



TECHNIQUES

Reconsidering Property Gifts in Light of Recent Tax Law Changes

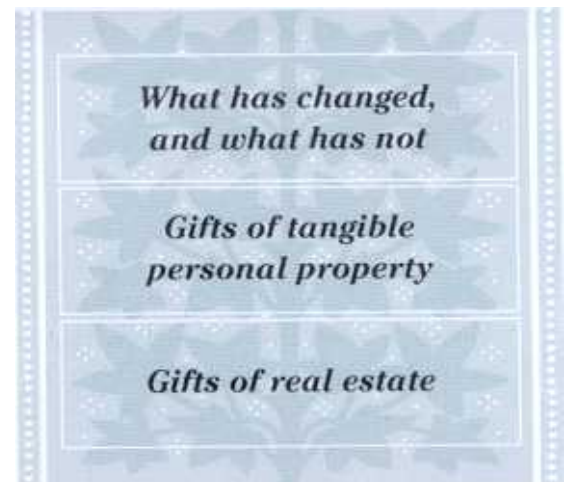
INTRODUCTION

Many donors give to charitable organizations simply by writing checks. In addition to the element of simplicity, cash gifts enjoy the most generous deductibility ceiling. A cash gift made to a qualified (public) charity may be deducted up to 50 percent of the donor's adjusted gross income (AGI) for the year of the gift, with a five-year carryover of any excess that is not deductible in the current tax year.

However, charitable gifts of appreciated property held long-term are also popular, even though they are subject to a lower deductibility ceiling: 30-percent-of-AGI, with a five-year carryover of any excess deduction. The traditional attraction of giving long-term appreciated property has been that the donor secures not only a charitable deduction for the fair market value of the property (if the gift is outright), but also avoids a current capital gains tax on the paper profit. In other words, the donor can deduct the property appreciation that has never been taxed.

Moreover, a donor of long-term appreciated property can make the so-called "step-down" election that reduces the amount of the contribution to the taxpayer's basis, but secures the 50-percent-of-AGI ceiling for the gift. The step-down election may make sense when a donor needs a larger deduction in the year of the gift.

The tried and true ways of giving to a charity remain the same. However, recent federal tax legislation gives us a reason to reconsider gifts of property. The change in capital gains taxes and dividend taxation may make a difference to your clients in what part of their portfolio they consider for a charitable gift.



WHAT HAS CHANGED FOR CERTAIN PROPERTY GIFTS

As noted above, appreciated property has traditionally been a popular choice for charitable giving. However, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (or JGTRRA) may have dimmed the appeal of giving appreciated property. One reason is that the top tax rate on net long-term capital gains has been reduced from 20 percent to 15 percent for most appreciated capital assets and for most taxpayers. Lower capital gains taxes upon a sale of appreciated assets may reduce a potential donor's incentive to contribute these assets to charity.

Another reason is the 15 percent top tax rate that applies to "qualified dividends," which include most dividends paid by domestic corporations and mutual funds. Qualified dividends are now subject to the same 15 percent top rate that applies to net long-term capital gains. As a result, some investors have rebalanced their portfolios to reduce their holdings of growth stocks and to increase their holdings of income stocks. Thus, individuals may be

holding fewer appreciated stocks, or stock with less appreciation potential, than in the past.

Though we all believe that charitable gifts are guided by higher notions of philanthropy and “giving back,” we know that taxpayers are economic actors who respond to tax incentives and disincentives.

WHAT HAS NOT CHANGED

Not all sales of property receive the favorable capital gains treatment introduced in JGTRRA. Gain on the sale of collectibles is still taxed at rates up to 28 percent. Collectibles are defined as any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage or any other tangible personal property specified by the IRS for this purpose and held for more than one year [IRC §408(m)]. Also, the net long-term capital gain attributable to the recapture of accelerated real estate depreciation (Section 1250) is taxed at rates up to 25 percent. The balance of these gains (over and above the recapture) is taxed at a top rate of 15 percent, for sales on and after May 6, 2003 and before January 1, 2009 (if the property was placed in service before 1987, some ordinary income may be recaptured if accelerated depreciation was taken on the property.)

Since the gain from the sale of collectibles and the gain attributable to Section 1250 property receive less favorable tax treatment than gain from other types of appreciated property, these two types of property gifts may still help your clients to reduce significantly their capital gains taxes.

Real Property Gifts

Since the fair market value of real property has grown enormously in many markets, a charitable gift of real estate is an attractive possibility. High real estate values *may generate a charitable deduction that is a multiple of the donor's original investment in the property.* If a portion of the capital gains attributable to Section 1250 property would be taxed at 25 percent, the donor has even more tax incentive to use the property to meet philanthropic objectives. Note, however, that the amount of the contribution must be reduced by any ordinary income that would have been recaptured if the property had been sold [IRC § 170 (e)(1)].

The charitable giving option must be considered in concert with other provisions of the tax code in mind. For example, if the proposed gift property is a donor's principal residence, the donor could potentially sell the property and take the exclusion allowed for gain on a principal residence (up to \$500,000 on a joint return.) Thus, the residential property may be a less suitable option for charitable giving than other real estate that does not enjoy the exclusion.

A taxpayer may make a gift of mortgaged property outright to a charitable organization (though some charities refuse to accept any gift of mortgaged property.) If the charity agrees to assume the mortgage debt, the gift is considered a “bargain sale.” The contribution is the fair market value of the real estate minus the mortgage debt (even if the charity agrees to take the property subject to the debt). To determine whether there is an allowable deduction for the contributed portion, and the amount of any such deduction, the value of the contributed portion must be reduced by any gain that would not have been long-term capital gain had the contributed portion been sold, taking into account the basis allocated to it [IRC §170(e)(1)(A)]. A partial deduction for the remainder interest portion of each mortgage payment may be possible if the donor agrees to make direct mortgage payments (principal and interest) to the debt-holder. However, a cleaner transaction is for the donor to make cash gifts to the charity and the charity uses the cash to pay the mortgage.

Other Types of Real Estate Gifts

In addition to commercial property subject to Section 1250 gain, other types of property may be suitable for charitable giving.

Tangible Personal Property Gifts (Collectibles)

If the item has been held long-term, the amount of the contribution depends on the “related use” rules: If the donated collectible is related to the charity's exempt purpose, then the amount of the contribution is the fair market value of the item. If the collectible is not related to the charity's exempt purpose, then the amount of the contribution is reduced to the taxpayer's cost basis.

The deduction in the year of the gift may be less than the amount of the contribution, of course, if the 30-percent-of-AGI limitation for gifts of long-term appreciated property comes into play. Any excess contribution that is not deductible currently may be carried over and deducted in up to five subsequent years (subject, again, to the percentage limitations in those years). A donor may elect to “step down” the amount of the contribution to the basis of the asset in order to apply the 50-percent-of-AGI limitation in calculating the deduction.

Gifts of collectibles valued at more than \$5,000 have to be supported by a “qualified appraisal.” Appraisal fees cannot be included in the value of the gift; however, such fees may be deductible as a miscellaneous itemized deduction (subject to the 2 percent floor), since the fees were an expense incurred to compute tax liability.

Reconsidering Property Gifts in Light of Recent Tax Law Changes

Vacation property: Charitably minded clients may donate a summer home that they no longer visit, or costs too much to maintain. Unlike the \$500,000 exclusion (joint return) for capital gains realized on a sale of principal residence, all the gain from a vacation home may be subject to the 15 percent tax rate. The lack of an exclusion may make a charitable gift more attractive.

Gift of an undivided portion of interest: Gifts of partial interests are usually non-deductible [IRC §170(f)(3)]. However, a gift of an “undivided portion” of the donor’s interest is an exception [IRC §170(f)(3)(B)(ii)]. An undivided interest consists of a fraction or percentage of every substantial right that the donor has in the property. A gift of this type of interest is deductible for income, gift and estate tax purposes. The gift must be consistent with the entire interest the donor owns, and should carry all proportional rights of use and possession.

Outright Gift of Remainder Interest in Personal Residence or Farm

Another popular way to make a gift of real estate is the outright gift of an irrevocable remainder interest in a personal residence or a farm. The taxpayer continues to enjoy the use of the property. The taxpayer may claim a charitable income tax deduction for the property’s value as discounted by his retained life estate [IRC §170(f)(3)(B)(ii)]. To determine whether the property qualifies as a personal residence or farm, state law controls. The gift is preferred by older individuals that reasonably expect to live in the house until death. The donor (usually) continues to pay for the maintenance and care of the property – taxes, insurance, repairs to the property, homeowner association fees, etc. In the event that the donor no longer wishes to remain in the home, he or she may choose to rent the property, or make a subsequent charitable gift of the remaining life estate.

Gifts of real estate can be complex transactions that require significant effort on the part of the donor and charity to work out proper valuation and exchange. There are several stages to the sale or transfer of real estate, including a qualified appraisal and environmental review. However, if your client is interested in obtaining a charitable tax deduction and avoiding capital gains taxes on the sale of real property, the savings may be worth the effort.

Taxation of Property Not Held for the Long Term

Though not nearly as advantageous as a gift of property held long-term, a gift of property held short term (less than one year) can also provide an option for the taxpayer.

Recent Legislative Changes

Concerning Donation of Property Gifts

The American Jobs Creation Act of 2004, signed into law on October 22, 2004, made several important changes with respect to charitable gifts of patents, copyrights and vehicles.

Patents: For gifts of patents made after June 3, 2004, the amount of the contribution is limited to the lesser of the taxpayer’s basis in the donated property or the fair market value – even though patents are capital assets. The taxpayer can also claim deductions for income earned by the charity on the patent over the course of ten years (though the deduction for this income is reduced after the initial two years by ten percent per year — 90% to 80% to 70%, etc.).

Copyrights: For gifts of copyrights made after June 3, 2004, the amount of the contribution is limited to the lesser of the fair market value or the taxpayer’s basis, whether or not the copyright is a capital asset in the donor’s hands (which is the case for copyright owners who received the copyright by inheritance or purchase). As with patents, the taxpayer may deduct the income earned by the charity on the copyright over the following ten years with a 10% reduction in each year after the initial two years.

Vehicles: Beginning January 1, 2005, charitable contributions for vehicle donations will be limited to the lesser of the fair market value or the amount realized upon the sale of the vehicle if the charity does not retain the vehicle for its own use.

The amount of the contribution is the lesser of the property’s fair market value or the donor’s basis. Therefore, the potential deduction is usually much less than for a comparable asset held long-term, but the high capital gains taxation is avoided. However, the applicable tax rate (equal to ordinary income tax rates) on the gain is potentially high for a taxpayer and a donation of that property held in the short term would avoid that capital gains tax.

Don’t Forget the Sunset Provision

Keep in mind that the 15 percent top tax rate on qualified dividends and most long-term capital gains will expire after December 31, 2008 (unless Congress extends these tax rates). However, your clients should adapt their giving strategies to the new tax realities during this brief window of time. These approaches may still be useful even after 2008 (we’ll see what Congress does next).

New Planned Giving Model — Donor Managed Investment Account (DMIA)

The IRS recently issued a Private Letter Ruling which approved a new method of charitable giving that permits the donor to invest irrevocably donated funds for up to ten years after making the gift. In a DMIA, the donor retains no interest or right in the gifted funds except for a limited power to manage the funds. The charity owns the account and has the option of withdrawing any or all the assets at any time. The donor is prohibited from any self-dealing between his fund and his other interests. There is an outright prohibition on investment in companies in which the donor owns 5% or more of the outstanding shares of stock. Furthermore, the proposed terms for this plan would limit the investment of DMIA funds to U.S. equities, U.S. mutual funds, U.S. closed-end funds, U.S. fixed income securities, off-shore or on-shore hedge funds, REITs, and private placements.

Winklevoss Consultants of Greenwich, CT invented the DMIA planned giving model (patent pending) and expects to license and administer the DMIA on

behalf of qualified non-profit organizations.

The Private Letter Ruling indicates the IRS willingness to allow donors new avenues to presume some control over the financial investment of donated funds; first, the donor advised fund (DAF), the constant favorite for donors with a high estimation of their investment abilities, and, now, the DMIA. However, the IRS will continue to reserve judgment on each proposed DMIA: the IRS will look to the terms of each DMIA to determine whether its terms are acceptable control factors or unacceptable material restriction factors. See Reg. § 1507-2(a)(8)(i)

Source: PLR 200445024, PLR 200445023

Early Termination of CRT

In a recent Private Letter Ruling, the IRS permitted the termination of a charitable remainder unitrust (CRUT) without reversing its tax-exempt status. The donor created a CRUT with a 5% payout of the net fair market value of the trust assets as valued on January 1st of each year. In addition,

the trust terms included a net-income with make-up provision. A primary beneficiary was to receive the distributions from the trust until her death. Following the death of the primary beneficiary, two contingent beneficiaries would share the payout until their deaths. The IRS noted that the critical question is whether early termination may be expected to result in greater allocation of the grantor's assets to the income beneficiary to the detriment of the charitable beneficiaries. After considering the affidavit signed by each contingent beneficiary to state that neither was in poor health, the analyst determined that the proposed distribution of the trust assets between both the non-charitable and charitable beneficiaries was sound.

The private letter ruling is the latest in which the IRS has permitted the early termination of CRTs. Perhaps the IRS will include some provision addressing the problem of a severely under-performing CRUT in its model CRUT Agreement (the IRS recently indicated that issuing model CRUT agreements was a priority for 2005.)

Source: PLR 200408031

This newsletter is for information and discussion purposes only. Each professional must evaluate the tax and financial consequences of each individual situation. The topics covered in this newsletter are discussed in more detail in our booklet, a copy of which you can receive simply by returning the enclosed card.



Santa Barbara County's
United Way

Network for Caring

You & I... helping local people as no one else can

www.unitedwaysb.org

Judy Goodbody, CFRE, CRTP
Gift Planning Services Officer

320 East Gutierrez Street

Santa Barbara, CA 93101

Tel 805/965-8591, ext. 120

Fax 805/962-3461

jgoodbody@unitedwaysb.org

www.unitedwaysb.org/endowment.html

