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## non-cash gifts: adjustments to deductible value

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*MSK Client Alert*

April 2007

**practice areas**

transactional tax

When you make a charitable contribution by writing a check, you get an income tax deduction equal to the amount of the check. It is simple. When you make a charitable contribution by transferring an asset other than cash to a charity, it's not quite so simple. First of all, the fair market value of that asset has to be ascertained. There are complex rules relating to the determination and substantiation of fair market value, as described in our last Charitable Section Letter (Vol. XV, No. 1). However, even after the fair market value of an asset is determined, a taxpayer will not necessarily get a charitable deduction equal to that fair market value. There are a number of situations where the taxpayer's charitable deduction is reduced. This article will review the basic rules and discuss some common situations.

### **Gifts to Private Foundations:**

If a taxpayer contributes an asset to a private foundation, his charitable deduction is limited to his tax basis in the contributed asset, with one exception. The exception, which is contained in Internal Revenue Code Section 170(3)(5), is for a contribution of corporate stock (so long as total contributions of such stock do not exceed 10% of the corporation's stock) for which "market quotations are readily available on an established securities market". In a recent private letter ruling (PLR 200702031), a taxpayer transferred stock to a charity, which stock was traded on the Over-The-Counter Bulletin Board. Daily quotes of the stock were readily available through several internet financial sites that were readily accessible. The IRS ruled that this met the readily-available-market-quotations test, and the taxpayer could deduct the full fair market value of the stock. The taxpayer was required to print out and save the current and historical market quotations for the stock. While a private letter ruling can only be relied on by the taxpayer who obtains the ruling, it does indicate the IRS thinking on this issue.

The favorable treatment in this recent private letter ruling should be contrasted with a private letter ruling issued in 1992, which held that if publicly traded stock is subject to transfer restrictions under SEC rules (such as stock which the



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taxpayer is prohibited from selling under Rule 144), it does not qualify for the enhanced deduction. Also, the IRS has ruled that a class of a corporation's stock which was not publicly traded, but which could be converted into stock where market quotations were readily available, did not qualify for the enhanced deduction. Finally, it should be noted that the enhanced deduction is only applicable to contributions of stock. It does not apply to contributions of bonds, notes, warrants, options or partnership interests, even if market quotations for such property are readily available.

### Gifts of Tangible Personal Property

A taxpayer's charitable deduction may be limited to his tax basis where the contributed asset is tangible personal property – such as an automobile, a boat, a painting, etc. In this situation, a deduction for full fair market value is only available if the donee charity uses the contributed asset for a purpose or function constituting the basis for its tax exemption. By way of example, assume two taxpayers – Jack and Jill. Jack contributes a sailboat to a university and Jill contributes a power boat to the same university. Both boats have a \$10,000 fair market value and an \$8,000 tax basis. The university uses the sailboat in connection with sailing classes that it offers to its students. The university sells the power boat and uses the money to pay the salary of the sailing instructor. In this situation, Jack can deduct the full \$10,000 fair market value of his boat, while Jill's deduction is limited to the \$8,000 tax basis of her boat. However, if the university sells Jack's boat within three years of the date of the contribution, Jack's \$2,000 enhanced deduction will be recaptured and must be reported as income on his tax return for the year in which the university sells the sailboat (unless the university is able to sign a certificate indicating that it intended to use the boat in its sailing classes but that such use became impossible or infeasible to implement).

### Gifts of Ordinary Income Property

If the property contributed to charity would not be taxed as long term capital gain if sold by the taxpayer, then the charitable deduction is reduced by the amount that would not be eligible for long term capital gain treatment. Let's take an example. Suppose Jack and Jill each own a piece of real estate that has a fair market value of \$1,000,000 and a tax basis of \$600,000.

As to Jill, assume that she has been involved in many real estate transactions in her lifetime, and has sold or developed a sufficient amount of real estate such that the IRS takes the position that Jill is a "dealer" in real estate (as distinguished from an "investor"). Accordingly, if Jill sold the real estate contributed to charity, the gain would be taxable as ordinary income and not capital gain. In this situation, Jill's charitable contribution is limited to the \$600,000 basis.

As to Jack, assume that he has had few prior real estate transactions in his lifetime and so he has "investor" status. However, assume that Jack has depreciated the real estate using an accelerated method of depreciation, so that if he sold the property, \$100,000 of his prior depreciation deductions would be taxed as ordinary income under the recapture of depreciation rules. In this case, Jack's charitable deduction is \$900,000 (i.e., \$1,000,000 fair market value less the \$100,000 of depreciation recapture).



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Let's take another example. Assume Jack and Jill each contribute a copyright to charity. Assume Jill's copyright was for a work that was created by her, while Jack's copyright was for a work created by a third party and purchased by Jack in an arms-length transaction. In this situation, Jill would realize ordinary income if she sold her copyright, while Jack would realize capital gain if he sold his copyright. Accordingly, Jill's charitable deduction is limited to her tax basis, while Jack can deduct the full fair market value of his copyright.

### Gifts of Certain Intellectual Property

If a taxpayer contributes a patent, certain copyrights (for example, where the taxpayer is not the creator of the copyrighted material), trademark, trade name, trade secret, know how, software or other similar property to charity, the rules really start to get interesting. The taxpayer's initial charitable deduction is limited to the lesser of his basis in the contributed asset or its fair market value. However, if the donee is a public charity (or a private operating foundation), the taxpayer may be entitled to additional charitable deductions in years after the contribution is made. The additional deduction is based on a specified percentage (which percentage changes every year) of the net income earned by the charity from exploiting the contributed asset.

Let's take an example. Assume that Jack contributes to a public charity a patent that has a tax basis of \$10,000 and a fair market value of \$100,000. Jack is entitled to a deduction of only \$10,000 in the year the contribution is made. Assume four years later the public charity exploits the patent and earns \$200,000 of income (after expenses). The specified percentage applicable to the fourth year is 80%, so the result is that in the fourth year Jack would be entitled to an additional charitable deduction of \$150,000 (i.e., 80% of the amount earned by the charity reduced by the \$10,000 originally deducted by Jack), even though he made no actual charitable contribution that year. It should be noted that in this example, Jack ended up with \$160,000 of charitable deductions (\$10,000 in the year of contribution and \$150,000 in the fourth year), even though the actual fair market value of the patent contributed to charity was only \$100,000.

### Conclusion

As demonstrated above, where the contributed asset is anything other than cash, the rules for determining the amount that is deductible are not simple. Sometimes the amount that is deductible is dependent on the tax status of the donee charity – for example, whether or not the charity is a private foundation. Sometimes the amount that is deductible is dependent on the marketability of the contributed asset – for example, whether stock given to a private foundation is or is not publicly traded. Sometimes the amount that is deductible is dependent upon the use the charity makes of the asset – for example, the power boat and the sailboat contributed by Jack and Jill in the example above. Sometimes the amount that is deductible is dependent upon the outside business activities of the taxpayer – for example, the two parcels of real property contributed by Jack and Jill in the example above. Sometimes the amount that is deductible is dependent on the future income which the charity generates from exploiting the donated asset – for example, the patent contributed by Jack in the example above.

No one ever said the Internal Revenue Code was simple.



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