. I.R.C. § 1001. Neither money nor property is received for the contribution portion. Hence, there is no amount realized. Consequently, there is neither gain nor loss.

311. *See* §§ 1.170A-4(c)(2), 1.1011-2(a)(1) (explaining rules for calculation of the basis allocation and section 170(e) value reduction).

Example:

> (19) Ruby would like to donate Blackacre to Famous Tech. Its value, however, is crucial to Ruby's economic security. She also needs additional liquidity to fund her retirement. Nevertheless, Ruby is willing to sell the property at a reduced value to confer a present benefit on the university. To express her beneficence and to increase her available funds, Ruby sells Blackacre—which has a fair market value of $100,000 and a cost basis to her of $40,000—to Famous Tech for $40,000 cash.

Like Ruby, Famous Tech is pleased. While it did not receive a full $100,000 in value, it can sell Blackacre and net $60,000.[312] Ruby's charitable contribution portion is the excess value of Blackacre over the payment she received from the university.[313] She can claim that amount, subject to the deduction ceilings and valuation rules.[314]

In this example, Ruby engaged in two transactions: a sale of property and a contribution of excess value.[315] She must allocate her cost basis between the two portions before determining gain or loss on the sale portion.[316] While ostensibly the amount Ruby received equals her basis, she must recognize a taxable gain.[317] Ruby sold Blackacre for 40% of its value. Therefore, only 40% of its basis ($16,000) is allocable to the sale portion. Subtracting the $16,000 basis allocated to the sale portion from the $40,000 received yields a $24,000 taxable gain. The net donation was $60,000, or 60% of the total value. Sixty percent of the basis ($24,000) is allocated to the contribution portion. Ruby does not realize a gain or loss on the portion contributed to the university. However, as a result of dividing a bargain sale into two portions and allocating basis pro rata between them, Ruby realizes gain on the sale portion.[318]

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312. *See* I.R.C. § 1012(a) (West 2012). Famous Tech now has a $40,000 cost basis in Blackacre. *See id.* Famous Tech can sell the property for the fair market value of $100,000, realizing $60,000 in cash. *See* I.R.C. § 1001(a) (West 2012).

313. *See* §§ 1.170A-4(c)(2), 1.1011-2(b).

314. *See infra* text accompanying note 379. Ruby needs to consider the possible effect of the donee's sale of the real estate within three years of acquisition and the report to the Service of that disposition. *See infra* text accompanying note 379.

315. *See* discussion and authorities cited *infra* note 319. Ruby possessed donative intent because she did not inadvertently sell at a price she believed to be the property's value. *See* discussion and authorities cited *infra* note 319.

316. *See* § 1.1011-2(b).

317. *See id.* (showing how the basis is apportioned between the gift and the sale, leaving less basis in the part sold and therefore resulting in a gain).

318. *See* § 1.170A-4(c)(2). Not all bargain sales yield or increase taxable gain. *See id.* In Example (19), if Ruby's cost basis had been in excess of fair market value, the pro rata allocation of basis would produce basis in excess of the proceeds for the sale portion. *See id.* In that case, Ruby would have a loss. *See id.*

C. Charitable Gift Annuity

A donor purchases a charitable gift annuity when the donor transfers cash or other assets to a charitable entity in exchange for the entity's promise to pay an annuity to the donor, or to the donor and another individual, or simply to another individual. The payments could be for a term of years, the duration of a single life, or for joint and survivor lives. The payments could begin immediately or they could be deferred.

The value of an annuity purchased from a commercial insurance company equals the consideration paid. A charitable gift annuity is different. The donor deliberately transfers to the charitable organization cash or assets with fair market value in excess of the present value of the organization's promise to pay an annuity.[319] The donor is entitled to a contribution deduction for the surplus value.[320] The deduction is subject to the percentage limitations and value reduction rules previously described.[321]

Gift annuities are popular because they satisfy two common, but competing, desires. The donor wants the satisfaction of making a gift to benefit charity and while receiving credit for it presently. At the same time, the donor is hesitant to part with the full value of the contemplated transfer. The donor may need to retain a portion of the property for economic security and, if the asset is illiquid, to convert a portion to a cash flow.

Gift annuities bear a superficial resemblance to charitable remainder trusts because a donor can use each of those devices to transfer cash or other property to a charitable organization and receive a payment back for life or for a term of years.[322] However, in the case of a gift annuity, the donor does not contribute to charity a partial interest in property.[323] The charity becomes the full owner of what it receives and can use the cash or property for any of its needs and purposes.[324] The quid pro quo from the charity is a promise to disburse a stream of payments from its general

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319. See Marc Hoffman, *Charitable Gift Annuity*, PLANNED GIVING DESIGN CENTER (Apr. 7, 2008), http://www.pgdc.com/pgdc/charitable-gift-annuity. The annuity rate for a gift annuity is lower than the rate (or higher than the price) paid (or charged) by a commercial issuer. *See id.* The donor's willingness to accept the lower payout rate (or pay a greater consideration) constitutes the donative intent to support a contribution deduction. *See id.* Many charities use payout rates suggested by the American Council on Gift Annuities. *See id.* The Philanthropy Protection Act of 1995 and the Charitable Gift Annuity Antitrust Relief Act of 1995 contain provisions exempting charitable gift annuities from federal securities laws and state and federal anti-trust laws. *See* Philanthropy Protection Act of 1995, Pub. L. No. 104-62, 109 Stat. 682 (1995); Charitable Gift Annuity Antitrust Relief Act of 1995, Pub. L. No. 104-63, 109 Stat. 687 (1995).

320. Treas. Reg. § 1.170A-1(d)(1) (2012).

321. *See supra* Part I.A.2–3 (discussing percentage limitations); *supra* Part II (discussing value reduction rates).

322. *See supra* Part III.A.1.

323. *See* Terry C. Havens, *Taxation of Charitable Gift Annuities: Valuation and Policy Concerns*, 67 VA. L. REV. 1523, 1524 (1981).

324. *See id.*

assets.[325] The promise is unsecured.[326] The source of the funds to pay the annuity is not the cash or property received from the donor.[327] Consequently, charitable gift annuities are not subject to the rules and limitations applicable to charitable remainder trusts.[328]

Payments to the annuitant are taxed under the annuity rules of section 72. A portion of each payment is taxable income and the other portion is return of cost basis.[329] The bargain sale rules also apply when a donor transfers an asset in kind to a charity in exchange for the annuity.[330] As previously noted, those rules require a donor's cost basis to be allocated between the sale portion and the contribution portion of the transfer.[331] This allocation can increase or create gain, which will be taxed to the donor, most likely as long term capital gain.[332] The gain can be deferred and be reported ratably when annuity payments are received as long as two conditions are satisfied.[333] First, the annuity can be assignable only to the issuing charity or cannot be assignable at all.[334] Second, the annuitant (the one who is to receive the payments) must be the donor or the donor's designated successor.[335] If gain is deferred, each payment to the donor will consist of three elements: return of capital (basis), earnings (ordinary income), and capital gain.[336] If the annuitant is not the donor, the entire capital gain will be recognized in the year of the transfer to charity.[337]

Example:

(20) Ruby, age 67, transfers $100,000 to Famous Tech. The university agrees to pay Ruby an annuity of $4,200 per year for the balance of her life.

This is a simple illustration of a charitable gift annuity. The donor transferred cash to a charitable organization. The recipient becomes the full owner of what it receives and can use the gift for any of its needs and purposes. Here, the excess of the $100,000 that donor transferred to the

325. *See id.*
326. *See id.* The donor's security is the financial strength of the promisor-charitable organization. *Id.*
327. *See supra* note 319.
328. *See supra* note 319.
329. *See supra* note 319.
330. Treas. Reg. § 1.1011-2(a)(4)(i) (2012).
331. *See supra* text accompanying notes 308–14.
332. See I.R.C. § 170(b)(1)(C)(iv) (West 2012) (defining capital gain property for charitable contributions).
333. Treas. Reg. § 1.1011-2(a)(4)(ii) (2012).
334. *Id.*
335. *Id.*
336. *See generally id.*
337. § 1.1011-2(a)(1).

university over the present value of the lifetime $4,200 annuity the donor will receive, constitutes a charitable contribution.[338]

V. SUBSTANTIATION OF DEDUCTIONS

The donor must obtain and retain evidence necessary to show entitlement to a charitable contribution deduction.[339] The necessary evidence varies with the nature and value of the contribution.[340] The Code imposes on charitable organizations the obligation to provide receipts and related documentation to assist donors with substantiation and to facilitate compliance with the rules regarding valuation and deduction of charitable donations.[341] The next section describes the responsibilities of both donors and recipients.

A. Income Tax Rules

1. Obligation to Obtain Receipt

If a contribution is valued at $250 or more, the donor must obtain from donee a contemporaneous written acknowledgment of the donation.[342] This applies to gifts of money and gifts of property.[343] If the charity is acknowledging a gift of property, its receipt should describe the property in reasonable detail but does not need to (and in most cases should not) provide a value of the property.[344] If the contribution was cash or by check, the receipt must specify the amount contributed, state whether return benefits were provided and, if so, estimate their value or, if intangible religious benefits were provided, so state.[345] An acknowledgment is contemporaneous if obtained on or before the earlier of the due date

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338. *See* DEP'T OF THE TREASURY, CHARITABLE CONTRIBUTIONS: FOR USE IN PREPARING 2012 RETURNS (2012).

339. *See* I.R.C. § 170(f)(17) (West 2012). Section 170(f)(8)(A) disallows a contribution deduction for a donation "of $250 or more unless taxpayer substantiates the contribution by a contemporaneous written acknowledgement" by the donee. § 170(f)(8)(A). Section 170(f)(17) denies a deduction "for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of such contribution a bank record or a written communication from the donee showing the name of the donee . . . , the date . . . , and the amount of the contribution." § 170(f)(17).

340. *Compare* § 170(f)(13)(A) (describing what is required for contributions of buildings located in historic districts), *with* § 170(f)(11)(A) (describing the requirements for individual, partnership, or corporation contributions of more than $500).

341. Treas. Reg. § 1.170A-13(f)(2) (2012) (stating donee's obligation to provide particular information in a written acknowledgement).

342. § 170(f)(8)(A).

343. *See* § 170(f)(8)(B)(i).

344. § 1.170A-13(f)(2)(i). The burden falls on the taxpayer, not on the donee, to substantiate the value of a contribution of property. *See* § 1.170A-13(f)(1).

345. § 1.170A-13(f)(2)(iii)–(iv).

(including extensions) for filing the return in which donor claims the deduction or the actual date of filing the return.[346]

Separate contributions during the year are not aggregated to reach the $250 level at which the donee's acknowledgment is required.[347] Although a written acknowledgment is not required for contributions below $250, a deduction may be denied "unless the donor maintains as a record of such cash, check, or other monetary gift, unless the donor maintains as a record of such contribution by cash, check or other monetary gift a bank record or a written communication from the donee" detailing the gift.[348] A cancelled check or a sufficiently detailed account statement constitutes a bank record.[349] However, the term written communication is another name for a receipt.[350]

A deduction for a donation of a clothing or household item is available only if such items are "in good used condition or better."[351] Household items include tangible personal property other than food, objects of art, jewelry, and collections.[352] The condition requirement does not apply to the contribution of any single item of clothing or household item valued at $500 or greater if a qualified appraisal of the item is included with the donor's tax return.[353]

2. Donee Responsibilities to Donor

The recipient charitable organization may be obligated to provide certain documentation to the donor that assists the donor in substantiating the deduction.[354] A charitable donee who provides goods or services in exchange for a contribution exceeding $75 must provide a statement to the contributor.[355] The statement must give a good faith estimate of value of those goods or services.[356] Additionally, the receipt must indicate that the donor may deduct only the portion of the transfer to charity that exceeds the

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346. § 1.170A-13(f)(3)(i)–(ii). The statutory requirements are strictly applied. *See* Durden v. Comm'r, T.C. Mem. 2012-140 (disallowing a deduction for contributions by check totaling $22,517 and supported by two receipts from the donee; the first letter failed to state whether donor received return benefits, and the second failed because it was not contemporaneous).

347. § 170(f)(11)(F); § 1.170A-13(c)(6)(iii), -13(f)(11)(ii).

348. § 170(f)(17).

349. *See* § 1.170A-13(a)(1). *See also* Van Dunsen v. C.I.R., 136 T.C. No. 25 (2011) (holding that a satisfactory substitute for a cancelled check needs to state the same information that would be on a cancelled check).

350. *See* § 1.170A-13(a)(1)(ii) (stating the definition of receipt).

351. § 170(f)(16)(A).

352. § 170 (f)(16)(D)(ii).

353. § 170(f)(16)(C). The threshold for attaching an appraisal to taxpayer's return is $5,000 for items other than clothing or household items. § 170(f)(11)(C).

354. *See generally* I.R.C. § 6115 (West 2012); § 1.170A-13(a)(1)(ii).

355. § 6115.

356. § 6115(a)(2).

value of the items received in return.[357] An exception applies when the recipient supplied intangible religious benefits.[358] If intangible religious benefits were made available to the donor, that donee should state that fact.[359] No value needs to be placed on those benefits.[360]

3. Appraisal Requirements

If a taxpayer's deduction for an in kind contribution of property exceeds $500, taxpayer must make certain disclosures in his or her income tax return.[361] For donations of property valued at $5,000 or less and for gifts of publicly traded securities of any value, the donor must identify the donee, describe the property and the date of contribution, provide the fair market value, state the method by which that value was determined, and supply information about acquisition and donor's basis.[362]

Gifts of property valued at more than $5,000 other than publicly traded securities generally require an appraisal.[363] An appraisal summary is attached to taxpayer's income tax return.[364] The appraisal itself is not attached unless a deduction is claimed for the following: (1) artwork valued at $20,000 or more (in which case photographs also may be required),[365] (2) clothing or household items not in good used condition and valued at $500 or greater,[366] (3) an easement on the exterior of an historic building,[367] or (4) an item or group of items valued at more than $500,000.[368]

A qualified appraisal must be performed not earlier than sixty days before the donation,[369] be received by donor before donor files the return in which the deduction is claimed,[370] be performed by a qualified appraiser,[371]

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357. § 6115(a)(1).

358. § 6115(b).

359. *See generally* § 6115.

360. *See id.*

361. Treas. Reg. § 1.170A-13(b)(3)(i) (2012). The disclosures are made on Form 8283. *See* I.R.S. Form 8283 (last revised Dec. 2012). The taxpayer must also maintain written records that corroborate the disclosures. § 1.170A-13(b)(3)(i).

362. *See* I.R.S. Form 8283 (last revised Dec. 2012). These disclosures are made in Section 1, Part 1, of Form 8283. *See id.* Information regarding acquisition and cost basis is not required for items valued at $500 or less. *See* § 1.170A-13(b). An appraisal is not required by statute for contribution of an asset valued at more than $500 but less than $5,000. The donor, however, must state the method used in determining fair market value on form 8283. If determined by appraisal, a copy of the appraiser's signed report is to accompany donor's tax return. Treas. Reg. § 1.170A-113 (b)(2)(ii)(D).

363. I.R.C. § 170(f)(11)(C) (West 2012); § 1.170A-13(c)(1)(i).

364. § 1.170A-13(c)(2)(i)(B). This summary is provided in Section B of Form 8283. I.R.S. Form 8283 (last revised Dec. 2012).

365. *See* Inst. to I.R.S. Form 8283 (last revised Dec. 2012). A photograph of the donated art object may be required if the single object is valued at $20,000 or more. *Id.*

366. § 170(f)(16)(C).

367. § 170(h)(4)(B)(iii).

368. § 170(f)(11)(D).

369. § 1.170A-13(c)(3)(i)(A).

370. § 1.170A-13(c)(3)(iv)(B).

contain certain specified information,[372] and be obtained for a permitted fee.[373] Additionally, the appraiser must sign the disclosure form that is attached to the donor's income tax return.[374] The appraiser's signature evidences the appraiser's independence, qualification, and understanding of the penalties to which the appraiser may be subject for gross misstatement of value or for false or fraudulent statements of value.[375] The regulations require the recipient charitable organization to sign the disclosure form.[376] The execution by an authorized representative of the charity also carries significance. It is the charity's acknowledgment that it actually received the donated property.[377] Execution further signifies whether the property will be put to a use that is unrelated to the donee's exempt purpose.[378] This also confirms that the donee will notify the Internal Revenue Service if it disposes of the donated property within three years from the date of contribution.[379] The recipient's obligation to notify the Service of disposition of the donated asset ties into provisions for recapture of donor's charitable deduction.[380]

Example:

(21) Ralph and Ruby attend a fundraising event at the local museum. They paid $500 for two patron tickets. As part of the event, the museum provides a dinner worth $60 per person.

Ralph and Ruby need a receipt from the museum to substantiate their contribution.[381] The receipt should state that they contributed $500, received meals worth $120 in exchange, and that only the excess is deductible as a federal income tax charitable contribution.[382]

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371. § 1.170A-13(c)(3)(i)(B), -13(c)(5).
372. § 1.170A-13(c)(3)(ii).
373. § 1.170A-13(c)(6).
374. § 1.170A-13(c)(3)(i)(B).
375. § 1.170A-13(c)(3)(iii). The appraisal and related documentation requirements may be applied strictly. *See* Mohamed v. Comm'r., 2012 WL 1937555 (T.C. May 29, 2012).
376. § 1.170A-13(c)(4)(i)(B).
377. § 1.170A-13(c)(4)(iii).
378. *See* I.R.S. Form 8283, Part IV (last revised Dec. 2006).
379. § 1.170A-13(c)(4)(iii). Section 6050L(a)(1) imposes the obligation to notify the Service of disposition within three years of contribution. The recipient can give notification on Form 8282. *See* I.R.S. Form 8282 (last revised April 2009).
380. I.R.C. § 170(e)(7)(A) (West 2012). *See supra* text accompanying notes 172–76.
381. *See supra* Part V.A.1.
382. *See supra* Part III.A.1.b.

Example:

(22) Impressed with the museum's artwork, Ralph and Ruby donate a piece of folk art to the museum. A few weeks before the donation, they obtain a qualified appraisal that indicates the folk art is valued at $12,500. When they filed their tax return, Ralph and Ruby attached a properly completed Form 8283. About 18 months after receiving the piece of folk art, the museum sold the work to a New York gallery for $10,000 because folk art is not within the scope of the museum's collection.

The museum is obligated to notify the Internal Revenue Service of the disposition and to supply a copy of the notification to Ralph and Ruby.[383]

B. Transfer Tax Documentation

Evidencing entitlement to a charitable deduction under federal gift and estate tax laws is remarkably simple when contrasted with substantiation requirements under the income tax statute.[384] Gift tax regulations simply require the donor to "submit such data as may be requested by the Internal Revenue Service."[385] A gift tax return is not required if the donor's only gifts during the year are outright, fully deductible gifts to charities.[386]

Estate tax regulations are somewhat more expansive. They require the decedent's executor to submit a certified or verified copy of the relevant transfer document, to state whether a challenge to the validity or construction of the decedent's will has been filed or is contemplated, and to provide other evidence the district director may request.[387] Instructions to the estate tax return obligate the filer to provide any other information that affects allowance or calculation of the charitable deduction.[388]

VI. CONCLUSION

An intricate set of rules governs qualification for tax deduction of contributions to charitable organizations. Under the income tax law, the labyrinth is a tangle of ceilings on annual deductions, valuation restrictions, and substantiation requirements. Formal strictures on gifts of partial interests exist for both income and transfer taxes.[389]

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383. Treas. Reg. § 25.2522(a)-1(c) (2012).
384. *See supra* Part V.
385. § 25.2522(a)-1(c).
386. *See* Inst. to I.R.S. Form 709 (2012) (stating who must file).
387. Treas. Reg. § 20.2055-1(c) (2012).
388. *See* Inst. to I.R.S. Form 706 (last revised Aug. 2012) (stating specific instructions for Schedule O).
389. *See supra* Parts I–V.

Ceilings on annual deductions are percentages of taxpayer's contribution base or, for most taxpayers, adjusted gross income.[390] These ceilings may be as high as 50% for contributions to so-called public charities and as low as 20% for gifts to private foundations.[391]

Baseline valuation is fair market value.[392] Downward adjustments in value are necessary in many cases.[393] Subtraction is necessary to eliminate value that represents ordinary income if the contributed asset were sold.[394] Potential capital gain must be eliminated if an asset is given in kind to a private foundation.[395] This adjustment is unnecessary, however, if the donation consists of securities with readily available market quotations.[396] Another adjustment is to subtract all appreciation if use of a contributed asset is unrelated to the recipient's exempt purpose.[397] In all cases, the value of a gift to charity must be offset by any economic benefit returned to the donor unless insubstantial.[398]

The donor must demonstrate entitlement to a contribution deduction.[399] For income tax purposes, a bank record or written communication from the donee may suffice if the amount of the gift is under $250.[400] For greater amounts, an actual receipt is necessary.[401] When the value exceeds $5,000, an appraisal is required unless cash or publically traded securities are given.[402]

Individuals must carefully navigate the gamut of deduction ceilings, valuation restrictions, and substantiation rules to attain the goal of an allowable contribution deduction. The discussion in this article provides a basic roadmap for attaining that goal.

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390. *See supra* Parts I.A.2, III.A.1.b.
391. *See supra* Part I.A.2.
392. *See supra* Part II.A.
393. *See supra* Part II.A.
394. *See supra* Part II.A–B.
395. *See supra* Part II.C.
396. *See supra* Part II.C.
397. *See supra* Part II.D.
398. *See supra* Part II.B.
399. *See supra* Part V.
400. *See supra* Part V.
401. *See supra* Part A.1.
402. *See supra* Part V.A.3.