Maximizing a Charitable Gift: Donations of Non-Cash Assets

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Charitable gifts of non-cash assets have become an attractive option for donors. Such gifts offer advantages to donors and can be the basis of important estate planning techniques. But if not properly structured a non-cash gift may not meet its full potential. Taxpayers and their advisors must consider the tax code’s classification of the charity, the type of asset to be gifted, and the charity’s ultimate use of the gift.

Introduction

Income tax savings continue to act as a stimulus for charitable giving. However, as the overall percentage that is gifted annually to charity continues to rise, donors, advisors, and charitable organizations are each exploring alternative methods to structure charitable gifts with assets other than cash. In that regard, more donors desire to make charitable gifts of alternative assets from their investment portfolios, and charitable organizations are increasingly accepting these gifts.

It is easy to see why charitable gifts of non-cash assets have become such an attractive option. In today’s world cash gifts, whether current or deferred, are becoming harder to accomplish. Therefore, donors are looking for alternative ways to benefit their favorite charities. For example, it is estimated that real estate assets comprise over 35 percent of the assets of U.S. households. Because of this, real estate can provide attractive advantages to both the donor and the charitable organization. A donor who owns real estate with a large built-in gain may be able to avoid realization of the gain by contributing the real estate to charity, yet still receive a fair market value income tax deduction. Further, by gifting real estate to charity, the donor’s cash flow will likely not be impacted in a negative way. In fact, if properly structured, the donor’s cash flow may actually be increased by a gift of real estate to charity.

The question for the charity is “Why alternative assets?” For example, it used to be that a gift of real estate was one of the toughest for a charity to

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deal with, and many charities would not accept real estate gifts. However, most charities have come to the realization that some donors may be cash strapped but rich in other assets. Because of this, charities have become more sophisticated in dealing with non-cash gifts and are no longer afraid of them. As a result, their endowments and operating funds are growing.

Despite the increase in non-cash charitable gifts and the increased sophistication of charities, making and accepting non-cash gifts may still be a risky process. Unless structured properly and with full knowledge of the relevant tax laws, the non-cash gift may not meet its full potential.

**Type of Charitable Organization Receiving Gift**

An individual who makes a non-cash donation to a charitable organization will generally receive an income tax charitable deduction. The calculation of the deduction involves many rules, and several limitations must be considered. First and foremost, prior to making the gift, the donor should be aware of the type of charitable organization to which the gift is being made.

Not all charitable organizations are created equal. As required by the Internal Revenue Code, the IRS distinguishes between so-called 50 percent charities and 30 percent charities. This distinction is important because it sets the ceiling for the donor’s available income tax deduction, which is a percentage of the donor’s contribution base. In most instances, a contribution to a 50 percent charity will generate a higher income tax deduction ceiling than a contribution to a 30 percent charity.

A charitable organization that is publicly supported is generally a 50 percent charity. Such organizations meet the “public support test” because they receive a significant amount of their contributions from the general public. Some of the most recognizable charities (such as the Red Cross, Salvation Army, and Habitat for Humanity) are publicly supported. In addition to publicly supported charities, 50 percent charities include churches, schools, hospitals, governmental units, and certain types of private foundations, such as “operating foundations,” “pass-through foundations,” and “pooled-fund foundations.”

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1. See IRC § 170(b)(1); IRS Pub. 78, Cumulative List of Organizations.
2. The contribution base means an individual’s adjusted gross income, disregarding any net operating loss carryback to the current taxable year.
3. When there are contributions to both 50 percent organizations and 30 percent organizations, there may be an additional reduction affecting the 30 percent limitation. This is because there is an overall 50 percent annual limitation for all charitable contributions of which no more than 30 percent may consist of contributions to 30 percent organizations. Contributions to 30 percent organizations suffer since such contributions are taken into account only after deductions for contributions to 50 percent organizations. IRS Publication 526, Charitable Contributions, provides a worksheet for computing the deduction limits where there is an interplay between the 50 percent and 30 percent limitations.
4. See IRS Pub. 78, supra note 1.
A 30 percent charity is a charitable organization that is not a 50 percent charity. The most common form of 30 percent charity is the non-operating private foundation, often a family foundation.

Once the donor determines whether the donee charity is a 50 percent or a 30 percent charity, the donor then can calculate the allowed charitable deduction associated with a gift of a non-cash asset.

**Gifts of Publicly Traded Securities**

There is an old saying that cash is king. When making a determination whether to make a charitable gift of cash or an appreciated publicly traded security, however, in most instances the security is king.

Appreciated stock has built-in gain associated with it. Therefore, if appreciated stock is sold, the seller must recognize capital gain on the difference between the amount realized and the seller’s basis. However, when appreciated stock is gifted to charity, neither the donor nor the charity pays a capital gains tax on the built-in gain, and the donor still can realize a charitable income tax deduction equal to the stock’s fair market value. Therefore the donor can recognize the full potential of the charitable gift. The tax incentives associated with a gift of appreciated securities make appreciated stock one of the most attractive charitable gift alternatives to cash.

**Gifts of Real Estate**

**Outright Gifts.** An outright gift of unencumbered real estate is a simple way to make a charitable gift. Many charitable organizations welcome outright gifts, however, before accepting the gift, the charitable organization will likely weigh such factors as the ease with which it may be able to sell the real estate and any environmental concerns.

A donor making a charitable gift of unencumbered real estate to a public charity will receive a current income and gift tax deduction equal to the full fair market value of the real estate. Gifts of real estate in excess of $5,000 require a qualified independent appraisal. The donor’s income tax deduction for a gift to the public charity will be limited to 30 percent of the donor’s adjusted gross income (with a five-year carryforward for excess deduction).

A donor who cannot use the full deduction in the current year may instead want to consider making gifts of partial interests of the real estate over a period of time, or reducing the fair market value of the gift by the amount of appreciation, in which case the income tax deduction will be

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5. See IRC §§ 170(a)(1), (c).

limited to 50 percent of the donor’s adjusted gross income.\textsuperscript{7} Depending on the circumstances, these alternatives may result in a greater benefit to the donor.

**Proceeds From Sale of Real Estate.** In today’s market many owners of real estate are currently operating at a loss and in some instances are under water (i.e., the mortgage is greater than the current fair market value of the property). The question in such situations is whether an outright gift of the real estate is appropriate.

If real estate has decreased in value since it was acquired, the better solution may be for the donor to sell the property and then make a charitable gift of the proceeds to charity. The reason for this is that when the donor sells the real estate for less than basis, a capital loss is generated that the donor can use to offset any capital gain. By then making a charitable gift of the proceeds, the donor also generates a charitable income deduction that can be used to further offset taxable income. If the donor simply made an outright gift of the real estate to charity, the donor would not be able to take advantage of the capital loss, and the charitable deduction would still be limited to the fair market value of the real estate.

**Remainder Interest in Personal Residence.** A donor may receive a current income and gift tax charitable deduction by retaining a life estate in the donor’s personal residence and gifting the remainder interest to a charitable organization.\textsuperscript{8} A personal residence for this purpose includes the donor’s primary residence, vacation home, condominium, or stock in a cooperative apartment.\textsuperscript{9}

The donor will receive a current income and gift tax deduction equal to the full fair market value of the remainder interest in the personal residence.\textsuperscript{10} The donor’s income tax deduction if the gift is made to a public charity, however, will be limited to 30 percent of the donor’s adjusted gross income, with a five-year carryforward for any excess unused deduction. Generally speaking, the remainder value is determined using the value of the real estate reduced by an actuarial determination of the value of the life estate retained by the donor (and the donor’s spouse, if applicable).

The gift of a remainder interest in a personal residence, while attractive, may not be for everyone. In those instances where a sale of the personal residence is considered in the future, or may become necessary, caution should be taken prior to gifting the remainder interest. After the remainder interest is

\textsuperscript{7} Treas. Reg. § 1.170A-4(b)(2).
\textsuperscript{8} IRC § 170(f)(4).
\textsuperscript{9} IRC § 170.
\textsuperscript{10} IRC § 170(f).
gifted, the donor retains only a life interest, and it is unlikely that the life tenant will be able to sell just that interest. Further, even if the life interest could be sold, it is unlikely that a buyer would pay full value, because a buyer cannot be certain how long the life interest will last. Because the buyer would have the same difficulty selling the interest in the future, the buyer would likely request a further discount on the purchase price for lack of marketability.

In order to sell the interest in the residence, the donor and the charity likely would both have to agree to the sale. In most states, neither a life tenant nor a remainder owner can compel the other to sell its interest. Therefore, it is common in these scenarios for the donor and the charity to enter into an arrangement for the property to be sold and for each to take its present value interest of the sale proceeds. However, a donor should not bank on the charity’s willingness to agree to such a scenario. Instead, a contemplated sale after the initial gift should be discussed in a well-structured gift agreement between the donor and the charity. While it is important to address a subsequent sale in a gift agreement, any subsequent sale or transfer of the life estate should not be planned prior to the donor’s gift of the remainder interest.

Art Donations

Related Use Rule. The deduction that a donor will receive for a gift of art that is capital gain property is dependent on its use by the donee charity, referred to commonly as the “related use rule.” The related use rule requires that, if the full value of donated appreciated art is to be deductible, the use of the art by the donee charity must be related to the purpose or function constituting the basis for the donee’s exemption from taxation. Since the application of this rule depends on the use made of the contributed property, it is important for a donor, prior to any contribution of art, to ascertain what use will be made of the donated property by the charity.

There are still many unanswered questions concerning what is a related use for art, and the income tax regulations do not provide much guidance. For example, a donor may contribute to a museum a valuable appreciated painting that is considered capital gain property. 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 likely the case even if the museum later sells or exchanges the painting. In addition, since very few museums have sufficient space to exhibit all their art properties 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 likely not cause the amount of the deduction to be reduced. On the other hand, what if a donor donates the painting to a hospital that plans to hang the painting in its waiting room? Generally this contribution should still constitute a contribution to a charity for related use. However, since the painting is not an item which would normally be a retained by the hospital, the donor should obtain evidence of actual use by the hospital.

If a donor contributes art that is capital gain property to a charity for an unrelated use, then the donor is entitled to a charitable deduction equal only to the donor’s adjusted basis. The donor’s deduction is reduced because the charity is generally expected to sell rather than retain the property. If a donor donates a work of art that is capital gain property to a charity for a use related to its purpose or function constituting the basis for the donee charity’s exemption, the donor may take an income tax deduction for the full fair market value of the donated art, subject to the applicable ceilings.

**Gift of a Fractional Interest.** As a general rule, an individual does not receive a deduction for a contribution of less than his entire interest in property. One exception to this general rule, however, is a contribution of an undivided part of the donor’s entire interest in the property, sometimes referred to as a fractional interest. For a deduction to be allowed:

1. The charity must be given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to the donor’s interest in the property; and
2. The entire interest in the property must have been held by the donor (or the donor and the qualifying organization receiving the property) immediately before the contribution.

This exception can create a planning opportunity for a donation of art. For example, if a donor makes a gift to a museum of a right to possession of a painting for three months out of each 12-month period, 25 percent of the painting’s fair market value (assuming the related use test has been met, but not to exceed the applicable percentage limitation) is deductible.

For contributions of art after January 1, 2007, there are new rules regarding the recapture of tax benefits for the donation of a fractional interest.

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13 See IRC § 170(e)(1)(B)(i)(I).
in art. For those contributions, if within 10 years of the date of the initial contribution of a fractional interest, or, if earlier, the donor’s death, the donor fails to contribute all of his remaining interest in the art, the prior income tax deductions associated with the art are recaptured. Further, prior to 2007, a charity did not need to take physical possession of the art during the year of deduction. However, under the new law, there is also a recapture of any deduction for the current tax year if during that year the charity does not take “substantial physical possession” of the art and use it for its charitable purposes.

For purposes of determining the fair market value of each additional contribution of a fractional interest in art, the fair market value for determining the income tax deduction is determined to be the lesser of (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the property at the time of the subsequent contribution. Thus any appreciation in the art following the initial fractional contribution is ignored for purposes of determining the income tax charitable deduction.

**Gifts of Retirement Account Balances**

Many individuals have accumulated assets in retirement plans, including profit sharing plans, 401(k) plans, and individual retirement accounts (IRAs). In most of these retirement plans, an individual or employer will contribute money to the plan over time and will not pay any income tax on the appreciation until the money is withdrawn. Unfortunately, however, when the owner of a retirement asset dies, a non-charitable beneficiary of the retirement asset will have to pay income tax on the appreciated value that has not been withdrawn. This deferred income tax is called “income in respect of the decedent.” In addition, the retirement asset is also included in the deceased owner’s estate and may be subject to federal estate taxes and state inheritance taxes. Therefore, the actual value of the retirement asset on the date of death, if left to a non-charitable beneficiary, may be substantially depleted by the required payment of income, estate, and inheritance taxes.

Because a retirement asset may be depleted by taxes if left to a non-charitable beneficiary, substantial charitable goals can be achieved by designating a charity as the beneficiary of the retirement asset with little cost to the non-charitable beneficiaries. First, because a charity generally is not subject to income tax, the charitable beneficiary will not have to pay income tax on the built-in appreciation of the retirement asset. Second, the gift to the charitable beneficiary will also generally qualify for a federal estate tax charitable deduction, and there will be no federal estate tax payable on the retirement asset. In essence, the charity will be benefitted by receiving the full value of the retirement asset, and there will be minimal cost to the non-charitable
beneficiaries who would have received an asset substantially depleted by taxes if it had been left to them. To effectuate the best tax savings, the charity should be directly named as the beneficiary of the retirement asset either on a beneficiary form or as a specific bequest in a will or trust.

Planning Opportunity With Life Insurance

A charitable remainder trust (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, with the assets remaining in the CRT at the end of the trust term passing to a charity or charities. In regard to income taxes, a CRT is tax exempt and pays no tax when it sells assets or earns income. The non-charitable beneficiary, on the other hand, may be subject to income taxes when the beneficiary receives his annuity payment under a tiered tax system with ordinary income being taxed first, followed by capital gains. In regard to estate taxes, the remainder interest is not subject to estate taxation upon payment to the charitable remainder beneficiary. There are two main forms of a CRT, a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT).

A CRAT is structured to pay an annuity to the income beneficiary that is calculated based upon a fixed percentage of the fair market value of the CRAT’s assets determined on the date the assets are contributed to the trust. Thus, the annuity amount will not change from year to year. Instead, the annuity is a sum certain calculated on the date the CRAT is created. A CRAT thus provides an excellent planning opportunity for an appreciated asset, such as real estate and life insurance.

Often donors are faced with an interesting problem: they want to benefit their favorite charity yet are concerned that the transfer of assets will deprive their descendants of a portion of their inheritance. Further, when low-basis real estate is involved, often the donor may also want to create cash flow without incurring the corresponding capital gain associated with a sale. The combination of a CRAT with a Wealth Replacement Trust can provide for the donor, his or her heirs, and the charitable beneficiary.

In this scenario, the donor establishes a CRAT and retains an annuity stream during the term. The donor gifts the low-basis real estate to the CRAT. The charity can then sell the real estate without incurring capital gains.

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15 IRC § 664.
16 Id.
17 IRC § 664(d).
18 Id.
gain. The proceeds from the sale provide cash flow to pay the annuity, thus accomplishing the donor’s cash flow objectives.

There may also be a concern that by giving away the real estate the donor has significantly lessened the donor’s assets to be transferred to his descendants upon death. An effective way to then replace the gifted assets is to also establish a Wealth Replacement Trust.

A Wealth Replacement Trust is effectively an Irrevocable Life Insurance Trust. Each year the donor gifts all or a portion of the annuity stream to the Wealth Replacement Trust. The CRAT is the preferred planning tool because the annual annuity payment is set and does not vary. The Wealth Replacement Trust then uses the income to purchase a life insurance policy on the donor’s life and pay the ongoing premiums. If established correctly, the death benefit from the life insurance policy will not be included in the donor’s estate upon his or her death. Further, the insurance policy proceeds will replace the assets that were given to charity through the CRAT and will be distributed to the donor’s family beneficiaries with no estate taxes or probate costs.

**Conclusion**

One of the great things about charitable giving, in addition to the difference it can make to a worthy cause, is that there are so many creative ways to give. Virtually everyone can find a way to contribute. A donor’s assets and investment portfolio may include certain non-cash assets that could be used to create a greater tax benefit and would also be perfect for a gift to charity. Donors and their advisors should certainly explore the possibility.