Fundamentals of the Income Tax Charitable Deduction

Barbara Rhomberg, J.D.
www.RhombergLaw.com

March 12, 2015

> "Every generalization is false, including this one."
> *Usually attributed to Mark Twain.*

I. What is a deductible gift?

Rhomberg definition: It is (1) a gift of money or property that is made (2) to a qualified recipient organization with (3) no substantial return benefit to the donor, and the contribution must be (4) voluntary and (5) not disallowed under some arcane tax rule.

1. A gift of money or property

   (a) No deduction for the value of donated services (e.g., professional services, ad space in a newspaper).

   (b) Out-of-pocket costs incurred to provide volunteer services to a charity are deductible (if substantiated).

   (c) No deduction for pledges or promises to give, even if legally enforceable. (Only actual payments are deductible.)

2. To a qualified recipient organization

   Qualified recipient organizations[1] are:

   - *Federal, state, or local governments* in the United States, for public purposes.
   - *Section 501(c)(3) organizations*, as long as they are formed in the United States.[2]
   - Posts or organizations of war veterans that are organized in the United States, provided that no net earnings insure to the benefit of private shareholders or individuals.
   - For individual (but not corporate) donors, domestic fraternal societies operating under the lodge system, but only if the contribution is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or the prevention of cruelty to children or animals.
   - Section 501(c)(13) cemetery companies.

[1] 26 USC §170(c).
[2] Except that a §501(c)(3) organization with a purpose of "testing for public safety" is not eligible to receive deductible gifts. 26 USC §170(c).

(a) Gifts to individuals, no matter how needy or worthy, are not deductible.

(b) Gifts **earmarked** by the donor to benefit a particular individual are also not deductible. For a gift to be deductible, the charity must decide who benefits.

(c) A deduction also can be denied if the donor earmarks a gift to hire a particular employee or contractor to perform services.

(d) There is no deduction if the charity is only a nominal recipient, and is required by the terms of the gift to transfer the money to another organization that is not qualified to receive deductible charitable gifts. (Again, to be deductible, the charity must have control over the use of the gift and discretion to choose any secondary grantee).

3. No substantial return benefit

(a) Donative intent is a fundamental requirement of a deductible charitable gift

- For any part of a payment to be deductible, the donor must *purposefully* contribute more than the value of any return benefits.
- If the donor expects to receive economic benefits as a result of the donation that are sufficiently substantial in relation to the value of the donated property, there is no deduction at all. (For example, if giving real estate to a public agency greatly increases the value of retained land, the donor's deduction may be disallowed).

(b) A charitable deduction is allowed for contribution made when the donor's payment intentionally exceeds the value of the return benefits. *See Section II below for the valuation of return benefits.*

4. Voluntary

A donor must voluntarily choose to make the payment for the gift to be deductible.

5. Not disallowed under some arcane disallowance rule

For example:

(a) "Partial interest" rule: A gift of a partial interest in property is only deductible if it takes specific, regulated forms.

- A gift to a split-interest trust (with both private and charitable beneficiaries) is deductible only if it is in the form of a qualified CRT, CLT, or pooled income fund.
- A remainder interest in property is only deductible if it is a remainder in a personal residence or farm.
- Fractional interests (a share of each and every property right) are deductible.
- The right to use property is a partial interest in property; hence, giving a charity the right to use property (e.g., providing a no-rent lease) does not generate any tax deduction for the rental value.

(b) No deduction for a gift that is earmarked for lobbying, or for out-of-pocket costs incurred as a volunteer to lobby.

(c) No deduction for a gift of tangible personal property to a split-interest trust until the property is sold (or distributed to charity).

(d) No deduction if the charity pays premiums on personal benefit contracts benefiting the donor.

II. Valuing Return Benefits

When a donor intentionally gives more than the return benefits are worth, the donor can claim a charitable deduction for the difference between what s/he gives and what s/he receives.

1. Insubstantial return benefits don't affect the donor's deduction

Some "insubstantial" return benefits do not reduce the amount of the donor's deduction, and can be ignored by the donor in calculating the amount of the gift (and by the charity in preparing the acknowledgement.)

(a) Naming rights have traditionally been viewed as insubstantial (e.g., having a building or scholarship named after the donor).

(b) The IRS has ruled that certain "token items" are insubstantial.[3] These insubstantial benefits are (in 2015)[4]:

- If the benefits provided by the charity are worth less than 2% of the value of the donor's gift, and also worth less than $105, then the benefits are insubstantial.
- If the donor's gift was at least $52.50, and the only return benefits are token items bearing the charity name or logo that cost in aggregate less than $10.50, the token benefits are insubstantial.

These dollar amounts are adjusted for inflation each year.

(c) Some membership benefits are treated as insubstantial[5], and can be ignored for charitable deduction purposes:

- The membership must be provided in exchange for an annual payment of $75 or less, and
- The member benefits consist of recurring rights and privileges such as:
  1. Discounted admission to events,
  2. Discounts from the gift shop,
  3. Free or discounted parking, or
  4. Free or discounted admission to member-only events, IF the per-person cost of the event (not including overhead) is less than $10.50[6]

[3] Rev. Proc. 92-102 and Rev. Proc. 92-49.
[4] The dollar amounts are adjusted for inflation each year. See Rev. Proc. 2014-61, §3.29 for 2015 amounts.
[5] Treas. Reg. 1.170A-13(f)(8)(i)(B).
[6] The $10.50 amount is adjusted for inflation annually.

The $75 cap on the cost of the membership is *not* indexed for inflation—it's a fixed number. Museums and cultural institutions that charge more than $75 for a basic membership cannot rely on this regulatory exception.

(d) Newsletters or program guides (other than commercial quality publications) will be treated as insubstantial (specifically, they are considered token items that do not have a measurable fair market value or cost) if:

- their primary purpose is to inform members about the activities of an organization, and
- they are not available to nonmembers by paid subscription or through newsstand sales.

(e) Intangible religious benefits are considered insubstantial for tax purposes.

2. Return benefits that reduce the donor's deduction

The value of any return benefits that don't qualify as "insubstantial" reduce amount of the donor's charitable deduction. Return benefits are any goods or services provided to the donor in exchange for the gift (other than insubstantial benefits).

- Good and services include "cash, property, services, benefits, and privileges."[7]
- Benefits are provided in exchange for a gift "if, at the time the taxpayer makes the payment to the donee organization, the taxpayer receives or expects to receive goods or services in exchange for that payment."[8]

3. Donor may rely on the charity's estimate of return benefit value

Donors may rely on the charity's good faith estimate of the FMV of the return benefits in determining the amount of their deductions.[9] (However, a donor cannot rely on the charity's valuation if the donor knows or has reason to know that the charity's valuation is unreasonable or wrong).

4. Estimating benefit value: general rules

(a) The charity may use any reasonable methodology in making a good faith estimate, provided it applies the methodology in good faith.[10]

(b) If the goods or services are not generally available in a commercial transaction, the charity may estimate by reference to the fair market value of similar or comparable goods or services (even if the comparable goods or services do not have the unique qualities of the goods or services provided by the charity).[11]

(c) Celebrity presence doesn't have to be valued.[12]

---

[7] Treas. Reg. §1.170A-13(f)(5).
[8] Treas. Reg. §1.170A-13(f)(6).
[9] Treas. Reg. §1.170A-1(h)(4).
[10] Treas. Reg. §1.6115-1(a)(1).
[11] Treas. Reg. §1.6115-1(a)(2).
[12] Treas. Reg. §1.6115-1(a)(3), Ex. (3).

5. Valuing return benefits: special cases

(a) Payments to or for the benefit of colleges and universities to obtain the right to purchase athletic tickets: the FMV of obtaining the right to purchase tickets is 20% of amount paid.

(b) Payments for raffle tickets: chance to win is worth the price of the ticket. (Caution: raffles are regulated as gambling under the Penal Code in California. See http://oag.ca.gov/charities/raffles)

III. Amount of the Deduction

This section reviews the amount of the deduction allowed for particular charitable gifts:

- Without considering percentage limits on a donor's overall charitable deductions (which is discussed in the following section), and
- Without taking into account any return benefits provided to the donor (the FMV of which will reduce the deduction)

1. Monetary gifts.

For gifts of cash (i.e., donations of money, whether by cash, check, credit card, or wire transfer), the donor can deduct the face value of the money.

2. Property gifts (other than money).

For gifts of (non-monetary) property, the amount of the deduction depends on three factors:

(a) ***First factor***: Is the gift to a public charity or private foundation?

The following are treated like public charities under charitable deduction rules:

- Schools, hospitals, and churches
- Publicly supported charities
- Supporting organizations
- Federal, state, and local governments
- Private operating foundations and pass-through foundations
- CRTs **if** only public charities are permissible remainder beneficiaries
- Pooled income funds

The following are private foundations:

- Section 501(c)(3) organizations classified private foundations (except for private operating foundations and pass-through foundations)
- CRTs if a private foundation is a permissible remainderman (even if the named remainder beneficiaries are public charities!)

(b) ***2nd factor***: What would the donor's tax consequences be if he or she sold the property instead of donating it?

If the donor sold the asset at its fair market value, would the donor realize:

- long-term capital gain or loss
- short-term capital gain or loss
- ordinary income or loss

(c) ***3rd factor***: For gifts of tangible objects, how does the charity use the donated object?

3. Non-cash gifts to **public charities**

(a) General rule for most assets: Deduction is FMV *minus* any ordinary income or short-term gain the donor would realize on a sale.

This means:

- For investment assets or personal assets held more than a year, deduction is FMV.
- For short-term assets held less than a year, inventory, or other ordinary income property, deduction is basis (or FMV, whichever is less).

(b) Tangible personal property – General rules

- For business inventory or objects held less than a year, deduction is basis (or FMV, whichever is less).
- For objects held more than a year other than business inventory (i.e., objects held for investment or personal use, or equipment used by a business but not held for sale to customers), the deduction depends on what the charity does with the object.
  - Deduction is FMV if charity uses object to carry out is exempt purposes
  - Deduction is basis (or FMV, whichever is less) if charity sells the object

(c) Tangible personal property – Special Rules

- Motorized vehicles (cars, boats): If the charity sells the vehicle without significant charitable use or material improvement, the donor's deduction is limited to the amount the charity actually receives from the sale.
- Household objects: No deduction unless the item is in good used condition or better. (Doesn't apply to art, jewelry, antiques, or any item worth more than $500 that is appraised).
- Incentives for some business inventory gifts: Several "enhanced deduction" rules exist to encourage business inventory contributions. The enhanced deduction is generally capped at twice the donor's tax basis in the item. Some of these provisions are temporary (with sunset dates) but are usually renewed by Congress. Enhanced deduction incentives may exist for:
  - Corporate donations that will be used to care for the ill, needy, or children; or for any business that donates wholesome food that will be used to feed the ill, needy, or children
  - Contributions of book inventory to public schools
  - Contributions of scientific equipment manufactured by the donor, and used by a charity for research
  - Contributions of computer technology and equipment to schools

- Fractional interests: A 2006 law enacted specific rules for gifts of undivided fractional interests in tangible objects. The rules mostly affect gifts of fractional interests in art to museums.

(d) Special Rule for Intellectual Property

- For gifts of patents, some copyrights, and some other intellectual property, the donor's initial deduction is limited to basis, but the donor can claim subsequent donations to the extent the charity earns income from the donated property within ten years of the gift.

3. Non-cash Gifts to a **private foundation**

(a) Publicly Traded Stock to a PF:

- For publicly traded stock held more than a year, deduction is FMV. (Applies to "qualified appreciated stock" meeting certain specific requirements).

(b) Any other asset to a PF:

- Deduction is basis or FMV, whichever is less.

4. What is Fair Market Value?

(a) Fair market value is defined as is the price a willing, knowledgeable buyer would pay, and a willing, knowledgeable seller would accept.

(b) For publicly traded securities, FMV is the average of the high and low price on the date of gift.

(c) For property worth $5,000 or more (other than publicly traded stock), an appraisal is required.

(d) Donor restrictions on the use or disposition of property must be considered in the appraisal, and may affect value.

5. Deductions for Planned Gifts

(a) Bequests:

- No income tax charitable deduction
- But the donor gets an estate tax deduction, and
- If "income in respect of a decedent" is donated, estate or heirs are spared paying income tax

(b) Charitable Remainder Trusts

- Deduction is actuarial value of remainder going to charity (based on beneficiary age and IRS-published interest rates).
- Calculation is based on the deductible amount for an outright gift.

(c) Charitable Lead Trusts:

- Creation of a grantor lead trust generates an up-front deduction for the actuarial value that is project to pass to charity.
- Creation of a non-grantor lead trust doesn't generate an immediate deduction for the donor (but the trust gets charitable income tax deductions for amounts required to be distributed to charity every year).

(d) Remainder Interest in a Residence/Farm

- Deduction is actuarial value of remainder going to charity, based on tenant's age, IRS-published interest rates, property value, and expected depreciation in property.

(e) Charitable Gift Annuity

- Deduction is the amount of money or value of property transferred to charity, minus the present value of the annuity stream (which is determined through an actuarial calculation based on annuitant age and IRS-published interest rates).

6. What assets should donors give?

(a) For gifts to a public charity

- **Appreciated**, long-term capital gain property is a sweet deal:
  - The donor gets a FMV deduction AND
  - Doesn't recognize any capital gain
  - Donor is better off giving the asset than if he or she had sold the property and given the proceeds.

- It rarely makes sense to give **depreciated** investment property (whether long- or short-term):
  - Deduction is FMV, but donor misses the chance to claim a capital loss
  - Donor is better off selling the asset and giving the proceeds, since she or he gets both the FMV deduction and the loss to offset other capital gains

(b) For gifts to a private foundation

- Qualified appreciated stock is still a sweet deal – donor gets same treatment as for a public charity gift

- But most other property makes sense to give only if basis is close to FMV

IV. Percentage Limits on Charitable Deductions

Overall limits are based on donor's adjusted gross income (AGI)[13].

1. <u>For individual donors:</u>

   (a) For gifts to public charities:
   - Limit is 50% of AGI for cash gifts to charity
   - Limit is 30% of AGI for appreciated property
     (50% for property if deduction is limited to the donor's basis in the property, not current FMV)

   (b) For gifts to private foundations:
   - Limit is 30% of AGI for cash gifts
   - Limit is 20% of AGI for appreciated property

   (c) Any deduction in excess of limits can be carried forward for five years.

   (d) Higher deduction limits may apply to gifts of land for conservation – 50% of AGI for most taxpayers, 100% for ranchers / farmers. (This provision has expired may be renewed).

   (e) A 20% limit applies to gifts "for the use of" a charity, including the deduction for a donor that creates a grantor CLT.

2. <u>For corporate donors</u>

   (a) For C corporations, limit is 10% of taxable income.

   (b) For S corporations, deductions pass through to shareholders (shareholder's limits apply).

3. <u>Section 68: Reduction of deductions</u>

   (a) High-income taxpayers (in 2015, individuals with AGI over $258,250, joint returns with AGI over $309,000) take a "haircut" on their overall itemized deductions.

   (b) Applies to most deductions, including charitable contributions, mortgage interest, state income and property taxes.

   (c) Amount of hair cut: 3% of the amount by which AGI exceeds $258,250 ($309,000 for joint returns), or 80% of total itemized deductions, whichever is less.

[13] Actually, the limits are based on the donor's "contribution base," which is AGI without applying an net operating loss carryback. §170(b)(1)(G).

V. Substantiation Required for Deduction

1. Monetary gifts below $250**.** The donor must have either:

   - A bank record OR
   - A receipt from the charity showing the charity's name, date of the contribution, and amount of the contribution.

2. Property gifts below $250**.** The donor must have:

   - A receipt from the charity showing the charity's name, date and location of contribution, and description of the property.
   - Alternatively, the donor may maintain reliable written records containing the same information if the contribution is made in circumstances where it is impractical to obtain a receipt (such as by depositing items at a drop site).

   Tax regulations provide that the donor's records must also show the charity's address, a description of the property in "detail reasonable under the circumstances," method of determining FMV, and any restrictions on the charity's use or disposition of the property.

3. Cash or property worth $250 or more:

   In addition to the requirements above, the donor must obtain a contemporaneous written acknowledgement from the charity stating:

   - The amount of money (or a description of the property) donated;
   - Whether the charity provided any goods or services to the donor in consideration of the donation;
   - If goods or services were provided, a good faith estimate of their value

4. Gift of property worth $500 or more

   - Donor must attach Form 8283 to tax return, which asks for method of acquisition, date of acquisition, and tax basis of the donated property.

5. $5,000 or more

   - The donor must get a qualified appraisal of the property (EXCEPT for publicly traded securities)[14];
   - The appraiser must sign the donor's Form 8283;
   - The charity must sign Form 8283, but only to acknowledge receipt of the property (not to confirm the claimed value).

[14] Also, gifts of closely-held business interests only require appraisal if the value is over $10,000.

6. <u>Gifts to donor advised funds:</u>

(a) Not deductible unless the charity acknowledgement states that the sponsoring charity has exclusive legal control over the assets contributed.

(b) Donor advised fund: Defined as a fund or account identified by reference to contributions by a donor or donors, with respect to which the donor (or a person designated by the donor) reasonable expects to have advisory privileges with respect to investments or distributions.

7. <u>Charity's obligation to provide acknowledgement</u>

(a) In general, a charity has no legal obligation to provide gift acknowledgements to donors.

(b) Exception: Quid Pro Quo Gifts over $75. If the donor gives $75 or more and receives goods or services in return, the charity must provide a written statement to the donor that:

- Gives a good-faith estimate of the fair-market value of the goods or services provided.
- States that the donor's deduction is limited the amount by which the amount of money (or value of property) contributed by the donor exceeds the fair market value of the goods or services provided in return.

The charity can ignore insubstantial benefits.

VI. When is a gift complete and deductible

1. <u>When Gifts are Complete</u>

(a) <u>In general</u>: Gift is made on the date that the donor gives up control over the property.

(b) <u>Mailbox rule</u>: If the donor mails a check which clears in due course, the date of mailing is date of gift.

Caution: This rule may **not** apply to checks sent by Federal Express or other private carrier.

(c) <u>Credit Card Gifts</u>: A contribution made by credit card is deductible in the year in which the charge is made, regardless of when the donor pays the credit card company.

Caution: The date of gift may be when the credit card company pays the charity, not when the donor submits information on the charity's website.

(d) <u>Text message gifts</u>: The gift is deductible in the year the donor sends the text, if the gift is charged to the donor's phone or wireless bill.

(e) <u>Stock and Securities</u>

- If the donor transfers securities from his or her brokerage account to the charity's account, the gift is complete when the securities are actually transferred.
- If the donor directs a closely held company to transfer the stock in the company's records, the gift is complete **when the company actually records the transfer.**

- If the donor completes a stock power of attorney to transfer closely held stock to the charity, the gift is complete **when the donor delivers the executed stock power** (the mailbox rules applies if stock power is sent by US mail).

(f) Gifts of Real Estate: Gifts of real estate are complete when the charity takes title under the law of the state where the real estate is located, which usually requires delivery or recording of a signed deed.

(g) Gifts of Tangible Personal Property

- A gift of tangible objects generally requires delivery to the charity (or an agent of the charity).
- In some cases, constructive delivery can be shown, for example, by delivery of a signed bill of sale

2. Conditional gifts

(a) If a gift is conditional (requires some act or occurrence, otherwise property will be returned to the donor), there is no deduction unless the possibility that the condition will not be fulfilled is "so remote as to be negligible."

(b) This type of condition will not affect the deduction if there is an unconditional "gift over" to another charity if the original donee cannot fulfill the condition.

VII. Bargain Sales

1. Bargain Sales

(a) A "bargain sale" occurs when a donor transfers property to charity, and receives some consideration in return (but the consideration is worth less than the donor's gift).

(b) The donor can deduct the difference between the value of the property donated and the amount of money (or the value of the services or property) received in return.

(c) But the donor **also must recognize gain** (if any) on the "sale" part of the transaction. To calculate gain (or loss), the donor must allocate his or her basis between the "gift" and the "sale."

2. Charitable Gift Annuities

(a) Transfer of property in exchange for a charitable gift annuity is a bargain sale. The donor will have a deduction on the "gift" part of the transaction, but will recognize gain the "sale" part (if the donated property is appreciated).

(b) If the donor (or donor and spouse) are the only annuitants, and if the annuity cannot be transferred to anyone but the charity, the donor may spread recognition of capital gain over his/her lifetime, as annuity payments are received.

(c) The creation of a CRT is not treated as a bargain sale. Donation of appreciated property to a CRT does **not** trigger gain recognition to the donor.

3. Property Subject to Debt

   (a) If donated property is subject to a mortgage or lien, the donor is treated as if s/he had sold the property for the amount of the debt. The gift of encumbered property is therefore a bargain sale that triggers gain (or loss) recognition. This is true whether the debt is recourse or nonrecourse, and whether or not the charity agrees to pay it.

   (b) Beware of UBIT! In the case of an intervivos gift, the encumbered property will be debt-financed in the hands of the charity *unless* the donor has owned it for 5 years and the debt was more than 5 years old at the time of the gift. (The rule is different for property received by bequest—then, encumbered property is not treated as debt-financed in the hands of the charity regardless of when the donor acquired the property or incurred the debt.)

4. Provision of Substantial Return Benefits

   If a donor gives cash, return benefits merely reduce the amount of the deduction. But if a donor gives appreciated property, return benefits turn the gift into a bargain sale and trigger gain recognition.

VIII. Assignment of Income

1. General Idea:

   (a) In tax law, the gift of property is treated differently than an assignment of the right to receive income earned from the property. (Gift of the tree is different than gift of the fruit).

   (b) If the right to receive compensation is given, the donor is still taxed on the income paid for her services (even if the donor directs that it be paid to a charity instead).[15]

   (c) If the donor keeps the underlying property and gives the income stream, the income will still be taxable to the donor.

2. Pre-Arranged Sales

   (a) If the donor negotiates the sale of property and signs a binding contract with the purchaser, it is too late for the donor to avoid recognizing capital gain on the sale. Even if the donor transfers the property into the charity's name before the sale closes, the donor will still be taxable on the gain—it will be considered an assignment of income. The donor will be treated as if he or she donated the sales proceeds to charity (and will get a corresponding deduction).

   (b) Generally, the donor will not be taxed on the capital gain as long as there is no binding commitment to sell at the time property is donated.

   (c) Key question is whether the charity has the ability to keep the property or negotiate its own sales terms if it wishes.

[15] Treas. Reg. § 1.61-2(c). The donor may claim a charitable deduction for the amount s/he directed to charity, subject to substantiation rules and percentage limits.