

PUBLICATION

Charitable Contributions of Appreciated Property

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The holiday season is a particularly good time for many individuals to consider donations to their favorite charities, whether the contribution is in cash or by the transfer of property. The purpose of this Alert is to generally address the charitable contributions of appreciated property and some of the conditions required for deductibility of such contributions by individuals.

Some Basics

There are two principal sets of rules affecting the deductibility of charitable contributions made by individuals. The first set concerns the nature of the organization to which the contribution is made. The second set looks to the type of property that is being contributed and whether the contribution is of an interest in a trust.

“To” or “for the use of.” Contributions “for the use of” the charity are typically limited to 30% of the taxpayer's contribution base. If the charity's interest is in trust and is preceded by a predecessor estate, as in the case of a charitable remainder trust, the contribution is “for the use of” the charity. [See Internal Revenue Treasury Regulation (Treas. Reg.) Section 1.170A-8-(a)(2)]

Contribution Base. An individual's “contribution base” for a year is adjusted gross income computed without regard to any net operating loss carryover. [See Internal Revenue Code (IRC) Section 170(b)(1)(G)]

Classes of Charities

Fifty Percent Charities. Contributions to the following classes of donees (Fifty Percent Charity) are generally allowed up to 50% of a taxpayer's contribution base [See IRC Section 170(b)]:

(a) Church, or a convention or association of churches. The IRS has developed 14 criteria that it applies to determine whether an organization qualifies under this exemption, which are as follows:

- distinct legal existence
- a recognized creed and form of worship
- a definite and distinct ecclesiastical government organization
- a distinct religious history
- a membership not associated with any other church or denomination
- an organization of ordained ministers
- ordained ministers selected after completing prescribed studies
- a literature of its own
- established places of worship
- regular congregations
- regular religious services
- Sunday schools for religious instruction of the young
- schools for the preparation of its ministers

A convention or association of churches may consist of member churches of different denominations or include a cooperative undertaking by churches of the same or different denominations.

(b) Educational organization. This type of donee normally maintains a regular faculty and has a regularly enrolled body of students. [See IRC §170(b)(1)(A)(ii)] A private school that does not have a racially nondiscriminatory policy as to students does not qualify as a charitable organization.

(c) Hospitals and medical research facilities. This category includes hospitals and certain hospital-affiliated medical research organizations that are committed to spending contributions for medical research. To qualify as a hospital, the principal purpose of the entity must be the provision of medical or hospital care, medical education or medical research. The term "hospital" also includes government-owned hospitals.

(d) University Endowment Funds. This type of donee must support public educational organizations. Curiously, this exemption was added due to the inability of some state-controlled universities to accept donations.

(e) Governmental units. This category includes a state, a possession of the United States, any political subdivision thereof, or the United States but only if the contribution is made for exclusively public purposes. Generally, the donee must have meaningful sovereign powers. For example, the IRS has ruled that a state bar association does not qualify.

(f) Private foundations. That is, those which qualify as private operating foundations [as defined in IRC Section 4942(j)(3) or (5) (see explanation infra)] and private distributing foundations which are private foundations that, not later than the 15th month after the close of the foundation's taxable year in which contributions are received, makes "qualifying contributions" (see discussion below regarding qualification as a private operating foundation or private distributing foundation) equal to at least the amount of contributions received.

(g) Publicly supported organizations. These donees normally receive more than one-third of their support from the public, organizations organized by and controlled by publicly supported organizations and organizations organized for testing for public safety.

The deduction for the contribution of appreciated property to a Fifty Percent Charity is limited to 30% of the donor's contribution base unless the donor elects to limit the deduction to the donor's basis. [See IRC Section 170(e)(1)(A)]

Thirty Percent Charities. In general, other contributions not described above are allowed to the extent that the aggregate of such contributions does not exceed the lesser of 30% of the taxpayer's contribution base for the year, or the excess of 50% of the contribution base for the year over the aggregate of contributions set forth above. [See IRC Section 170(b)(1)(B)]

A special limitation is imposed in the case of contributions of certain tangible personal property (generally property, the use of which is not related to the purpose of the charity or property given to a private foundation). In general, the limitation is 30% of the taxpayer's contribution base for the year. [See IRC Section 170(e)(1)(B)(i)] The thirty percent limitation also applies to contributions "for the use of" an organization which ordinarily would be a Fifty Percent Charity.

There are also special rules, due to expire this year, not discussed herein that apply to conservation contributions (See our December 6, 2011) Alert: [Potential Benefits of Land Contributions for Recreation and Education](#) and property used in agriculture and livestock production.

Twenty Percent Limit. In the case of any contribution to a private foundation other than a private operating foundation or a private distributing foundation, the limit is 20% of the taxpayer's contribution base. (See IRC Section 170(b)(1)(D).)

Private Foundations

The deduction for the contribution of appreciated property to a private foundation which is neither a private operating foundation nor a private distributing foundation is limited to the donor's basis in the property contributed. [See IRC Section 170(e)(1)(B)(ii)] The election to limit the contribution to the donor's basis in the property is not available as it would be in the case of a contribution of appreciated property to a Fifty Percent Charity.

Private Operating Foundations. Most foundations will be classified as private foundations unless they can raise substantial contributions from the public. A private operating foundation is a Fifty Percent Charity but is still subject to the restrictions of other private foundations.

To qualify as a private operating foundation under IRC Section 4942(j)(3), an organization must meet the "income test" and any one of three alternative tests, which are the "assets test," the "endowment test" or the "support test."

Income Test. To pass the income test, the organization must make "qualifying distributions" directly for the active conduct of the activity constituting the purpose or function for which it is organized and operated, such distributions being equal to substantially all of the lesser of (i) its adjusted net income, or (ii) its minimum investment return. In general, "qualifying distributions" are distributions directly for the active conduct of the activities constituting its charitable, educational or other similar exempt purposes. See Treas. Reg. Section 53.4942(b)-1(b)(1) for examples. A typical example of a qualifying distribution is a college scholarship program where the foundation has significant involvement in granting and administering scholarships. See *Leckie Scholarship Fund v. Commissioner*, 87 T.C. 251 (1986).

Alternative Tests. In addition to the income test, a private operating foundation must meet one of three alternative tests:

- (a) **Assets Test.** Substantially more than one-half of the foundation's assets must be held for use in a foundation's exempt function. Assets which qualify as "held in the exempt function" include only those actually used for the active conduct of the exempt function. Passive portfolio investments are generally excluded.
- (b) **Endowment Test.** This test requires that the foundation make direct distributions of at least two-thirds of the otherwise required 5% minimum investment return, or 3 1/3 % of the value of its assets. This is the most commonly utilized test to be entitled to private operating foundation status.
- (c) **Support Test.** This test has three parts, to wit: (i) at least 85% of the foundation's support (other than investment income) must be from a combination of the general public and five or more exempt organizations; (ii) not more than 25% of support, other than gross investment income, can be from any one exempt organization; and (iii) not more than 50% of support can be gross investment income.

The foregoing tests must be satisfied for any three years during a four-year period consisting of the year in question and the three immediately preceding taxable years.

Private Distributing Foundation. A private distributing foundation is a private foundation other than a private operating foundation that, not later than the 15th day of the third month after the close of the taxable year in

which contributions are received, distributes an amount equal to 100% of the contributions received in such year and has no remaining undistributed income for the year. [See IRC Section 170(b)(1)(F)(ii)] There can be no undistributed income. The distributions must be "qualifying distributions" as defined in IRC Section 4942(g), which generally means distributions to organizations not controlled by or under common control with the foundation.

General Limitations

Ordinary Income Property. Contributions of certain types of property, regardless of the classification of the donee, are required to be reduced by the amount of ordinary income that would have resulted if the property contributed had been sold at fair market value. While Treas. Reg. Section 1.170A-4(b)(1) provides some examples of such ordinary income reduction property types, the following is a general listing:

- (a) Property held by the donor primarily for sale to customers in the ordinary course of business;
- (b) A work or art created by the donor;
- (c) A manuscript prepared by the donor;
- (d) Letters and memoranda prepared by the donor;
- (e) A capital asset held by the donor for less than one year;
- (f) IRC Section 306 stock;
- (g) Collapsible corporation (IRC Section 341) stock¹ and stock to which IRC Section 1248(a) applies² ; and
- (h) IRC Section 1231 assets to the extent of the gain on sale that would be recognized as ordinary income.

Tangible Personal Property. When the property contributed will be used by the donee for a purpose unrelated to the organization's purpose or function that its basis for exemption, the amount of the deduction must be reduced by 100% of the gain that would have been long term capital gain if the property had been sold for its fair market value. [See IRC Section 170(e)(1)(B)(ii)]

Intellectual Property. The deduction for a patent, copyright, trademark, trade name, trade secret, knowhow, software or similar property is limited to the lesser of the donor's basis or the fair market value of the property. [IRC Section 170(e)(1)(B)(iii)]

Carryover of Excess Contributions. In the case of excess contributions by individuals, the excess over 50% of the contribution base is treated as paid in each of the five succeeding taxable years. [See IRC Section 170(d)]

Contributions to Foreign Organizations. In general, contributions to foreign-based charities are not deductible unless sanctioned by treaty. Contributions to a U.S. charity which are required to be used in another country are generally not deductible. [IRC Section 170(c)(2)(A)]

Compliance

Substantiation. For contributions of money in any amount, a bank record or written communication from the donee is required. [See IRC Section 170(f)(17)]

No deduction is allowed for any contribution of \$250 (whether cash or property) or more without contemporaneous (generally before the tax return is due) acknowledgment from the donee organization. [See IRC Section 170(f)(8)]

For contributions of property, different rules apply depending on the amount involved. Such rules are generally described as follows (these requirements are cumulative as the amount increases):

(a) *Less than \$250.* The donor must obtain a receipt from the donee stating the name of the donee, the date and location of the contribution and a description of the property donated.

(b) *\$250 or more but not more than \$500.* The acknowledgement from the donee must state (i) the amount of cash contributed and a description of any other property donated, (ii) whether the donee provided any goods or services, (iii) if the donee provided any goods or services other than intangible religious benefits, a description and good faith estimate of the value thereof, and (iv) if the donee provided any intangible religious benefits, a statement to that effect.

(c) *More than \$500 but not more than \$5,000.* In addition to the above, the donor must obtain a qualified appraisal from a qualified appraiser, complete IRS Form 8283 and obtain the signature of a representative of the donee. Note, this can be obtained after the gift but must be obtained on or before the due date of the return. [See Treas. Reg. Section 1.170A-16-(d)]

(d) *More than \$500,000.* In addition to the above, the qualified appraisal must be attached to the return.

Penalties. The Internal Revenue Code imposes draconian penalties for overstatement of value or basis. [See IRC Section 6662] Those penalties include the following:

(a) 20% of the deficiency if the value or basis claimed is 150% or more of the correct amount;

(b) 40% of the deficiency if the value or basis claimed is 200% or more of the correct amount.

Special Situations. There are numerous situations where the donor attempts to combine donative intentions with other objectives, and each such situation must be considered based upon its own facts and circumstances together with applicable law. For example, some donors have considered contributing stock in a controlled corporation to a charity, then have the controlled corporation redeem the stock soon thereafter. The IRS, in *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd* on other grounds 523 F.2d 1308 (8th Cir. 1975) unsuccessfully argued that the transaction should be restructured as a redemption of the stock followed by a gift of the proceeds. In Rev. Rul. 78-196, 1978-1 C.B. 83, the Service announced that it would not contest such transactions unless the donee is legally obligated to surrender the stock for redemption.

However, as stated above, each such situation must be analyzed based upon its own facts and circumstances and in connection with applicable law, to determine whether the contribution itself (or any other intended benefit) could be compromised as a result of combining any other objectives with the making of the donor's contribution.

Conclusion

The contribution of appreciated property is just one way that donors can support their favorite charities. Should you have any questions regarding the contribution of appreciated property or otherwise wish to discuss any other aspect of your year-end planning, please contact any one of the following attorneys within the Firm's [Tax Department](#).

¹ IRC §341 is one the provisions of the Code which sunsetted by virtue of EGTRRA but which is effective after 2012.

² Stock of a foreign corporation if the donor owns 10% or more of the total combined voting power of all classes of stock entitled to vote of such corporation