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In this issue:

- Tax rate for long-term capital gains on tangible personal property
- The ordinary-income reduction rule
- The related-use rule: a potential pitfall
- Gifts of undivided interests

Charitable Gifts of Tangible Personal Property

Charitable gifts of tangible personal property — i.e., physical, "touchable" assets such as antiques, artwork, precious gems and coins — are subject to valuation and deduction rules that may affect their suitability for charitable giving. In this issue, we review important considerations applicable to charitable gifts of tangible personal property (TPP), including opportunities for your clients and potential pitfalls that you should help them to avoid. This issue should be particularly relevant due to stricter rules introduced by the Pension Protection Act of 2006.

I. 28 Percent Income Tax Rate Applies to Long-Term Capital Gains on Tangible Personal Property

The Tax Increase Prevention and Reconciliation Act (signed into law on May 17, 2006) extended the current law's top tax rate on net long-term capital gains at 15 percent for most types of capital assets. This 15 percent rate is in effect through December 31, 2010. However, there are exceptions, including one concerning the tax rate for TPP. Gain on the sale of appreciated, long-term TPP remains subject to a tax rate of 28 percent — the rate for long-term gain on most types of capital assets before enactment of the Tax Relief Act of 1997.

While the 28 percent rate makes appreciated TPP a less attractive option than other capital assets to sell from a tax liability standpoint, the 28 percent rate conversely makes TPP a better choice for charitable giving than a similarly situated intangible personal asset such as a stock or shares in a mutual fund. More capital gains tax can be avoided when clients make a gift of the TPP in lieu of another capital asset that is subject to a 15 percent top tax rate on the long-term capital gain. Consider the following illustration:

	XYZ Stock	TPP Item
Fair Market Value	$ 50,000	$ 50,000
Cost Basis	–15,000	–15,000
Net Long-term Capital Gain	35,000	35,000
Capital Gains Tax	$ 5,250	$ 9,800

Like the gift of XYZ Stock, the gift of TPP can generate a charitable deduction of $50,000 (subject to important qualifications we will discuss shortly), but the TPP is the gift property of choice because $4,550 of "extra" capital gains tax can be avoided by donating the TPP rather than the XYZ Stock.

II. Ordinary-Income Reduction Rule May Decrease Charitable Deduction

A gift of appreciated TPP to charity generally is deductible at its fair market value (subject to the overall 30-percent-of-AGI limitation), provided the property has been held long-term. The amount of the deduction, however, must be reduced by any gain that would have been ordinary income or short-term capital gain if the property had been sold for its fair market value on the date of the gift [IRC §170(e)(1)]. Assets subject to this reduction include:

- Appreciated property held for sale in the ordinary course of the donor's trade or business (e.g., a manufacturer's inventory, a dealer's stock-in-trade, artworks or manuscripts created by the donor);
- Appreciated property subject to recapture;
- Appreciated short-term capital assets; and
- Certain kinds of appreciated stock, the gain on which would not be long-term capital gain if the stock were sold.

III. Exceptions for Certain Types of Inventory

Contributions to Benefit the Ill, Needy or Infants

Contributions of inventory by C Corporations to public (qualified) charities are reduced by only one-half of the amount that would have been ordinary income upon a sale when such inventory is used for the care of the ill, needy or infants [IRC §170(e)(3)]. The limit on the donor's deduction is the property's tax basis plus one-half of the appreciation, though only up to a limit of twice the property's basis. The meaning of "care of the ill, needy or infants" is defined in Reg. §1.170A-4A(b)(2)(ii).

Scientific Research Equipment

A corporate donor (though not an S corporation, personal holding company or service organization) who contributes newly manufactured scientific equipment to a college, university or scientific research organization for use in research, experimentation or research training may claim an income tax charitable deduction equal to its tax basis plus one-half of the appreciation in the property [IRC §170(e)(4)]. Like the contributions of inventory by a C corporation noted above, the limit on the donor's deduction is the property's tax basis plus one-half of the appreciation, though only up to a limit of twice the property's basis. The corporate donor should secure written confirmation from the charity as to the planned use of the donated equipment.

Food Inventory

The Katrina Emergency Tax Relief Act of 2005 included a provision that extended the enhanced deduction that C corporations enjoy for gifts of inventory to all entities engaged in a trade or a business in regard to food inventory. Recently, the Pension Protection Act of 2006 extended the food inventory deduction through the end of 2007. However, the total amount of the deduction is limited to 10 percent of the taxpayer's net income from all sole proprietorships, corporations, or partnerships from which contributions of "apparently wholesome food" are made.

Book Inventory

Similar to food inventory, the Katrina Emergency Tax Relief Act of 2005 (and extended by the Pension Protection Act) included a provision to permit C corporations the same enhanced deduction for gifts of book inventory to elementary and secondary public schools effective for contributions made after August 28, 2005 and through the end of 2007.

IV. Contributions of Used Motor Vehicles, Boats and Airplanes

In response to perceived abuses in the gifting of used vehicles (inflated values that donors deducted compared to what the charity actually realized on selling the vehicle) Congress enacted IRC §170(f)(12) as part of the American Jobs Creation Act of 2004. Under the new rules, for gifts over $500, the amount of the taxpayer's deduction is limited to the gross proceeds received by the charity upon sale of the vehicle. Furthermore, in order to reflect fair market value it had to be in an arm's length transaction between unrelated parties. The donor completes Form 8283 detailing the information on the value of the contributed vehicle to be filed with the tax return. In the event the charity disposes of the vehicle within three years of its contribution, the charity needs to complete Form 8282. Note there are exceptions to limiting the deduction to the gross proceeds (i.e. a donor may deduct the fair market value even if the vehicle is sold for less than that fair market value to a needy individual in direct furtherance of the organization's charitable purpose of relieving the poor, distressed or underprivileged in need of transportation).

V. The Related-Use Rule: A Potential Pitfall for Your Clients

The deduction for a gift of appreciated TPP may also be reduced by the gain that would have been long-term capital gain had the property been sold at its fair market value on the date of the gift. This reduction is triggered when the charity's use of the donated TPP is unrelated to the charitable purpose or function for which the charity was awarded its tax-exempt 501(c)(3) status [IRC §170(e)(1)(B)(i)].

If a collection has been donated to charity, the charity's related use of the gift will not be undermined if the charity sells or otherwise disposes of an "insubstantial part" of the collection [Reg. §1.170A-4(b)(3)(i)].

Many donors are surprised to learn that they bear the burden of determining whether the charity will put the TPP to a related or unrelated use. A donor may treat the TPP as having been put to a related use if:

- The donor determines that the charity has not in fact put the TPP to an unrelated use, or
- At the time of the gift, the donor could reasonably anticipate that the property would not be put to an unrelated use by the charitable donee [Reg. §1.170A-4(b)(3)(ii)].

The donor should obtain written confirmation of the charity's related-use plans for the property in advance of making a TPP gift.

"Related Use" Is Not Always Clear

A "related use" may be found to exist even when it is not apparent upon cursory examination. The IRS ruled that etchings of wildlife donated to a state and displayed to the public in state office buildings qualified as a related use [Ltr. Rul. 8301056]. The donation of a stamp collection to a university was ruled a related use when the collection was displayed in the university's art gallery and was used by the university's art students [Ltr. Rul. 8208059]. The donation of porcelain art objects to a not-for-profit retirement home was ruled a related use because the donated objects improved the quality of the residents' living environment [Ltr. Rul. 8143029; see also Ltr. Rul. 8247062]. But the donation of a horse to a cancer charity was not a related use, and the donor's deduction was reduced by the "built-in" long-term capital gain in the horse [Coleman v. Comm'r, T.C. Memo 1988-538].

VI. Recapture of Tax Benefit on Property Not Used for Exempt Purpose

The Pension Protection Act of 2006 included new rules regarding gifts of TPP for which a donor has taken a charitable deduction at fair market value based on its related use. If the donee charity disposes of the property within three years of its contribution, the donor must adjust his claimed tax benefit as follows:

- If the charity disposes of the property in the same tax year as the contribution, the donor may only claim his or her basis in the property, not the fair market value.
- If the charity disposes of the property in year two or three after the year of the contribution, the donor must include as ordinary income an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed as a charitable contribution with respect to such property over (ii) the donor's basis in such property at the time of the contribution.

This recapture provision applies to deductions of more than $5,000.

There is a safe harbor provided for donors if a charity provides a certified writing to show either that the property was properly used, or that a related use was contemplated at the time the gift was made, but that later circumstances made the intended use impossible or infeasible to implement.

New penalties are imposed for any person that identifies property as having a related use knowing that it is not intended for such use.

Note that the charity reporting requirements for the sale of contributed property have been extended from two years to three years.

VII. No Current Deduction for Gift of Future Interest in Tangible Personal Property

No income tax charitable deduction is allowed at the time of the gift for a gift of a future interest in TPP. For example, if the owner of a valuable artwork donates it to charity but retains the right to possess and enjoy the artwork for the rest of his or her life, no deduction arises at the time the remainder rights are assigned to charity (plus, the partial interest rule of IRC §170(f)(3)(A) may also be violated). However, an income tax charitable deduction may be allowed (subject to other limitations on the charitable deduction, including the partial interest rule) when all intervening rights have expired or passed to a person other than the donor or someone closely related to the donor [IRC §170(a)(3)].

There is no similar restriction for federal estate and gift tax purposes. However, a partial-interest gift or bequest generally must be made in the form of a charitable remainder trust to be gift or estate tax deductible [IRC §§2522(c)(2)(A), 2055(e)(2)(A)]. A gift or bequest of TPP to these charitable vehicles is generally appropriate only when the trustee plans to sell the property, because the donor's deduction is postponed until the TPP is sold [see Ltr. Rul. 9452026].

VIII. Gifts of Undivided Interests

Tax law generally denies a charitable deduction for gifts of partial interests [IRC §170(f)(3)(A)], with certain important exceptions. One such exception is for gifts of an "undivided portion of a taxpayer's entire interest in property" [IRC §170(f)(3)(B)(ii)]. The interest donated to charity must consist of a portion of each and every substantial right or interest owned by the donor, and it must extend over the entire period of the donor's interest [Reg. §1.170A-7(b)(1)(i)].

In the case of TPP, the undivided interest is often a fractional interest in art objects, which may be expressed as a number of months per year. For example, a donor might donate to a university the right to exhibit a painting for six months each year, or perhaps for that portion of the year which coincides with the academic year [see Ltr. Rul. 9303007]. The donor reserves the right to possess and enjoy the painting during the balance of the year.

Thus, while a donor cannot currently deduct a gift of a future interest in TPP, he or she can "time-share" TPP with a charity and secure a current deduction. However, the value of the charity's interest may have to be discounted because it represents only a partial interest in the property [see Rev. Rul. 87-37, 1987-1 C.B. 295; Estate of Fawcett v. Comm'r, 64 T.C. 889 (1975)].

The Pension Protection Act of 2006 has further restricted the gift of an undivided interest in TPP.

- Under the new law, the entire interest in the property must be transferred to the charity within ten years of the initial fractional contribution, or upon the donor's death (whichever event is earlier).
- If the charity fails to take physical possession during the period described or fails to use the property for an exempt use, all prior charitable income and gift tax deductions claimed by the donor will be recaptured, plus interest plus an additional tax of 10 percent.
- Subsequent contributions of an undivided interest in the property will be limited to the lesser of either the initial value used as the fair market value, or fair market value at the time of the later contribution. This limit applies to income, gift and estate taxes. Note that this limit could create an unwelcome result in the form of additional estate taxes should the donor die within ten years from the initial fractional gift without gifting the entire interest in that property.

New Tax Developments

The IRS recently published two separate Notices seeking comments pursuant to new requirements under the Pension Protection Act of 2006.

Notice 2007-21 seeks comment on an ongoing study concerning Donor Advised Funds and outlines specific questions including:

- What are the advantages and disadvantages of donor advised funds and supporting organizations to the charitable sector, donors, sponsoring organizations, and supported organizations, compared to private foundations and other charitable giving arrangements?
- How will new excess benefit restrictions change the practices and behavior of donors, donor advised funds, sponsoring organizations, supporting organizations and supported organizations?
- Should there be any reduction in the deduction depending on donor control over the assets contributed to the donor advised fund or the type of asset donated?
- What would be appropriate payout requirements for a donor advised fund?
- What are the advantages and disadvantages of perpetual existence of donor advised funds or supporting organizations?

Notice 2007-24 seeks comment on draft forms that address a reporting requirement for charities and certain other entities with respect to certain structured insurance contracts. The reporting requirements cover those organizations which acquire an applicable insurance contract in a reportable acquisition after August 17, 2006, but on or before August 17, 2008. An applicable insurance contract is any life insurance, annuity, or endowment contract in which both an applicable exempt organization and a person other than an applicable exempt organization have directly or indirectly held an interest (whether or not at the same time).

Notice 2007-21, 2007-9 IRB 1; Notice 2007-24, 2007-12 IRB 1

2006 Art Advisory Panel Publishes its Annual Summary Report

The Art Advisory Panel meets every year to determine the correct valuation of art objects as both charitable contributions and estate assets. The Annual Summary Report describes the closed meeting activity of the panel. The report outlines the procedures of the Art Advisory Panel, provides a list of panelists and summarizes the art items reviewed during the year by the panel broken down by estate and charitable contribution.

For 2006, the panel reviewed 1638 items with an aggregate taxpayer valuation of $219,199,100 on 124 taxpayer cases under consideration. The claimed value of the average charitable contribution item was $124,250 and the average estate and gift item was $134,122. The panel recommended total adjustments of $126,535,800. On the adjusted items, the panel recommended adjustments amounting to a 57 percent reduction on the overvalued items in charitable contribution claims and a 95 percent increase on the undervalued items in estate and gift appraisals. Adjustments were recommended on 61 percent of the reviewed appraisals.

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