<u>UNLOCKING YOUR DONORS' NON-CASH TREASURE CHESTS</u>

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Case studies are contained in Section X of the article and will be discussed in the presentation.

I. INTRODUCTION

Although cash donations comprise the lion's share of total giving, a high percentage of donors, charitable organizations, and advisors are exploring alternative means of donation. Likewise, charities are seeking non-cash forms of donations to supplement cash donations. For the 2009 tax year, 21.9 million individual taxpayers itemizing deductions reported $31.8 billion in deductions for non-cash charitable contributions. Non-cash assets include publicly traded securities, C-Corporation and S-Corporation stock and assets, limited liability company (LLC) interests, partnership interests, real estate, as well as art and other collectibles, life insurance, IRAs, mineral interests and other tangible assets.

This evolution from substantial cash donations to non-cash assets has been a fairly recent development for many donors. Historically, some charities would only accept cash donations due to their ease of transfer and the security of the investment. However, as charitable organizations have become better equipped to accept non-cash assets, their hesitation toward accepting alternative assets has been assuaged. Additionally, charitable organizations have become conscious of their increased likeliness to fill their coffers by accepting non-cash assets.

This change is attributable to the nature of a donor's financial situation: a donor may be cash-strapped but rich in other assets. Additionally, alternative assets provide donors and charities tax deductions and exemptions that are not available with cash donations. For example, a donor who owns publicly traded securities or real estate with a large built-in gain can avoid the realization of the gain by contributing the asset to charity yet also receive a fair market value income deduction. Further, by gifting non-income producing assets to charity, the donor's cash flow is not negatively impacted.

Nonetheless, while contributions of non-cash assets can provide various deductions and exemptions that are not available to cash gifts, these donations also present novel issues for the donor and charity that require careful consideration. This article weighs the advantages and risks of donating non-cash assets to public and private charitable organizations and provides planning ideas for donors and charities.

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II. Choosing a Charitable Organization

A. Public Charities vs. Private Foundations

Public charities receive donations from a broad range of donors.[2] A charity qualifies as a public organization if it receives 33 1/3 percent of its support directly or indirectly from the general public or the government.[3] Examples include the American Red Cross, libraries, churches, hospitals, or community museums.

Private foundations[4], on the other hand, are generally funded and managed by one person or members of the same family.[5] The deduction rules reflect Congress's intention to enhance regulatory oversight of private foundations.[6]

B. Income Tax Deduction Limitations

i. 30/50 Percent Deduction Limitation

Contributions of non-cash assets to a public charity or a Donor Advised Fund ("DAF") are subject to a 30 percent deduction limitation if the donor deducts the fair market value of the property. Under a DAF, a donor executes a written agreement with a charity in which the donor makes contributions to a specially designed fund established and administered by the custodian charity. However, the deduction limitation may be increased to 50 percent if the donor elects to deduct his or her basis in the property, rather than the fair market value.[7] In turn, the deduction will decrease the donor's basis in the property and the deduction limitation will increase to the maximum 50 percent deduction limitation. The majority of charities that qualify for the 50 percent deduction are public charities, however, certain private charities, including private operating foundations, pass-through foundations, donor-advised funds and pooled-fund foundations also qualify for the 50 percent deduction ceiling.[8]

In contrast, for donations of non-cash assets to private charities, a donor is limited to a 30 percent deduction where the donor deducts the basis of the property. Thus, a donor may only deduct 30 percent of his contribution base for non-cash contributions to private charities.[9]

III. Determining the Value of Property

If the property qualifies as ordinary income property, the donor's deduction is limited to his or her basis in the property. If the property qualifies as capital gain property, the donor can potentially deduct the fair market value of the property. Fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts."[10]

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[2] Martin Hall & Jerry McCoy, ALI-ABA, *Setting the Stage for Charitable Giving*, (2010).
[3] 26 C.F.R. § 170A-9(e)(2).
[4] Examples of charities that do not qualify as public charities are private non-operating foundations (other than pass-through foundations), veterans' organizations, fraternal societies, and cemetery organizations.
[5] Hall, *supra* note 12.
[6] Hall, *supra* note 12.
[7] I.R.C. § 170(b)(1)(A).
[8] I.R.C. § 170(b)(1)(F).
[9] Further, for donations of non-cash assets to private charities, a donor is limited to a 20 percent deduction if the donor's basis deduction is based on the fair market value of the property.
[10] Treas. Reg. § 1.170A-1(C)(2).

Fair market value can be an ambiguous assessment, so the IRS has set forth substantive requirements to help donors determine the value of certain types of property. For example, when evaluating the fair market value of publicly traded securities, a donor should evaluate the size of the contributed block of stock. In determining the fair market value of real estate, a donor should consider whether the property is encumbered by a mortgage, the ease or difficulty a charitable organization would face in selling the property, and any relevant economic factors.

IV. PUBLICLY TRADED SECURITIES

Publicly traded securities are the most common form of alternative gift asset. Securities include stocks, bonds or mutual funds. Additionally, publicly traded securities are attractive gift assets because they are easily transferrable and can be valued without an appraisal. Additionally, when an individual donates securities to charity, they do not pay any federal or state income tax on the gain. However, they also present various negative tax consequences that should be examined.

A. CALCULATING THE DEDUCTION

Taxpayers with securities stand to reap significant tax savings by donating the appreciated publicly traded securities to charity instead of donating cash. For example, by selling appreciated stock or a mutual fund (to gain cash for charity), a taxpayer is required to pay tax on the capital gain. In contrast, if a taxpayer donates securities to charity, the donor does not pay income tax on the gain.

Additionally, an appreciated security with long-term unrealized gain (meaning it was purchased over a year ago and has a current value greater than its original cost) may be donated to a charity and a tax deduction taken for the full market value of the security, which may be up to 30 percent, if to a public charity, of the donor's adjusted annual gross income. Since the security was donated to charity rather than sold, the donor also saves the federal and state income taxes that he or she would have paid on the gain in the securities had the securities been sold. Therefore, donating securities to charity can be an efficient route to evading the Internal Revenue Service's grasp.

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

B. VALUATION OF PUBLICLY TRADED SECURITIES FOR CHARITABLE CONTRIBUTION

A taxpayer making a contribution of publicly traded securities is not generally required to obtain a qualified appraisal to determine their value when contributing them to charity.[11] However, if the securities are subject to any restrictions that materially affect their value to the donor or prevent them from being freely traded, the taxpayer is required to obtain a qualified appraisal.

[11] Treas. Reg. § 1.170A-13(c).

In general, the value of stocks and bonds is the fair market value per share or bond on the applicable valuation date. If there is a market for stocks and bonds, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond. If there were no sales on the valuation date but there were sales on dates within a reasonable period before and after the valuation date, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and after the valuation date.[12]

C. Types of Publicly Traded Securities

1. Common and Preferred Stock

Common and preferred stock are the most common type of securities contributed to charity. It is considered a capital asset,[13] thus stock that meets the minimum holding period of one year qualifies as long-term capital gain property and if donate to a public charity, the donor can generally take a deduction for income tax purposes equal to its fair market value. The resulting deduction is then subject to the 30% limitation. However, stock that does not meet the minimum holding period requirement is ordinary income property. The corresponding deduction will be based on the lesser of the donor's adjusted cost basis or fair market value of the stock on the date of contribution. The resulting deduction is then subject to the 50% limitation.

2. Mutual Funds

In 2012, more than $12 trillion was invested in U.S. mutual funds, which was nearly double the amount in 1992. Similarly to stocks, mutual funds are treated as capital assets for charitable contribution purposes. Additionally, they are generally structured as open-end investment companies that qualify as "regulated investment companies" (RICs).[14] The fair market value of a share in an open-end investment company is the public redemption price of a share. In particular cases, taxes are withheld from mutual fund investments from all shareholders on a pro-rata basis.

Although charitable gifts of mutual funds confer the same tax benefits as donations of individual securities, there are several tax advantages exclusive to mutual funds. For example, appreciated mutual fund shares held for more than a year provide the same income tax deductions as stocks held individually: an income tax deduction for the asset's full fair market value. However, mutual funds also avoid the associated capital gain. Further, unlike other securities, shares in mutual funds are not purchased and sold on an exchange, but instead are bought and sold through an issuer. Despite this difference, mutual funds are still considered "publicly traded." [15] Lastly, in contrast to individual securities, mutual funds are not subject to income tax on distributed income. Instead, all gains and dividends pass along to their shareholders who pay tax on these items as if they held the underlying securities directly.

3. Closed-End Investment Companies

Unlike a mutual fund, after an initial sale by the company, the shares are traded in the secondary market like the shares of any other public corporation. The price per share fluctuates in relation to the company's portfolio and demand for its shares. They are valued in the same manner as stock.

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[12] Publication 561, Determining the Value of Donated Property, *available at* http://www.irs.gov/pub/irs-pdf/p561.pdf.
[13] I.R.C. § 1221.
[14] RICs are governed by I.R.C. § 851-860.
[15] Treas. Reg. § 1.170A-13(c)(7)(xi)(3).

4. U.S. Savings Bonds

If Series E, EE, H or HH savings bonds are transferred to charity during life, the donor may claim a charitable contribution deduction for their fair market value. However, since all unrealized income will be taxed to the trustor on the date of contribution, savings bonds are generally not an advisable asset to donate during the lifetime of the donor. The donor could be taxed on over 76% of the bond's interest income through estate and income taxes.

However, the Internal Revenue Service's grasp can be evaded by transferring the bond on a testamentary basis by the decedent to charity. This strategic move will allow the bond to be transferred without recognition of income. In turn, the donor may deduct 100 percent of the bond's value to a charity of his or her choice.

Alternatively, the bond owner can transfer the bonds at death to a tax-exempt charitable remainder trust. This transfer will qualify the donor for a partial estate tax deduction. Additionally, the transfer will have the effect of deterring taxation on all of the bond's interest income. However, if the decedent elects to pursue this route, he should provide careful instructions for implementation in his will. Without sufficient instructions, the estate could be taxed on all of the bond's interest income and would be unable to claim an offsetting charitable income tax deduction for the payment. Therefore, donors pursuing a CRT should ensure careful instructions are provided in their wills.

D. Stock Held in "Street Name"

Publicly traded stock is often held in "street name," which means that the shares are registered on the books of central clearinghouses under the name of the brokerage house in which the donor has an account, rather than under the donor's name. This is significant, because it will affect the date of a gift. For example, if stock is registered in street name, its transfer is not effective for federal income tax purposes until the stock is traded into the account of the charity on the books of the brokerage house. Therefore, this delays the timing of the donor's charitable contribution tax deduction until the transfer has been reflected on the books of the brokerage house.

E. Publicly Traded Securities Held at a Loss

With the volatility of the stock market, some owners of publicly traded securities are holding their securities at a loss. In light of this situation, the donor must ask whether an outright gift of the security is advisable. Selling the security at a loss and then donating the proceeds may be more advantageous to simply making an outright gift of the security to charity.

For example, when the donor sells the security for less than basis, a capital loss is generated that the donor can use to offset any capital gain. Additionally, by making a charitable gift of the proceeds, the donor generates a charitable income deduction that can be used to further offset taxable income. In contrast, if the donor had just made an outright gift of the security to charity, the donor would not be able to utilize the capital loss and the deduction would still be limited to the fair market value of the security. Accordingly, a donor should consider selling a security that has decreased in value, rather than donating it and missing out on an income tax deduction.

V. CLOSELY HELD STOCK & OTHER BUSINESS INTERESTS

Business interests in an LLC or partnership and closely held stock comprise a significant portion of many Americans' savings portfolios. As the Baby Boomer generation reaches retirement, many business owners sell these assets rather than bequeathing them to family. However, in some cases, these assets can better satisfy their charitable and financial goals. The relevant strategies are discussed below.

A. C-CORPORATIONS

i. CONTRIBUTING C-CORPORATION STOCK

a. CALCULATING THE DEDUCTION

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

Additionally, the business owner will avoid any built-in capital gain on the gifted stock. After the transaction, the business owner may end up financially in a similar position had he just sold all of his stock and he benefits from the added advantage of achieving his charitable goals.

Finally, unlike S-Corporation stock, with C-Corporation stock, the charity is not taxable on any stock dividends, nor is it taxable on the gain when it sells the stock.

ii. CONTRIBUTING C-CORPORATION ASSETS

a. CALCULATING THE DEDUCTION

A C-Corporation pays income taxes on its taxable income as a separate taxpayer. Further, a C-Corporation may deduct the value of charitable contributions received up to 10 percent of its adjusted taxable income for the tax year. The 10 percent rate is flat and does not change with the type of asset contributed or the nature of the charity, public or private.

B. S-CORPORATIONS

In 2006, over 66% of the nation's corporations were S-Corporations and in 2007, 60% of these S-Corporations had only one shareholder. This compact structure allows for ease in deciding whether the company wants to contribute stock or assets to a charity.

In order to become an S-Corporation and to remain an S-Corporation, the corporation must: (1) be a domestic corporation, (2) have 100 or fewer shareholders, (3) ensure all shareholders are individuals, estates, certain types of trusts, qualified retirement plans, and charitable organizations exempt from income tax, (4) and have only one class of stock issued and outstanding. Also, a charitable remainder trust cannot be an S-Corporation shareholder because the trusts are not qualified exempt organizations.

i. GENERAL RULES FOR CHARITABLE DEDUCTIONS

An S-Corporation may not claim a deduction for its charitable contributions itself; therefore, the contributions are excluded from the S-Corporation's taxable income. Instead, income, deductions, losses, and credits flow to the shareholders.

The laws governing charitable gifts by S-Corporations are generally comparable to the laws governing most charitable gifts, with the exception that an S-corporation is permitted to contribute to a split-interest trust, such as a charitable lead trust and a charitable remainder trust. Additionally the laws governing charitable gifts by S-Corporations differ from C-Corporations in that an S-Corporation shareholders may only claim a charitable income tax deduction in the year in which the S-Corporation actually makes the charitable gifts;[16] whereas, an accrual method C-Corporation can claim a charitable income tax deduction in the year that the board of directors makes a legally binding pledge, provided the corporation pays the pledge before the 15th day of the third month following the close of the tax year.[17]

Lastly, a gift of non-publicly traded stock requires a written appraisal if the value of the gift exceeds $10,000 (or 5,000 for gifts of other property). Since, stock of a closely held corporation, including S-Corporation and C-Corporation stock, is non-publicly traded, an appraisal is required for a donation worth over $10,000. The failure to obtain an appraisal will disqualify a charitable income tax deduction.

ii. Contributing S-Corporation Stock

a. Calculating the Deduction

When a donor contributes S-Corporation stock, the donor must reduce the deduction by the amount of recapture or other ordinary income the stock would have accumulated had the donor sold the stock at fair market value.[18] Also, an income tax deduction for a charitable gift of S-Corporation stock will be less than the appraised value to reflect any "ordinary income" assets that the S corporation might have.[19] Thus, a corporation may pay more to redeem the stock than the shareholder was able to actually deduct.

Unlike partnership owners, donors of S-Corporation shares may deduct only to the extent of their basis in the S-shares, plus the long-term capital gain element in his S-Corporation stock and the amount of loans made by the shareholder to the S-Corporation.[20] The S-Corporation shareholder then reduces his basis in the stock by the full amount of the deduction.

If S-Corporation stock is donated to a private non-operating foundation and its value is greater than its tax basis, a donor will be limited to a deduction for the value of the stock's lower basis. Therefore, the provision that reduces the deduction by the ordinary income component does not apply. Contrarily, if the S-Corporation stock is donated to a private operating foundation, the donor can claim a deduction for some of the appreciated value under the general income tax rules that apply for a gift of S-Corporation stock to a public charity.[21]

b. UBTI

Generally, charities are exempt from paying income tax on revenue from their exempt functions; however, they must pay the unrelated business income tax on "unrelated business taxable income" (UBTI).[22] Congress enacted UBTI to eliminate unfair competition between a tax-exempt organization and

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[16] Rev. Rul. 2000-43, 2000-2 C.B. 333; TAM 200004001 (July 7, 1999); TAM 19990039 (Sept. 30, 1998).
[17] I.R.C. § 170(a)(2); Treas. Reg. § 1.170A-11(b).
[18] I.R.C. § 512 (e)(1)(A).
[19] I.R.C. § 170(e)(1). *See* Christopher R. Hoyt, *Charitable Gifts Made by S Corporations: Opportunities and Challenges,* 477 ACTEC L.J. (2010).
[20] I.R.C. § 170(e)(1).
[21] I.R.C. § 170(b)(1)(A)(vii), 170(b)(1)(F)(i).
[22] I.R.C. § 511-514.

a taxable organization.[23] For example, a tax-exempt organization should not receive a taxable advantage when its profitable activity is not directly related to its charitable function.

S-Corporations, unlike partnerships or LLCs, are subject to UBTI on all income attributable to an S-Corporation, including interest, dividends, rents and capital gains.[24] For example, even the gain from the charity's sale of S-Corporation stock is taxable.[25] This produces a substantial disparity between the UBTI treatment of partnerships and S-Corporations.

UBTI is generally greater for a charity organized as a trust, versus a corporation. For example, whereas, ordinary income in a trust is subject to the highest 39.6% marginal income tax rate once UBTI reached $8,350,[26] a corporation's income is not subject to the highest 39% marginal rate until UBTI reaches $100,000 and then the rate falls to 34% when UBTI exceeds $335,000.[27] However, a trust's long-term capital gains are generally subject to only a 20% tax rate,[28] and corporations do not benefit from the lower tax rate on long-term capital gains.

A charity accepting S-Corporation stock will want to learn the donor's adjusted basis in the stock before accepting. This will affect the overall UBTI of the charity, because this will determine the stock's taxable gain upon sale.[29] A low basis could be detrimental for a charity, as it will cause a greater taxable gain and UBTI upon the sale of the stock. Also, if the S-Corporation has losses instead of profits, the charity might not be able to deduct the entire amount of the losses. The loss deduction is limited to the charity's basis in the stock and any unused loss is carried forward.[30]

Additionally, a charity will be concerned that it has sufficient cash available to pay the UBTI as it comes due. In turn, the charity should examine the Schedule K-1s that the donor received over the course of the past few years to match the taxable accounting income with the amount of cash distributions. Therefore, even though S-Corporations generally provide cash to their shareholders to pay the UBTI liabilities, a charity should address this issue before accepting a gift of S-Corporation stock.

c. Disadvantages of Contributing S-Corporation Stock

Contributions of S-Corporation stock, rather than donations of assets may be less desirable to charitable organizations for several reasons:

First, the donor's tax deduction will be less than the appraised value of the stock. For example, the income tax deduction for a gift of appreciated property must be reduced by the amount of "ordinary income" that the donor would have had if the donor had sold the property.[31] Therefore, since the sale of S-Corporation stock usually produces a 100% long-term capital gain,[32] not a gain of ordinary income, most donors assume they can deduct the entire appraised value of the stock. However, this is false, since the tax laws state that charitable gifts of S-Corporation stock should be reduced under rules that are analogous to charitable gifts of partnership interests, not C-Corporation stock.[33] Instead, if an S-Corporation donates

[23] *See* S. Rep. No. 2375, 81st Cong., 2d Sess., reprinted in 1950-2 CB 483, 504.
[24] I.R.C. § 512(e).
[25] *Id*.
[26] I.R.C. § 511(b); Treas. Reg. § 1.511-1.
[27] I.R.C. § 511(a).
[28] I.R.C. § 511(b); Treas. Reg. § 1.511-1.
[29] I.R.C. § 1223(3).
[30] I.R.C. § 1366(d); 1367(2)(B).
[31] I.R.C. § 170(e)(1)(A); Reg. Section 1.170A-4(a).
[32] *See* Priv. Ltr. Rul. 9224036 (March 16, 1992).
[33] I.R.C. § 170(e)(1).

stock to a charity, he must reduce his income tax deduction by the proportion of the gain that would be treated as ordinary income if the assets were sold. It should be noted, however, that this reduction only applies to income tax deductions.

Second, the dividends, gains, and interest on dispositions of the stock are subject to Unrelated Business Taxable Income ("UBTI") rules.[34] Therefore, as a shareholder of the S-Corporation, the charity will generally be subject to UBTI on any income it derives during its period of ownership and on its gains from the sale.[35] In turn, the charitable organization must bear the burden of reporting income as UBTI daily and pay the UBTI.[36] Additionally, if a private foundation[37] owns more than 20 percent or 35 percent of the outstanding voting stock of a company (depending on the circumstances) and such excess holdings are not disposed of within five years, an excise tax of 10 percent is imposed on the excess business holding and increases to 200 percent if corrective action is not taken.

Third, the sale of the appreciated S-Corporation stock will trigger a UBTI liability to the charity. Accordingly, charities receiving S-Corporation stock should be concerned with the basis of the stock they are receiving, as it will impact the applicable UBTI liability.

Fourth, Section 1374 provides that an S-Corporation that was a former C-Corporation is liable at the highest corporate rate (currently 35%) if within ten years of the conversion date (the "recognition period")[38] it makes a taxable disposition of any appreciated property that it owned on the conversion date. Additionally, the shareholders will be liable for their share of the S-Corporation's gain from the taxable disposition.

Lastly, complications arise when the receiving charity is a shareholder of the contributing corporation. For example, can a corporation such as Dell donate computers to a university that owns shares in Dell? In this situation, Dell should be able to claim a charitable income tax deduction rather than be treated as making a dividend distribution to a shareholder. However, this example becomes more complex when the charity owns all of the corporation's stock. The Service, the Tax Court and several federal courts of appeal have held that distributions from wholly owned subsidiaries to a tax-exempt parent charity do not qualify for charitable income tax deductions.[39] They are instead considered dividend distributions. In contrast, there is no legal precedent in the partnership laws.

d. ADVANTAGES/DISADVANTAGES OF CONTRIBUTING S-CORPORATION STOCK TO TRUSTS

A charity that is organized as a trust will pay more UBTI on an S-Corporation's ordinary income than a charity organized as a corporation. However, the UBTI burdens of S-Corporation stock can be lessened by contributing to a public charity organized as a trust, because the charitable trust will pay less UBTI on a large long-term capital gain. Trusts can take advantage of low capital gains rates that are not applicable to a corporation and can receive an income distribution deduction to offset the UBTI. For example, charitable lead trusts ("CLTs") can help eliminate or reduce the estate and gift taxes on assets that will

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[34] I.R.C. § 512(e)(1)(B)(i).
[35] I.R.C. § 512(e)(1)(B)(i).
[36] I.R.C. § 512(e)(1)(B)(ii).
[37] The Pension Protection Act of 2006 made these rules also applicable to donor advised funds.
[38] I.R.C. § 1374(d)(1),(d)(3)(B).
[39] *See*, *e.g.*, *C.F. Mueller Co. v. Comm'r*, 479 F.2d 678 (3d Cir. 1973); *Dave Inv. Co. v. Comm'r*, 462 F.2d 1373 (1972).

inevitably pass to new owners.[40] Under a CLT, a donor establishes and makes contributions to an irrevocable trust that pays a charity an annuity for a term of years or the life (only the donor, donor's spouse or lineal ancestors with remainder interests can be the measuring lives). At the end of the term of the trust, the remaining balance either reverts to the donor or passes to other non-charitable beneficiaries.

CLTs are taxable trusts, however, and are subject to regulation of the "private foundation rules" established under the federal tax law. A CLT can be taxed as a grantor trust or as a complex trust under the I.RC. If taxed as a grantor trust, the donor receives an immediate deduction, but income earned by the trust until termination is taxed to the donor. The deduction amount is based on the present value of the payment stream. If taxed as a complex trust, the trust income passes to the charity to the extent of the annuity payments. CLTs are more advantageous to the donor if interest rates are low.

Charitable remainder trusts ("CRTs") should also be considered. A CRT is an irrevocable tax exempt trust that pays an annual stream of income to a non-charitable beneficiary for one life, two lives, or a term of years. The CRT must be created as a "term charitable remainder trust" with a limited life of no more than 20 years, however, because the corporate donor to the CRT is not an individual.[41] Also, the annuity payment to the non-charitable beneficiaries must be not less than 5 percent nor more than 50 percent and the charity's actuarial interest must be at least 10 percent of any assets transferred to the trust. At the end of the term, the assets pass to charity. CRTs allow for the transfer of the appreciated corporate asset to the trustee who can sell the asset and manage its proceeds.[42] The CRT income can be distributed to shareholders who will be taxed on the extent of ordinary and capital gains income.[43] The donor receives an income tax deduction based on the total value of the contribution less the present value of the payment stream to non-charitable beneficiaries. CRTs are more advantageous to the donor if interest rates are high.

However, trusts can be problematic, because certain trusts, including CRTs, are not eligible to receive or hold S-corporation stock.[44] A transfer of S-Corporation stock to a CRT will cause the corporation to be taxed as a C-Corporation. Further, while a CLT can qualify as a shareholder,[45] it is subject to income tax on the trust's income.[46]

Charitable gift annuities are another alternative to trusts. By using a charitable gift annuity, the donor transfers assets to a charity, and in return, the charity will make the annuity payment to one or more individuals for their lifetimes. This option allows for the donor to retain income interests and deduct the market value for the contribution. However, taxpayers should be cautious of potential UBTI issues.

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[40] H. KING MCGLAUGHON, WELLS FARGO PRIVATE BANK, CHARITABLE PLANNING WITH CLOSELY-HELD BUSINESS INTERESTS: MAXIMIZING ENTREPRENEURIAL VALUE FOR TODAY AND TOMORROW 5(2011).
[41] MCGLAUGHON, *supra* note 50.
[42] MCGLAUGHON, *supra* note 50.
[43] MCGLAUGHON, *supra* note 50.
[44] Hoyt, *supra* note 29. While organizations described in Section 501(c)(3) and exempt from taxation under section 501a) are now permitted to be shareholders, CRTs are still not eligible S-Corporation stock shareholders. IRC. § 1361(c)(6).
[45] Hoyt, *supra* note 29.
[46] I.R.C. § 642(c)(1); I.R.C. § 671.

iii. GIFTS OF ASSETS OWNED BY AN S-CORPORATION

a. CALCULATING THE DEDUCTION

Gifts of appreciated real estate to a governmental entity qualify for a charitable deduction equal to the full value of the property.[47] Also, the IRS established that the corporation does not have to recognize the built-in gains tax under section 1374.

However, if an S-Corporation donates appreciated property, the shareholder's basis in the corporation's stock is reduced by the amount of the charitable deduction rather than by the cost basis of the property that was donated.[48] For example, if an S-Corporation makes a donation of an appreciated asset with a basis of $20,000 but a value of $100,000, the shareholder can deduct $100,000 but must reduce his basis in the stock by the full $100,000. When the shareholder ultimately sells the stock, it will have a larger gain.

b. ADVANTAGES OF DONATING S-CORPORATION ASSETS

A charitable gift by an S-Corporation will produce more favorable tax results to both the S-Corporation shareholder and the charity than a shareholder's gift of stock. The respective advantages are discussed herein.

First, an S-Corporation's financial transactions flow through to the shareholder's tax return, so if an S-Corporation makes a gift to a charity, the charitable income tax deduction will be claimed on the shareholder's tax return.[49] Thus, as long as the shareholder has sufficient basis in his stock to deduct the gift, there is no need for the shareholder to contribute stock to obtain a deduction when the corporation's gift can produce the same tax benefits. The shareholder just reduces his basis in the stock by the full amount of the deduction allocated. Also, the corporation can likely gift at a lesser cost because there is no need to pay for the stock to be appraised.[50]

Second, unlike gifts of S-Corporation stock, a charity is not subject to UBTI on the income of contributed assets or the gain from their sale. This is favorable to the donor, who will not need to be as concerned with his basis in the property. Also, the charitable organization will prefer gifts of S-Corporation assets, because they will not need to be concerned with the financial loss and complexity of UBTI.

Third, charitable gifts of corporate property are also advantageous because they can avoid the "built-in gains tax" of Section 1374.[51] The charity also benefits from gifts by the corporation, rather than the shareholder, because it will not have to pay the UBTI on income produced from assets donated by the corporation.[52]

Fourth, a charitable deduction for a gift of corporation assets will not be reduced by a lack of marketability discount, as a shareholder's gift of stock would be. For example, corporate assets can be valued at their full worth, whereas, stock will often be appraised at less than fair value because of the difficulty of selling a minority interest. Therefore, there will be a greater income tax deduction for gifts of assets, compared to stock.

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[47] I.R.C. § 1371(a)(2)(b); Pvt. Letter Rul. 200004032 (Oct. 26, 1999).
[48] I.R.C. § 1371(a)(2)(b); Pvt. Letter Rul. 200004032 (Oct. 26, 1999).
[49] I.R.C. § 1366(a); Treas. Reg. § 1366-1.
[50] Hoyt, *supra* note 29.
[51] Hoyt, *supra* note 29.
[52] I.R.C. § 512(e)(1).

Lastly, as will be discussed further below, a charitable remainder trust (CRT) can hold and receive gifts of corporate assets, whereas it cannot receive or hold corporate stock. A CRT is advantageous because it is tax-exempt and will not pay tax on the gain from the sale.

c. Disadvantages of Donating S-Corporation Assets

As discussed above, charitable gifts of S-Corporation assets generally provide a shareholder with better tax benefits than a gift of stock. Nonetheless, there are corresponding disadvantages of donating S-Corporation assets.

First, a shareholder's ability to claim an income tax deduction for a corporation's charitable gifts can be limited to the shareholder's basis in the property. Therefore, donors with a small basis in the asset could receive a minimal deduction. For example, if a shareholder receives a $20,000 deduction for a gift of corporate assets, yet the shareholder only has stock with a basis of $12,000 in the corporation, the shareholder will be limited to a $12,000 deduction that year. Second, an S-Corporation's donation of appreciated property to a charity that is a shareholder can trigger a taxable gain that can cause all shareholders, including the charity, to pay an income tax. Third, if the S-Corporation donates substantially all of its assets to a charity, the transfer could be considered a liquidated distribution that triggers a taxable gain.

d. Advantages/Disadvantages of Donating S-Corporation Assets to Trusts

Although CRT's cannot hold S-corporation stock, they can receive and hold corporate assets, such as real estate, thereby making them an attractive option for charitable gifts.[53] S-Corporations can contribute real estate or other appreciated property to a CRT and then have the CRT sell the real estate. The charitable income tax deduction from the gift of real estate will flow through to the shareholder's individual tax return. [54] Also, the CRT will not have to pay tax on the gain when it sells the real estate since it is tax-exempt. [55]

Corporate gifts to a CRT can be problematic, however. First, there can be tax complications if the property donated to the CRT was subject to the Section 1374 built-in gains tax.[56] Second, the investment income from the CRT could trigger a corporate tax, which could involuntarily cause the S-Corporation to covert to C-Corporation status after three years.[57] Third, the term of the CRT must be a fixed number of years, rather than for the life of the shareholder, otherwise the trust will fail to qualify as a trust for federal income tax purposes and could not qualify as a CRT.[58]

Particular problems arise when an S-Corporation donates substantially all (at least 85 percent of the value[59]) of its assets to a charitable organization or a CRT.[60] This likely occurs when an individual owns a corporation that holds a single large asset. If this occurs, the corporation must recognize taxable gain or

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[53] Hoyt, *supra* note 29.
[54] Treas. Reg. § 1.1366-1(a)(2)(iii).
[55] I.R.C. § 664(c)(1).
[56] PLR 200644013 (June 21, 2006).
[57] I.R.C. § 1362(d)(3).
[58] PLR 200203034 (Oct. 18, 2001); PLR 200644013 (June 21, 2006).
[59] The phrase "substantially all" is not defined in Sec. 337(b)(2) or in Reg. 1.337(d)-4. However, it is defined as 85% in several other places in the Code: Treas. Reg. 1.514(b)-1(b)(1)ii); 53.4942(b)-1(c); 53.4946-1(b); 1.401(k)-1(d)(1)ii).
[60] Treas. Reg. § 1.337(d)-4(c)(2)(ii).

loss immediately before the transfer as if the assets transferred were sold at their fair market values.[61] Therefore, a corporation cannot circumvent the general corporate liquidation rules by either merging to a tax-exempt organization or by transferring all of its assets to a tax-exempt organization.

C. Contributing LLC and Partnership Interests

An individual member or a partner may contribute LLC[62] or partnership interests to a charitable organization. Transfers may be made through various methods: an outright contribution, a contribution of the proceeds following a sale of the interests, or a partial gift/partial sale. Generally, for partnership interests, the charitable deduction is equal to the fair market value less any ordinary income gain (except for donations to private foundations).

i. Calculating the Deduction

Generally, for partnership interests, the charitable deduction is equal to the fair market value less any ordinary income gain (except for donations to private foundations). Fair market value of a partnership interest is generally the difference between the donor's share of the fair market value of the partnership assets and his share of partnership liabilities, whether recourse or non-recourse. However, the deduction is limited to the extent the partnership owns ordinary income assets (or "hot assets"). This limitation is discussed further later in this section. Also, as discussed in a previous section, a donor must contribute his entire interest in the property (or partnership interest), or no deduction will be allowed.

When donating to a public charity, the donor must reduce his deduction by any gain that would not be treated as long-term capital gain had the interest been sold at fair market value rather than contributed. Also, if the donor contributes the interest to a non-public charity, the deduction is limited to the lesser of the fair market value of the interest or the basis of the property.

A partnership itself can also donate assets to charity, rather than an individual partner. If this occurs, each partner's basis in his partnership interest will be reduced by his share of the partnership's basis in the property contributed.

ii. UBTI

Donation of partnership interests may cause the charitable organization to be subject to UBTI. The income tax laws view the investment as a charity's indirect participation in an unrelated commercial enterprise: the partnership's underlying business activities.[63] In turn, only the charity's share of the income attributable to the partnership's unrelated commercial activities is subject to UBTI. Thus, the charity does not pay tax on its share of partnership income from passive investments, such as interest, dividends and capital gains.[64] As discussed above, this is in contrast to an S-Corporation, which must pay UBTI on all income attributable to the S-Corporation, including interest, dividends, rents and capital gains.

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[61] Treas. Reg. § 1.337(d)-4(a)(1).
[62] Owners of interests in LLCs are referred to as members. Throughout this article, the word "partner" is used to include LLC members, and the term "partnership" to include LLCs that are treated as a partnership for income tax purposes. S-Corporation and C-Corporation interests are separately discussed. LLCs are typically taxed as partnerships under governing state law.
[63] I.R.C. § 512(c).
[64] Treas. Reg. § 1.512(c)-1.

iii. PARTNERSHIPS AS FLOW-THROUGH ENTITIES

When partnerships contribute to charity, the deductions are taken by the partners individually on their income tax returns, not computed into the partnership's total income or loss.[65] A partner's ability to deduct losses is greater than an S-Corporation's because a partner's tax base includes his share of all partnership debt, not just the debt loaned by the partner.[66] Ergo, a partner could deduct a charitable deduction that exceeds the tax basis of his interest in the partnership.[67] Following the deduction, the partner's basis in the partnership interest is reduced by the basis of the contributed property, not by its fair market value.[68] This is intended to preserve the deduction; for example, if the partners' bases were reduced by the fair market value of the contributed property, it would cause the unintended consequence of a gain (or a reduced loss) to the partners.[69]

iv. INTEREST ENCUMBERED BY DEBT

Issues arise when a partnership interest encumbered by debt is donated to a charitable organization. For example, when a partnership interest is encumbered by debt, the bargain sale provisions of the Internal Revenue Code may require the donor to recognize income.[70] The donee's acceptance of the interest subject to the debt and the donor's decrease in liability converts the nonrecognition event into a sale or exchange.[71] When this results in gain, the transaction is bifurcated into a charitable contribution and a sale.[72]

For the charitable contribution portion of the transaction, the amount of the donation is equal to the excess of the value of the partner's share of assets over the relief of debt (or, rather the partner's net equity value in the partnership).[73]

For the sale portion of the transaction, the amount of debt relief is the amount realized.[74] Further, the basis is prorated between the contributed and sold portions of the interest, based on the fair market value of each. However, donors should also note that no loss is recognized if the amount realized is less than the adjusted basis.[75]

This complex taxing procedure is illustrated by the following example. John, an individual, has an interest in a general partnership. On December 31, 2011, John contributed his partnership interest, subject to his partnership liabilities, to a public[76] charity. The fair market value of John's interest was $100,000 at the time of contribution. The partnership had no assets that would generate ordinary income if sold, and D held the interest for more than one year, thus it will generate capital gain. However, if the partnership had

[65] IRC. § 703(a)(2)(C). Under section 703(a)(2)(C), a deduction for a charitable contribution is not allowed to the partnership. *Id.* Instead, each partner takes into account separately the partner's distributive share of the partnership's charitable contributions. IRC. § 702(a)-(4).
[66] MCGLAUGHON, *supra* note 50.
[67] MCGLAUGHON, *supra* note 50.
[68] MCGLAUGHON, *supra* note 50.
[69] Rev. Rul. 96-11, 1996-1 C.B. 140 (1995).
[70] IRC. § 1011(b).
[71] IRC. § 752(b).
[72] *See* Rev. Rul. 75-194, 1975-1 C.B. 80; Treas. Reg. § 1.1001-2(c).
[73] IRC. § 752(b).
[74] IRC. § 752(d).
[75] Treas. Reg. § 1.1001-1(e)(1).
[76] IRC. § 170(c).

any IRC section 751 assets, a portion of the gain will be ordinary.[77] His basis in the partnership interest at the time of contribution was $80,000 computed as follows:

Capital contribution of cash	$100,000
Less: D's share of losses from partnership operations	(80,000)
Plus: D's share of partnership liabilities	60,000
Adjusted Basis	$80,000

The bargain sale portion is calculated as follows:

Amount Realized	=	$60,000	=	60%
Fair Market Value		$100,000		

Amount Realized	$60,000
Less: Basis in partnership interest (60% X $80,000)	(48,000)
Gain on bargain sale	$12,000

Since the amount of the charitable contribution is the fair market value of the partnership interest ($100,000), less the amount deemed sold ($60,000), it is equal to $40,000.

v. EFFECT OF IRC SECTION 751 "HOT ASSETS"

"Hot assets" impact the deductibility of the charitable contribution.[78] Further, to the extent a sale or exchange of the charitable contribution would have generated ordinary income rather than long-term capital gain, the amount of the deduction must be reduced.[79] Thus, to the extent a sale of a partnership interest will result in ordinary income due to "hot assets," the amount of the charitable contribution is reduced.

vi. SUSPENDED PASSIVE ACTIVITY LOSSES DEDUCTION

Additionally, a charitable contribution of a partnership interest does not result in a deduction of suspended passive activity losses to the donor.[80] Rather, the suspended passive activity losses are added to the donor's basis at the time the partnership interest is contributed. In regard to the charitable organization, the suspended passive activity losses not recognized as the result of a gift are added to the donee's carryover gift basis from the donor.[81] This, in turn, affects the amount of taxable gain or loss recognized by the charity on subsequent disposition where UBTI is applicable.[82]

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[77] Treas. Reg. § 1.1011-2(c) and 1.170A-4(d).
[78] IRC. § 469(j)(6).
[79] Treas. Reg. § 1.170A-4(c)(3); IRC. § 170(e)(1).
[80] *See* IRC. § 469.
[81] IRC. § 469(j)(6).
[82] Treas. Reg. § 1.170A-4(c)(4).

vii. DISADVANTAGES OF DONATING PASS-THROUGH INTERESTS

Despite the aforementioned advantages of donating partnership interests to a charitable organization, there are also associated drawbacks and hurdles that require consideration.

First, while a contribution of a partnership interest may allow the partner to evade income tax under IRC § 501(a), the charitable organization may be subject to UBTI. [83] Although charities are generally exempt from tax, they pay tax on their UBTI, which is net income derived from any trade or business that is not substantially related to the charity's exempt purpose. Therefore, if a charity inherits an interest in a partnership that is engaged in an unrelated trade or business, the charity will be required to include the income derived from the partnership interest in its UBTI. Accordingly, a charity will be hesitant to accept an interest in a partnership that will produce UBTI unless it can be guaranteed it will receive cash distributions to offset the liability. In addition, if gross income from unrelated business activities exceeds $1,000 for a year, the charitable organization must file IRS Form 990-T.

Secondly, many charities, including The New York Community Trust, will not accept a general partnership interest.[84] Various charitable organizations concur that the for-profit activity of the partnership is inconsistent with their charitable mission. Additionally, many charitable organizations fear the partnership interest places the charitable assets at risk for liabilities of the partnership. Accordingly, donors should be aware of charitable organizations' general reluctance toward accepting partnership interests.

Next, partnership agreements commonly include capital calls. Therefore, before a charity will accept a contribution of a partnership interest it will generally require assurance that it will not be subject to any capital call provisions. Also, a contribution of a partnership interest worth more than $5,000 will require a written appraisal from a qualified appraisal (unlike contributions of publicly traded securities).

viii. ADVANTAGES AND RISKS OF FAMILY LIMITED PARTNERSHIPS

A Family Limited Partnership (FLP) is a limited partnership in which the interests are held solely by family members.[85] An FLP is treated as a flow-through entity. As discussed earlier, a flow-through entity means that the income items, deductions and credits flow through to the partners and are reported by the partners on their income tax returns. Therefore, in the situation of a charitable deduction by an FLP, the deduction will flow-through to the partners, who can each take their pro-rata share of the deduction on their individual income tax returns. Additionally, the deduction is not limited by the partner's basis in the partnership.[86] However, for a charitable gift of an FLP interest itself, a holding period in excess of one year in the hands of the donor will be necessary for the donor to deduct the full fair market value of the partnership interest.[87]

There are associated risks with donations of FLP and partnership interests, however. For example, if a FLP partner undertakes debt to acquire the partnership interest, bargain-sale rules may come into play.

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[83] IRC. § 511.
[84] *See* THE NEW YORK COMMUNITY TRUST, CONSIDERATIONS IN MAKING CHARITABLE GIFTS OF INTERESTS IN PASS-THROUGH ENTITIES (2010), http://www.nycommunitytrust.org/ProfessionalTaxEstatePlanningNotes/GiftsofInterestsinPassthroughEntities/tabid/555/Default.aspx.
[85] THE CATHOLIC FOUNDATION, CHARITABLE GIFTS OF FLP, LLC & S CORPORATION INTERESTS (2011), http://www.catholicfoundation.com/assets/the_good_advisor/TheGoodAdvisor_spr08.pdf.
[86] THE CATHOLIC FOUNDATION, *supra* note 95.
[87] THE CATHOLIC FOUNDATION, *supra* note 95.

Also, there is a risk of UBTI when an FLP interest is given to a charity.[88] Additionally, the UBTI consequences may be more severe if interests are transferred to a charitable remainder trust.[89] Also, transfers of 50 percent or more of a partnership during one year may lead to a technical termination of the partnership.

VI. Real Estate

A donation of real estate may provide the donor with various tax benefits, such as an avoidance of the capital gains tax on appreciated assets and a gift tax deduction. The main advantage to making the donation during the donor's lifetime is an income tax charitable deduction. [90]

Generally, the deduction is measured by the fair market value of the property on the date of contribution; however this amount also depends on (1) the type of charity to which he contributes and (2) the type of real estate that is contributed. The type of charity refers to whether it is a public or private charitable organization, and the type of real estate refers to whether it will generate short-term or long-term capital gain or ordinary income upon its sale.

A. Calculating the Deduction

The amount of a donor's charitable deduction varies depending on whether the charity is public or private and whether the property contributed is capital or non-capital gain property. Greater tax benefits stem from the contribution of capital gain property, rather than ordinary gain property, and from contributions to public charities, rather than private charities.

i. Capital Gain Property And Public Charity

A donor who contributes a charitable gift of unencumbered real estate that qualifies as capital gain property to a public charity will receive a current income tax deduction equal to the full fair market value of the real estate. [91] Capital gain property is any capital asset which, if sold at its fair market value, would generate a gain that is taxable as long term gain; and Section 1231 property, property used in a trade or business.[92]

Contributions of capital gain property shall be taken into account after all other charitable contributions. Also, donations of capital gain property are advantageous to the charity, because the charity can sell the appreciated property and will not pay income tax on the gain.

[88] IRC. § 512(c).
[89] *See Leila G. Newhall Unitrust*, 104 TC 236, 105 F3d 482 (1995), where the court held that if the charitable remainder trust owns an interest in an LLC or partnership, items considered UBTI could pass from the partnership or LLC to the charity.
[90] Goldstein, Kenneth A., Blending Real Estate and Philanthropy, *Tax Management Real Estate Journal* (July 7, 2012). pg 181.
[91] IRC. § 170(b)(1)(A).
[92] IRC. § 170(b)(1)(C)(iv).

ii. Not Capital Gain Property Or Not Public Charity

A donor who contributes capital gain property to a private charity or who contributes non-capital gain property to a public charity may only deduct his or her adjusted cost basis in the property.[93] Therefore, there are greater tax deductions available for donations of capital gain property to public charities.

B. Avoidance of Gain on Sale of Real Estate

Generally, a donor does not recognize any gain as a result of the gift of real estate to charity. Subject to the anticipatory assignment of income doctrine, the donor does not recognize any gain on sale when the real estate is ultimately sold by the charity. Under the anticipatory assignment of income doctrine, at some point in the sale process it is too late for the donor to avoid the realization of the income from the sale of the real estate that was contributed to the charitable organization.

C. Manner of Gift

i. Real Estate Encumbered by a Mortgage

Where contributed real estate is encumbered by a mortgage, the donor must reduce the amount of his or her contribution deduction by the mortgage on the property. Additionally, a gift of real estate subject to a mortgage is treated as if the donor had sold the property to the charity for the amount of the indebtedness, so bargain sale rules may apply.[94]

The donor will have taxable income equal to the difference between the mortgage amount and the portion of the donor's adjusted cost basis attributable to the deemed sale portion unless the donor agrees to hold the charity harmless and pays off the mortgage as it comes due.[95]

Debt-financed property gifted to charity will often result in UBTI for the charity. If the property is not used by the charity for its exempt purposes, it is treated as debt-financed property, which can cause rental income and gain realized on the later sale to be taxed as UBTI.[96] However, debt-financed property acquired by gift, bequest, or devise is not treated as acquisition indebtedness during the 10-year period following the date the tax exempt entity receives the property if: (a) the debt was placed on the property more than 5 years before the date the tax exempt entity received it, and (b) the donor held the property for more than 5 years before the date the tax exempt entity received it.[97]

ii. Contributing a Partial Interest in Real Estate

Generally, a taxpayer will not be eligible for a deduction for charitable contribution of property if the taxpayer contributes less than the taxpayer's entire interest in the property.[98] Therefore, if a donor contributes the right to use property, they have not contributed the entire interest, and it is thereby not deductible. The following two examples will demonstrate the effect of partial interests in real estate and

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[93] IRC. § 170(E)(1)(A).
[94] Treas. Reg. § 1.1001-2.
[95] Priv. Ltr. Rul. 8536061, 8526015.
[96] IRC. § 512(b)(4).
[97] IRC. § 514(c)(2).
[98] IRC. § 170(f)(3).

the corresponding tax implications.[99] First, if a donor owns a 15-story office building and only donates rent-free use of the top floor to a charitable organization, this will be the contribution of a partial interest. Since, the entire interest was not donated, the donor cannot take a deduction for the contribution. Second, if a donor owns a ski home and donates the right to use the vacation home for a week to a charity auction, the donor cannot claim a deduction for the partial interest.

However, there are various exceptions to the inability to deduct a partial interest of real estate. First, a donor may receive an income and gift tax charitable deduction by retaining a life estate in his residence and gifting the remainder interest (one that passes to the beneficiary after the end of an earlier interest in the property) to a charitable organization. A personal residence includes the donor's primary residence, vacation home, condominium or stock in a cooperative apartment. An example would be if a donor retains the right to live in the home during his lifetime and gives his church a remainder interest that begins upon his death. The deduction will be equal to the full fair market value of the remainder interest in the personal residence. This life interest in the property will be difficult for the tenant to sell and the donor and charity will likely both have to agree to any sale.

Second, an undivided part of the entire interest can be deducted, but it must consist of a part of every substantial interest or right the donor owns in the property and must last as long as the interest in the property lasts.

Third, no deduction is allowed for a contribution of a remainder interest in trust unless the trust is structured as a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund.[100]

Finally, a qualified conservation contribution, as discussed in the following section, is deductible.

iii. CONSERVATION EASEMENTS

A qualified conservation easement (QCC) is a legal agreement that permanently limits the use of the land to protect its conservation values. The donor relinquishes some of his rights to the property but may continue to still own and use the land, meanwhile the donor maintains the right to sell or pass the land onto heirs.

To qualify for a conservation contribution under § 170(h), a contribution must meet the following requirements: (1) it must consist of a "qualified real property interest," which may be (i) a remainder interest; (ii) a perpetual restriction on the property's use;[101] or (iii) the donor's entire interest except for a retained interest in subsurface materials;[102] (2) it must be made to a "qualified organization," which may be a publicly supported charity, a government, or an organization controlled by a publicly supported charity or government;[103] and (3) it must be "exclusively for conservation purposes."

Qualifying conservation purposes include: (1) the preservation of land areas for outdoor recreation or education of the general public; (2) the protection of a relatively natural habitat of fish, wildlife, plants, and similar ecosystem; (3) the preservation of open state for either the scenic enjoyment of the general

[99] *See* Rev. Rul. 81-282, 1981-2 CB 78 (stating that gift of voting stock where the donor retains the right to vote is a partial interest); Notice 99-36, 1999-26 IRB 3 (discussing there is no deduction for taxpayer participating in "charitable split-dollar insurance transaction" because it violates the partial-interest rule).
[100] IRC. § 170(f)(2)(A).
[101] Treas. Reg. § 1.170(A)-14(g)(6)(ii).
[102] IRC. § 170(h)(2).
[103] IRC. § 170(h)(3).

public, or pursuant to a clearly delineated governmental conservation policy. The contribution must yield a significant public benefit; or (4) the preservation of a historically important land area or a certified historic structure.[104]

The donor can typically deduct the fair market value of the easement. The value of the easement varies depending upon the restrictions placed on the land, but it can be determined by considering the decrease in the fair market value of the property due to the easement restrictions. Generally, the deduction for QCCs is limited to 50 percent of the donor's adjusted gross income less the deduction for all other charitable contributions.[105] Unused contributions can also be carried over because of the limit. However, for farmers and ranchers, the deduction for QCCs is limited to 100 percent, rather than 50 percent, of the donor's adjusted gross income less the deduction for all other charitable contributions.[106] Nevertheless, if the donated property is used in agriculture or livestock production, the contribution must remain available for such production or the limit is reduced to 50 percent.[107]

VII. ART OBJECTS AND OTHER COLLECTIBLES

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

The term art objects encompasses many different items, including paintings, sculptures, photographs, prints, and drawings. An individual who makes a donation of an art object to a charitable organization will generally receive an income tax charitable deduction. A donor's income tax deduction for a charitable contribution of art is determined by the type of charity or foundation he or she contributes to and the type of contributed property.[108]

A. THE RELATED USE RULE

In addition to determining the value of an art object, determining *how* the charitable organization will use the art object is one of the most common issues in contributing art. This determination is critical because it may alter a donor's potential deduction. The related use rule ensures that charitable organizations use the contributed property rather than selling it immediately after the contribution. The rule applies to all tangible personal property contributed to charitable organizations, including, but not limited to, book collections, jewelry, and most often, art objects.[109]

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[104] IRC. § 170(h).
[105] Publication 526, Special 50% Limit for Qualified Conservation Contributions, *available at* http://www.irs.gov/publications/p526/ar02.html#en_US_2011_publink1000254833.
[106] Publication 526, *supra* note 96.
[107] Publication 526, *supra* note 96.
[108] However, where the donor is also the creator of the art object, the donor's deduction is limited to the cost basis deduction. If the donor already deducted the costs attributable to the creative work as a business expense, the donor may not receive a charitable deduction for the contribution of his or her own art creation. Treas. Reg. § 170A-1(c)(4). This limited deduction also applies where the donor received the property by inter vivos gift from the creator. In contrast, if the donor inherits the art object from the creator, the donor can deduct the full fair market value for a later charitable contribution. Similar rules apply to contributions of taxidermy property. Thus, when the creator of the taxidermy contributes the property, his or her deduction is limited to the lesser of basis or fair market value. Only the cost of preparing, stuffing, and mounting is considered when determining the basis of taxidermy property, the donor may not consider indirect costs, such as traveling. I.R.C. § 1709(e)(1)(B), (f)(15).
[109] A donor may also consider donating a boat, plane or car as a form of tangible personal property. A donor's potential deduction for such contribution depends on whether the charitable organization retains or sells the

Where a donor contributes an art object to a public charity and that organization uses the art for a purpose or function related to its tax-exempt status, the related use rule is satisfied and the donor can deduct the fair market value of the art (assuming the art qualifies as capital gain property). The charitable organization's related use of the art does not have to be immediate to satisfy the related use rule. For instance, if a donor contributes a painting to a museum to put on display and the museum puts the painting in storage rather than immediately on display, the donor may still deduct the fair market value of the art because it was reasonable to anticipate at the time of the contribution that the property would eventually be displayed. If the painting is of a type generally retained by museums for museum purposes, it is generally reasonable for the donor to anticipate that the painting will be put to a related use by the museum unless the donor had actual knowledge that the museum was not going to put the painting to a related use. This is the case even if the museum later sells or exchanges the object. In addition, since very few museums have sufficient space to exhibit all their art at one time, the fact that a donor can anticipate that the gift may be placed in storage part or even most of the time will not cause the value of the gift to be reduced.[110]

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

Whether a charitable organization is using an art object in a manner related to its tax-exempt purpose is not always clear. For instance, if an art object is donated to a university and placed in a library for display and study by art students, the art is used for a related purpose and the donor may deduct the full fair market value of the object.[111] However, if that university sells the art object instead of placing it in the library for display and study, the use of the object is not related to the university's tax-exempt purpose and accordingly, the donor's deduction is reduced. But what happens to the donor's tax deduction if the university places the art object outside of the library for artistic display? There are still many unanswered questions concerning what is a related use. Due to this ambiguity, a donor should determine a charitable organization's potential use of an art object prior to contribution to ensure the donor receives the maximum tax benefits.

A donor may also run afoul of the related use rule if the charitable organization sells, exchanges, or otherwise disposes of the art within three years of the contribution.[112] If this occurs, a donor may protect his or her full fair market value deduction by obtaining certification from the charitable organization stating that the use of the art object prior to sale or exchange was substantial and related to the organization's tax-exempt status. The certification must also specify how the organization used the property and how such use furthered the organization's purpose or function. Alternatively, if the charitable organization did not use the art object for a related use prior to sale or exchange, the donor must obtain certification from the organization stating its intended use of the property at the time of the contribution and why such use became infeasible. Under either circumstance, if the donor obtains the

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property. If the organization retains the boat, plane, or car and uses it to further the organization's tax-exempt purpose, the donor may deduct the fair market value of the property. However, if the organization sells the property immediately after the contribution, deductions in excess of $500 are limited to the gross proceeds the organization receives upon the sale. I.R.C. § 170(f)(12).

[110] Reg. §1.170A-4(b)(3)(ii).

[111] Reg. §1.170A-4(b)(3).

[112] I.R.C. §170(e)(7)(A).

required certification, he or she may receive the maximum fair market value tax deduction for the contribution despite the subsequent sale or exchange.

B. DONATING A FRACTIONAL INTEREST IN TANGIBLE PERSONAL PROPERTY

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

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

Another consequence stemming from a fractional interest contribution is the possibility for recapture. If a donor fails to contribute the remaining interest in the partially contributed property to a charitable organization within 10 years of the initial contribution, the donor's previous tax deduction for the fractional interest contribution may be recaptured.[113] Additionally, if the charitable organization does not maintain substantial physical possession of the property in accordance with the fractional interest contribution or does not use the property for a purpose related to the organization's tax-exempt status, the donor's previous deduction, plus interest and a 10 percent tax penalty for the taxable year, may be recaptured.[114]

VIII. GIFT ACCEPTANCE AGREEMENTS

Oftentimes, a donor may not want to give an unconditional contribution to a charitable organization. Instead, it may be beneficial for the donor to attach strings to the contribution while also obtaining

[113] I.R.C. § 170.
[114] I.R.C. § 170(o)(1).

recognition for his or her generosity. However, charitable organizations often want as much flexibility as possible when determining how to utilize a contribution, and are hesitant about accepting a contribution encumbered with restrictions.[115] Many of the issues surrounding problem gifts may be avoided by entering into a gift acceptance agreement between the donor and the charitable organization. This agreement can outline the terms of a contribution so that the donor and charitable organization may agree on how the contribution will be used. Additionally, these agreements may be used for both cash contributions and contributions of non-cash assets. For instance, if a donor contributes an art object to an organization, a gift acceptance agreement can specify how the organization may use the contribution to ensure the related use rule is satisfied and the donor may receive the maximum tax deduction.

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

An ambiguous gift may arise when the donor and charitable organization have different views on how the organization should utilize the contribution. For example, a college or university may agree to name a building after a donor in return for the donor's contribution. However, the university may plan on placing the donor's name on an older building while the donor assumed his or her name would be on a new building.[116] A gift acceptance agreement may prevent various ambiguities by outlining with specificity the terms of the gift's purposes, describing how to evaluate the effectiveness of the gift, and including a dispute resolution provision. Problems may also arise when donors place too many restrictions on a gift. For example, a donor contributes an art object to a charitable organization on the condition that the art object must remain in the building where it is currently housed and it cannot be moved from the wall in the building where it hangs at the time of the gift. Years after the contribution, if the building containing the contributed art object is torn down, what happens to the contribution?[117] Knowing the charitable organization and preparing for changing circumstances in the gift acceptance agreement may help to avoid these common problems.

Generally, donors contributing larger gifts often request recognition for their contribution. Recognition may include naming something after the donor. Such recognition is often beneficial to the charitable organization as well because it can serve as a method of attracting donations. However, issues with naming rights gifts may arise where the organization names something after the donor, such as a scholarship fund or building, and the donor is later convicted of a serious crime or alleged to have committed a serious crime.[118] Gift acceptance agreements may help charitable organizations avoid this situation through stating circumstances where the name may be removed and what happens to the contribution, while also preparing for changed circumstances such as if the named building is sold or torn down. Large gifts may also lead to problems where there are more assets than necessary to fulfill the

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[115] *See* Richard M. Horwood and John R. Wiktor, "Accentuating the Positive With Gift Agreements," 6(3) Family Foundation Advisor 1 (March/April 2007); *See also* Richard M. Horwood and John R. Wiktor, "Gift Acceptance Agreements: Be Prepared When a Gift Comes with Strings," 1(5) College & University Law Advisor (May/June 2007).
[116] *See* Frank Phillips, "Agganis Pulls $1M Gift Offer to Salem State College on Building Name," The Boston Globe (March 7, 2005).
[117] A similar situation happened to a contribution by William Barnes to the Barnes Family Foundation. Claire Whitaker, "The Barnes Foundation Petitions Court to Move Gallery into Philadelphia," The Kreisberg Group Ltd. (September 24, 2002). A court eventually allowed the art to be moved after long and expensive litigation. *In re Barnes Foundation*, 672 A.2d 1364 (Pa. Super. 1996).
[118] *See* Rob Scherer, "Buildings Donated by "Corrupt" CEOs Face Name Shame." The Christian Science Monitor (October 9, 2002).

intended purpose.[119] Typically, this issue arises where the donor contributes non-cash assets, such as stock, art objects, or real estate, which have the potential to greatly increase in value after the contribution. Donors may plan for these issues through paying attention to the type of asset they are contributing, stating options for excess funds, and focusing on who the contribution is intended to benefit.

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

IX. VALUATION PLANNING OPPORTUNITIES

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

For example, taxpayer makes a gift of a fixed amount of shares in his closely held investment LLC and the assignment provides that shares with a fair market value of a fixed dollar value (i.e. $10,000,000) are to be distributed to a trust for the benefit of his family and any shares with a value in excess of the fixed dollar value are assigned to a specified charity. The charity should be actively involved in the appraisal process. Several courts have upheld defined value clauses over the IRS objections that they do not result from arm's length transactions and are void as against public policy. The recent taxpayer victories using formula allocation clauses include Estate of Petter v. Commissioner, No. 10-71854 (9th Cir. 2011), affd. T.C. Memo. 2009-280 (Dec. 7, 2009), Hendrix v. Commissioner, T.C. Memo. 2011-133 (2011), Estate of Christiansen v. Commissioner, 130 T.C. 1 (2008), affd. 586 F.3d 1061 (8th Cir., 2009), and McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), revg. 120 T.C.358 (2003).

In Hendrix v. Commissioner, T.C. Memo 2011-133 (June 15, 2011), the Tax Court upheld the validity of a defined value clause. Whether the charity is a public charity or a donor advised fund, the result should be the same. If the charity is a private foundation, it is less certain that a court would reach the same conclusion.

X. EXAMPLES

A. TAKING STOCK

Parents want to transfer appreciated publicly-held stock "downstream" to their children and grandchildren. Parents have held the stock for many years and have no desire to sell their interest in the company. Utilizing the discount advantages of a family limited liability company, parents transfer the stock into the LLC and take in exchange the LLC interest.

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

The plan is to then transfer the LLC interest to a trust for the benefit of their descendants and obtain a valuation giving the transferors a discount from the fair market value of the stock. To reduce the incentive for the IRS to challenge the discount, the gift is structured as a formula gift of the LLC interest to take advantage of a string of taxpayer victories where the discounts were respected when formula gifts were used. See Petter in particular. The trustees of the family trust and the charity obtain a valuation to support the allocation of the LLC interest based on the formula. Since the transaction was structured as a formula gift (whereby any increase in value determined by the IRS would increase the gift to a charity), the IRS has little incentive to audit since there would be no additional gift tax resulting from any change in the valuation.

B. MATCHING GIFT

In this example, a family member of client had an accident which resulted in a spinal injury. The rehabilitation took place at a hospital and after many months, the family member was fully recovered. The family now wants to fund the program at the hospital for research regarding spinal injuries. The client wants to fund his gifts to the hospital with gifts of publicly traded stock.

More importantly, the client would like to enhance the gift by creating a matching program for other donors to make gifts to the hospital for the purpose of spinal injury research. The development officers at the hospital need to find donors who will make such gifts that the client will match dollar for dollar.

It is important to have a gift acceptance agreement to set forth the various terms of the matching gift. For example, what if the matching funds fall short?; what if part of the program will be eliminated?; and what determines the time frame in which the matching gifts must be obtained? Lastly, if the hospital discontinues the program – do funds from donors stay with the hospital or go to the program at another hospital with a similar mission? This *cy pres* issue can be very important.

The benefits of the matching gift are several fold. The client has a significant involvement in the program, a current charitable deduction against income tax, and has leveraged the gift through the matching program. Matching gifts in an extended family setting are also attractive. Assume the family would like to involve relatives rather than going to other non-family donors. As a result, the extended family as a unit was able to fund the program without outside help. Working together on the funding was a worthwhile experience to keep the family engaged and involved with one another.

C. FAMILY BUSINESS FOR SALE

In this example, the owners of the business plan to sell it at a substantial gain. A portion of the business interests are transferred to a family limited liability company before the transaction is fully set. If the parents transfer units in the newly formed family limited liability company with a fix value to trusts for their children and grandchildren (which are grantor trusts for income tax purposes) as a gift with the excess value passing to a donor advised fund. It is anticipated that the transfer will result in 10% of the transferred LLC units to pass to the donor advised fund. The trusts and the donor advised fund obtain a valuation for are involved in the valuation of the LLC units.

After the transfer to the family LLC and the transfer of the units to the trust and donor advised fund, the business is sold with the lion's share of the proceeds to the family.

As a result, the appreciation in value transferred to the trusts is outside the estates of the parents/owners. All capital gains are avoided on the portion transferred to the DAF.

The use of the donor advised fund allows the family to take the income tax deduction in the year of sale, but to contribute those funds to charities in future years, rather than using a public charity where the income tax deduction would be taken in the year the gift is made to the charity. This transaction was structured to take advantage of the McCord case decision.

D. "CASH COW" REAL ESTATE

A real estate investor has an apartment building that generates significant cash flow, which she owns debt-free. She comes in for planning advice. Her goal is to transfer the real estate to her children and grandchildren at the lowest possible transfer tax cost.

The client is questioned as to whether she has an interest in any specific charity and she does identify one with respect to which she has a significant interest.

A plan is adopted whereby a family LLC is used with a charity through a formula gift. In this case, there is no intention of selling the apartment building, but rather a plan is to retain the building to reap the benefits of the cash flow. The charity is consulted and is content with a continuing ownership interest since there will be significant cash flow. Also, because the apartment building creates "rental income", that income is not an unrelated business taxable income (UBTI) for purposes of a charity.

It is important to note that this approach would not work if the apartment building was owned in an S corporation and if the property is debt financed, complications can arise.

E. RESIDENCE WITH SUBSTANTIAL ACREAGE

Client has a residence with substantial land and gardens surrounding the estate. She wants the residence to remain in the family and wants to donate the surrounding land and gardens to a university. She is currently in her eighties. She has had discussions with a university about funding building a music auditorium in her name but does not want to part with the surrounding land and gardens until her death. The challenge is to combine her desire to fund the auditorium building and to retain the surrounding acreage until her death, while giving the family the option to retain the residence.

After considering various alternatives, a plan was developed whereby the university would borrow funds to build the music auditorium currently and the client would commit to annual charitable contributions in cash to cover the interest cost of the borrowing. Inspired by the generous gift, various members of the donor's family have agreed to collectively sponsor a concert series in the auditorium upon its completion. At death, the surrounding acreage will be sold, the funds distributed to the university and the university will be able to pay off the loan.

As a result of the planning, the client gets to enjoy both her residence and the recognition bestowed upon her through the music auditorium built in her honor. In addition, other family members are participating in the project and have the option to retain the residence after her death.

F. SENIOR PUZZLE

A client in his eighties with substantial wealth wants to review his estate planning. He would like to provide that at least 10% of his wealth, either currently or at death, is provided to charitable causes but also wishes to reduce his family's estate tax burden upon his death. He has business interests, substantial investments in commercial real estate, two residences, a substantial art collection, an IRA and life insurance. The challenge is to provide a plan to permit charitable giving and also to reduce the estate tax burden on his death.

During lifetime, the commercial real estate and investment portfolio are attractive for making discounted gifts in trust to his family members. One attractive approach is using formula clauses to reduce valuation risk. Using the techniques in Petter and Hendrix, the client can transfer property with a certain formula value to family members in trust with the excess value going to the charity. The use of a charitable beneficiary in this manner (a public charity or a donor-advised fund, for example) can reduce the risk on estate or gift tax audits since the IRS will not obtain any additional tax if the valuation is increased.

An attractive option for charitable planning is the client's life insurance. If the life insurance is "paid up", there is no need for a continuing funding. The life insurance can be transferred to a charity to cover a campaign pledge, for example. Depending upon the life expectancy of the donor, the charity might consider the face value of a life insurance policy to be credited to the donor for donor recognition purposes.

On death, all of the assets including the IRA and the art collection are options. The IRA is particularly attractive for charitable giving because both estate and income taxes are avoided. The charity winds up with the full value undiminished by any tax costs. The art collection is also an attractive item to use for charitable donations on death to the extent that family members do not desire to keep the objects. Since the transfers will be made on death, the "related use" rules discussed above are not relevant since those rules apply to the income tax deduction, not the estate tax deduction.

Another testamentary planning technique is the use of disclaimers to charity. For example, the client can provide in his estate plan documents that each of his two children receive assets from the estate, but permit the children individually to disclaim all or part of their bequest to a charitable foundation to be set up for their specific families. This provides each child with a 9-month "look back" for them to determine whether or not they want assets to bypass their estates. An advantage of this technique is that the children can review their particular situation at that time and also take into account their estate tax situation at that time. Note, however, that while the disclaimer by the child will fund a charity or a foundation, there will not be any income tax deduction to the beneficiaries, only an avoidance of estate tax on the father's death.

As a result of permitting each family member to disclaim in favor of a charitable foundation to be set up by that branch of the family, the parents are encouraging charitable giving and also allowing the children to individually decide whether to fund the foundation and in what amount. Also because no one knows what the estate tax may be at that time and the children do not know their financial circumstances at that time, the decision can be deferred until the death of the parents when a more accurate assessment can be made by each of them.

XI. CONCLUSION

Non-cash contributions are on the rise. This is attributable to the condition of many donors: cash-strapped but rich in non-cash assets. Additionally, non-cash assets provide numerous tax exemptions and deductions that are not available to donations of cash assets. In light of these advantages, the landscape of charitable donations is rapidly evolving.

Donors and charitable organizations need to be cognizant of the tax issues that may arise with the contribution of non-cash assets. Donors looking to diversify their forms of charitable contributions should consult an expert before donating. Charitable organizations should solicit non-cash giving armed with the knowledge that will help to unlock donors' non-cash treasure chests.