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# THE TAX CONSEQUENCES OF INTER VIVOS CHARITABLE CONTRIBUTIONS AFTER DECEMBER 31, 1969 UNDER SECTION 170

*Olin R. Melchionna, Jr.**

To give and live to give again has always been the American way. Traditionally, Americans contribute to those charitable institutions and associations which effectuate their benevolent, philanthropic desires. Many individuals believe the funding of charitable institutions should be primarily by direct contributions from the private sector as opposed to federal and state government subsidies. This view is supported by the federal income,[1] gift[2] and estate[3] tax deductions.

Inflationary increases in personal income over the past twenty-six years coupled with relatively constant income tax rates have greatly increased many individuals' tax burdens. Nor is it surprising to find individuals whose stock portfolios and real estate holdings have swelled in value and are now producing handsome income. Often these individuals are called upon and desire to make charitable contributions. While such gifts usually have a beneficial effect on income taxes due, the precise effect is unclear and many people must seek assistance from their attorney.

For the attorney who does not regularly work with the Internal Revenue Code of 1954, the first examination of the Code section primarily dealing with the income tax consequences of charitable contributions, section 170,[4] may encourage him to embark on a less complicated endeavor. However, it is the purpose of this article to facilitate the understanding of and planning under section 170, and demonstrate by example the consequences, sometimes unpleasant, of various types of inter vivos charitable gifts.

For individuals who make modest contributions in reliance upon

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1. INT. REV. CODE OF 1954, § 170. All textual section numbers are sections of the Internal Revenue Code of 1954.

2. *Id.* § 2522.

3. *Id.* § 2055.

4. *Id.* § 170 (corresponds to section 201 of the Tax Reform Act of 1969, Pub. L. No. 91-172, tit. II, 83 Stat. 487).

the tax advice of charitable organizations' representatives, an unpleasant realization may soon arise. An individual taxpayer who is eligible,[5] and who elects,[6] to take the standard deduction[7] is not permitted to itemize his deductions in determining taxable income.[8] Thus, the charitable contribution of a person utilizing the standard deduction will not be included in the direct determination of his federal income tax for the year. Consequently, the first step for the prospective donor is to decide whether it will be economically practical to itemize his deductions.

If the taxpayer decides to itemize his deductions, he must then determine the amount of his charitable contribution deduction. This determination will entail an examination of the types of property donated (cash, appreciated securities, inventories and other types), the character of the charity (public, semi-public, or private), and the donor's contribution base.

## SECTION 170(e)

If the donor made a charitable contribution of property having a fair market value in excess of the donor's basis, then the fair market value may have to be reduced by part or all of the difference between the fair market value of the property contributed and the donor's basis in that property. Regardless of the donee, all charitable contributions of ordinary income property[9] must be reduced.[10]

5. *Id.* § 142. This section provides that not all persons may take the standard deduction. Thus where one spouse itemizes deductions, then the other may not use the standard deduction.

6. *Id.* § 144.

7. *Id.* § 141.

8. *Id.* § 63(b).

9. *Id.* § 170(e)(1)(A).

10. *Id.* § 170(e)(1)(A). Ordinary income property is property which would not have been treated as long-term capital gain property had it been sold by the donor at its fair market value at the time of its contribution to the charitable organization. Treas. Reg. § 1.170A-4(b)(1) (1972). Thus, section 170(e)(1)(A) is applicable to inventory, a work of art created by the donor, a manuscript, a letter or memorandum prepared by or for the donor, a capital asset held by the donor less than six months, section 306 stock, and stock to which section 341(a) (collapsible corporations) or section 1248(a) (foreign corporations) applies. *Id.* Also any ordinary income recognized because of the application of section 617(d)(1) (recapture of mining or exploration expenditures), section 1245(a) (recapture of depreciation on certain depreciable property), section 1250(a) (recapture of depreciation on certain realty), section 1251(c) (recapture on certain farm property), or section 1252(a) (recapture on disposition of certain farm land) must be subtracted from the fair market value of the donated property. *Id.* §

The amount of ordinary income which would have resulted if the contributed property had been sold at fair market value at the time of the contribution is the measure of the reduction.[11]

Considering the harsh reduction rule of section 170(e), the donor gains little by making this type of gift if the differential between fair market value and a lower basis is substantial. Nor would the donor substantially benefit by selling ordinary income type assets with a substantially lower basis and then donating the proceeds since an income tax will be carved out of the proceeds before he can make a gift of the residue.

An individual may make a charitable contribution of long-term capital gain, tangible personal property,[12] whose use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501.[13] In this case, the amount of the deduction is reduced by 50 percent of the long-term capital gain which would have been realized had the property been sold by the individual taxpayer for its fair market value.[14]

The donor may treat his donation of tangible personal property

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1.170A-4(b)(4). For example, on December 9, 1975, Mill Hatcher contributed inventory having a fair market value of $15,000 and an adjusted basis of $5,000 to his church, a public charity. In addition, he contributed 1,000 shares of Libby-Owens-Ford stock, which he purchased for $15,000 in November, 1975, but which had a fair market value of $25,000 on the date of gift, December 9, 1975. If the inventory had been sold to customers in the ordinary course of his business, Hatcher would have realized and recognized $10,000 of ordinary income. Therefore, under section 170(e)(1)(A), the charitable contribution is reduced to $5,000 ($15,000-$10,000). Since the stock would have yielded a short-term capital gain of $10,000 having been held for less than six months, this contribution is reduced to $10,000 ($25,000-$15,000).

11. INT. REV. CODE OF 1954, § 170(e)(1)(A).

12. *Id.* § 170(e)(1)(B)(i).

13. *Id.* § 501. The section provides a tax exemption for various specified charitable organizations.

14. *Id.* § 170(e)(1)(B)(i). For example, Mill Hatcher gave Hampden-Sydney College, a public charity, a painting and a desk. Both assets are long-term capital gain property, having been held more than six months. The painting cost $25,000 and now has a fair market value of $75,000; the desk cost $25 and has a fair market value of $50. The college uses the painting in the library for study by art history students. The desk is used in one of the college's offices in the course of carrying out its functions. Neither use is unrelated to the college's tax exempt purpose; thus, the contributions are not reduced. Treas. Reg. § 1.170A-4(b)(3)(i) (1972). If the painting had been sold and the proceeds used by the college for educational purposes, the use would have been unrelated and the deduction would be reduced to $50,000 [$75,000 (fair market value) - $25,000 (50 percent of the $50,000 long-term capital gain that would have been recognized had the painting been sold at the time of donation)]. For a listing of public charitable institutions see note 24 *infra*.

as being put to the required related use if he can establish that the charity is in fact not putting it to an unrelated use. Alternatively, the donor may show that at the time of the contribution (or when the contribution is treated as made), it is reasonable to assume that the property will not be put to an unrelated use by the donee.[15]

A charitable contribution of appreciated long-term capital gain property[16] to or "for the use of" a private foundation,[17] other than those treated as public charities,[18] is reduced by 50 percent of the long-term amount which would have been long-term capital gain had the property been sold by the taxpayer at its fair market value at the time of the contribution.[19] If the donor makes a charitable contribution of property, whose sale would have resulted in both ordinary income and long-term capital gain, such as section 1245 or 1250 property, a reduction in the amount of his charitable contribution may be required under both section 170(e)(1)(A) and section 170(e)(1)(B).[20]

15. Treas. Reg. § 1.170A-4(b)(3)(ii) (1972).

16. INT. REV. CODE OF 1954, § 170(e)(1)(B)(ii).

17. *Id.* § 509(a).

18. Certain private foundations treated as public charities are described in section 170(b)(1)(E). Examples of these types of private foundations treated as public charities are: private operating foundations, defined in section 4942(j)(3); organizations distributing their income as required by section 170(b)(1)(E)(ii); or, organizations maintaining a common fund as provided in section 170(b)(1)(E)(iii).

As a practical matter, the donor's attorney seldom examines the details of the charitable structure to determine whether the charity is public, semi-public, or a private foundation. Such an examination would be extremely time-consuming, costly and usually justified only where the proposed gift is exceptionally large. The most efficient method of determining the status of the proposed charity is to ask the administrator of the charity or the charity's attorney to assist in determining the formal tax exempt status.

Also, the Internal Revenue Service lists many charitable organizations in Publication No. 78, "Cumulative List of Organizations Described in § 170(c) of the Internal Revenue Code of 1954" which is published biennially and is supplemented every other month. This publication and supplements are available on a subscription basis from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402.

19. For example, on March 1, 1975 Mr. Hatcher contributed to a private foundation not described in section 170(b)(1)(E) land which had a fair market value of $60,000, an adjusted basis of $10,000 and which was investment property held for more than six months. The charitable contribution is reduced to $35,000 [$60,000 - $25,000 (50 percent of $50,000, the amount of long-term capital gain that would have been recognized had the land been sold)].

20. INT. REV. CODE OF 1954, §§ 170(e)(1)(A), (B).

For example: On April 1, 1975, Hatcher contributed to a private foundation not described in section 170(b)(1)(E) intangible property to which section 1245 applies which had a fair market value of $60,000 and an adjusted basis of $10,000. Let us assume that had the property been sold, $20,000 of the $50,000 gain would have been treated as ordinary income and $30,000

THE 50, 30 AND 20 PERCENT LIMITATIONS

*50 Percent Limitation.* After a reduction of the donation as provided in section 170(e), the percentage limitations must next be applied. While an income tax deduction is allowed for donations to domestic[21] charitable organizations, there is a yearly percentage limitation on the amount an individual may deduct. As a general rule, the maximum deduction is 50 percent[22] of his contribution base,[23] for contributions made to certain public charitable organizations.[24]

In calculating the 50 percent limitation, contributions to public charities are considered prior to contributions to semi-public charities, contributions to private foundations described in section 509(a), and contributions "for the use of" any charitable organization.[25] Thus, if an individual makes contributions equal to 50 percent of his contribution base to public charities, then no contribu-

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would have been long-term capital gain. Hatcher's contribution is reduced by $35,000 (100 percent of the ordinary income of $20,000 and 50 percent of the long-term capital gain of $30,000). Treas. Reg. § 1.170A-4(d) [Example 3] (1972).

21. INT. REV. CODE of 1954, § 170(c)(2).

22. *Id.* § 170(b)(1)(A).

23. *Id.* § 170(b)(1)(F). "Contribution base" is defined in the statute as adjusted gross income without regard to any net operating loss carryback. *Id.* "Adjusted gross income," as used in this statute, is gross income as provided for in section 61 less the deductions provided for in section 62.

24. *Id.* § 170(b)(1)(A)(i)-(viii). Those public charitable institutions are:

(1) A church or a convention or association of churches;

(2) An educational organization that maintains a regular faculty, curriculum and a student body attending resident classes;

(3) A hospital or an organization directly engaged in medical research in conjunction with that hospital;

(4) An organization that normally receives a substantial part of its support from the United States, a state or political subdivision thereof, or form direct or indirect contributions from the general public, organized to receive, hold, invest, and administer property for the benefit of state and local colleges or universities;

(5) A state, or any political subdivision thereof, or the United States, or a possession thereof, if the contribution is made exclusively for public purposes;

(6) An organization exempt as a charitable, religious, educational, scientific, or literary organization, if it normally receives a substantial part of its support from a governmental unit, or from direct or indirect contributions from the general public;

(7) Certain private foundations that meet very stringent requirements as to distribution of support funds received; and

(8) Public foundations. These public foundations are described in section 509(a)(2) and (3). INT. REV. CODE of 1954, § 170(b)(1)(A)(viii).

25. *Id.* § 170(b)(1)(B)(ii).

tions to semi-public charities,[26] private charities (private foundations)[27] or "for the use of"[28] any charity are deductible. Contributions to public charities may be carried over to later years.[29]

*20 Percent Limitation.* The 20 percent[30] limitation applies to contributions to semi-public and private charities (private foundations) as well as contributions "for the use of" any organization. The aggregate of such contributions shall be allowed as a deduction to the extent of the lesser of 20 percent of the taxpayer's contribution base for the taxable year,[31] or the excess of 50 percent of the taxpayer's contribution base for the taxable year over the amount of charitable contributions allowable under the 50 percent limitation.[32] Contributions to which the 20 percent limitation applies may not be carried over to succeeding years.[33]

26. Semi-public charities are the charitable organizations not described in section 170(b)(1)(A) and which are not private foundations as defined in section 509(a). They consist of a post or organization of war veterans, or an auxiliary unit or society, or trust or foundation for any such post or organization organized in the United States with no part of the net earnings inuring to the benefit of private shareholders or individuals, INT. REV. CODE OF 1954, § 170(c)(3); a domestic fraternal society, order or association operating for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals, *id.* § 170(c)(4); a non-profit cemetery company owned and operated exclusively for the benefit of its members, *Id.* § 170(c)(5).

27. INT. REV. CODE OF 1954, § 509(a).

28. Treas. Reg. § 1.170A-8(a)(2) (1972). This regulation provides in part that a contribution of an income interest in property, whether or not transferred in trust, for which a deduction is allowed under section 170(f)(2)(B) or (3)(A) shall be considered as made "for the use of" rather than "to" the charitable organization. A contribution of a remainder interest for which the donor will get a deduction shall be considered "to" the charitable organization. However, if such interest is transferred to a trust which provides that upon termination of the preceding estate, the remainder shall be held in trust for the benefit of such organization, then the contribution shall be considered "for the use of" such organization.

29. For a discussion of the carryover provision under section 170(d)(1)(A) see notes 43-48 *infra* and accompanying text.

30. INT. REV. CODE OF 1954, § 170(b)(1)(B).

31. *Id.* § 170(b)(1)(B)(i).

32. *Id.* § 170(b)(1)(B)(ii). For the purpose of calculating the amount called for in section 170(b)(1)(B)(ii), appreciated long-term capital gain property given to 50 percent public charities are not reduced by the 30 percent limitation, hereinafter discussed.

33. For example, Hatcher's 1975 contribution base is $100,000. During 1975, he donated $40,000 in cash to a public charity and $20,000 to a semi-public charity. Hatcher has an allowable deduction for 1975 of $50,000 ($40,000 to the public charity, and $10,000 to the semi-public charity). The $10,000 is equal to the lesser of $20,000 (20 percent of his contribution base) or $10,000 [$50,000 (50 percent of his contribution base) - $40,000 (the amount of the contribution allowed under the 50 percent limitation)]. Since there is no carryover for nondeductible contributions to semi-public or private charities, $10,000 of the $20,000 gift to the semi-public charity is lost forever as a deductible donation.

*30 Percent Limitation.* In the case of charitable contributions of capital gain property[34] to which section 170(e) does not apply, the donor may not deduct more than 30 percent of his contribution base.[35] The 30 percent limit is applicable to contributions governed by both the 20 and 50 percent limitations.[36] Thus, a taxpayer contributing only 30 percent capital gain property is limited to a maximum deduction equal to 30 percent of his contribution base. If such property is also limited by the 20 percent deduction rule, it is subject to this lesser limitation.[37]

Since contributions to public charities are considered prior to contributions of semi-public charities,[38] contributions in the latter category are only deductible in an amount equal to the difference between 30 percent of the taxpayer's contribution base and contributions to public charities to which the 30 percent limit applies. However, contributions to private foundations are not subject to the 30 percent limitation.[39]

A taxpayer may elect under section 170(b)(1)(D)(iii) to apply the reductive mandates of section 170(e) to any contribution of appreciated property and avoid classification of the contribution as 30 percent capital gain property.[40] Contributions to public charities governed by the 30 percent limitation may be carried over.[41] The

34. For the purpose of section 170(b)(1)(D), "capital gain property" means, with respect to any contribution, any capital asset the sale of which at its fair market value would have resulted in gain which would have been long-term capital gain. Also, any property used in the taxpayer's trade or business (as defined in section 1231(b)) shall be treated as a capital asset. INT. REV. CODE OF 1954, § 170(b)(1)(D)(iv).

35. *Id.* § 170(b)(1)(D)(i).

36. *Id.*

37. For the purposes of the 20 and 50 percent limitations, contributions of capital gain property shall be taken into account after all other charitable contributions. *Id.*

38. Before one may insert the numerical calculations required by the formula in section 170(b)(1)(B)(i) and (ii) in order to determine the 20 percent limitation, the contributions to public charities must be determined under section 170(b)(1)(A).

39. All contributions of appreciated property to such private organizations are reduced by section 170(e)(1)(B).

40. Accordingly, if a taxpayer with a $100,000 contribution base donates capital gain property having a fair market value of $60,000 and basis of $30,000 to a public charity, he has two options. First, he may deduct $30,000 (30 percent of $100,000) this year and $30,000 next year assuming his contribution base remains the same. Second, he may apply section 170(e), reducing his contribution to $45,000 [$60,000 - $15,000 (50 percent of the $30,000 gain)] and not be bound by the 30 percent limitation. Since 50 percent of his contribution base is $50,000, the entire $45,000 is deductible, but there is no carryover to a later year.

41. INT. REV. CODE OF 1954, § 170(b)(1)(D)(ii).

The following examples will demonstrate the interaction of the three limitation provisions. Treas. Reg. § 1.170A-8(f) (1972) contains fifteen similar illustrations of the interaction of the percentage limitations. All examples are for donations after December 31, 1969, by an individual taxpayer. They could be applicable to a husband and wife filing a joint return in which case the contribution base and the various donations would be the cummulative contribution bases and donations of both parties.

Example 1: Mill Hatcher has a contribution base of $50,000 and contributes $27,000 in cash to Hampden-Sydney College, a public charity. His charitable deduction is limited to $25,000 (50 percent of $50,000), and he is entitled to a $2,000 carryover.

Example 2: Mike Davis has a contribution base of $50,000 and contributes $20,000 in cash to a public charity and $15,000 in cash to a semi-public charity. Davis is allowed a charitable donation of $25,000 (50 percent of $50,000) consisting of the $20,000 contribution and $5,000 of the $15,000 contribution. Section 170(b)(1)(B) limits the $15,000 contribution to the lesser of $10,000 (20 percent of Davis' contribution base) or $5,000 [$25,000 (50 percent of the contribution base) less $20,000 (value of the property donated to the public charity)]. No carryover is allowed for the non-deductible $10,000. However, if Davis had not made any contributions to public charities, then $10,000 of the $15,000 would have been deductible and $5,000 would have been permanently lost as a deduction.

Example 3: Assume the same facts as Example 2, except the $20,000 contribution consists of a Raphalle Peale original having a fair market value of $20,000 and basis of $10,000 to Davis, which he has owned for more than six months. Thus, the painting is 30 percent capital gain property which will be put to a related use by the charity. The 30 percent limitation allows a deduction of $15,000 (30 percent of $50,000) of the $20,000 contribution. However, there is no change in the $5,000 allowed of the $15,000 since the 20 percent limitation calculation is done exactly as in the example above which disregards, for the purpose of the calculation, the 30 percent limitation and instead uses the value of the contribution. The value of the contribution, however, may be reduced by section 170(e) if applicable. Davis' total deduction for the year is $20,000 instead of $25,000, and he is entitled to a carryover of the remaining $5,000 of the 30 percent property, which will maintain its character as 30 percent capital gain property. The $10,000 not deductible is not carried over and is lost forever as a deduction.

Example 4: Assume that both contributions in Example 2 consisted of 30 percent capital gain property. In this case the 30 percent rule would apply to the entire $35,000 of contributions and would limit Davis' deduction to $15,000 (30 percent of $50,000). Davis is entitled to a carryover of only $5,000 ($20,000 contributed to the public charity less $15,000). The $15,000 to the semi-public charity is not deductible and there is no carryover for this amount. Contributions to public charities are considered before contributions to semi-public charities and private foundations.

Example 5: Fitz O'Conner makes contributions to a public charity consisting of $1,000 in cash and $5,000 in 30 percent capital gain property. O'Conner's contribution base is $10,000 and thus his charitable deduction is limited to $4,000, *i.e.*, the $1,000 in cash and $3,000 (30 percent of $10,000) of the $5,000 contribution. Since cash is taken into account first, O'Conner is allowed a carryover of $2,000 ($5,000 - $3,000), which retains its status as 30 percent capital gain property.

Example 6: Assume O'Conner contributed $3,000 in cash instead of the $1,000 in Example 5 above. O'Conner's charitable deduction is limited to $5,000 (50 percent of $10,000) by the 50 percent limitation. Since cash is taken into consideration before 30 percent capital gain property, O'Conner's deductions consist of $3,000 cash and $2,000 of 30 percent capital gain property. O'Conner is entitled to a carryover of $3,000 ($5,000 less $2,000), which retains its status as 30 percent capital gain property in carryover years.

Example 7: Bill Miller's contribution base is $50,000. During the year, Miller gave his church $2,000 cash and stock shares held for more than six months, having a fair market value carryover, however, will maintain its 30 percent limitation character.

## CARRYOVERS

If the individual taxpayer's contributions exceed 50 percent of his contribution base (30 percent for certain capital gain property),[42] he may deduct the excess during the five succeeding years.[43] However, contributions regulated by the 20 percent limitation may not be carried over.[44] Those contributions qualifying for carryover may be deducted subject to the limitation that they not exceed 50 percent of the contribution base, less the amount currently donated.[45] If the taxpayer utilizes the standard deduction in any of the carryover years, he must reduce the carryover by the amount that would have been deductible had he itemized his deductions.[46]

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of $30,000 and a basis to Miller of $10,000. He also gave $5,000 cash to a private foundation to which the 20 percent limitation applies. The $2,000 in cash donated to the church is considered first. The deduction for the gift of the stock is limited to $15,000 (30 percent of $50,000). The unused portion ($15,000) may be carried over to next year. Since more than $25,000 was given to an organization to which the 50 percent limitation applies (disregarding the 30 percent limitdtion), Miller's $5,000 contribution to the private foundation is not deductible. Therefore, his deduction is limited to $17,000 ($2,000 plus $15,000); but he has a $15,000 carryover to later years. If Miller elected to calculate his deduction under section 170(b)(1)(D)(iii), he could disregard the 30 percent limitation but would be required to reduce the fair market value of the stock by 50 percent of the appreciation. Therefore, his deduction for the stock would be $20,000 ($30,000 less 50 percent of $20,000) which is added to the $2,000 cash contribution to the church. The amount deductible for the contribution to the private charity is the lesser of $10,000 (20 percent of $50,000) or $3,000 [50 percent of $50,000 less $22,000 (the value of the contributions to public charities after the reduction by 170(e))]. Thus, the total deduction is $25,000: $2,000 in cash contributed to the church, $20,000 for the stock contributed to the church, and $3,000 in cash contributed to the private foundation. There would be no carryover to later years.

42. INT. REV. CODE OF 1954, §§ 170(b)(1)(D)(iii), (d)(1). *See also* text accompanying notes 34-41 *supra*.

43. INT. REV. CODE OF 1954, § 170(d)(1)(A).

44. Treas. Reg. § 1.170A-10(a)(1) (1975).

45. INT. REV. CODE OF 1954, §§ 170(d)(1)(A)(i), (ii). For example, Davis had a contribution base of $20,000 in 1974. During the year he contributed $11,000 to his church. He may deduct $10,000 in 1974 (50 percent of $20,000), and carryover $1,000. In 1975, if he had a contribution base of $20,000 and contributed $9,000 or less during the year, he could deduct the entire carryover from 1974. However, if he deducted $9,500 during 1975, he could deduct only $500 of his carryover, with a $500 carryover to 1976.

46. Treas. Reg. § 1.170A-10(a)(2) (1975). For example, Davis had a contribution carryover of $500 from 1974 to 1975. If his contribution base were $10,000 for 1975, his deductible contributions were $300, and he elected to take the standard deduction, he could not carryover the $500 to 1976. If he itemizes his deductions in 1975 the total of his contributions

Carryovers of capital gain property to which the 30 percent limit applies are subject to the 30 percent limitation in the year to which they are carried over.[47] If the taxpayer carries over 30 percent capital gain property and elects in the subsequent year to disregard the 30 percent limitation by taking appreciation into account, he must recompute the carryover. The appreciation election would be considered as having been made in the prior year and the result would be reduced by the amount previously deducted.[48]

## PLANNING CONSIDERATIONS

Having discussed the reduction, limitation and carryover provisions, some observations and planning considerations are in order. There is never any net gain to the donor by making charitable donations. With proper planning, however, the charity will receive the maximum benefit within the means and desires of the donor at the least cost to him. Charitable contributions should be planned so the taxpayer can deduct for all his donations. Careful attention should be given to the impact of percentage limitations and carryovers on present contributions, especially when a semi-public charity or private foundation is involved. Gifts of appreciated securities and capital gains real estate are ideal properties for a charitable donation. The full fair market value is an allowed deduction, subject to the applicable limitations, and no capital gains tax is realized on their transfer. Thus, the taxpayer contemplating a donation should always determine if an appreciated capital asset

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paid during 1975, and the carryovers to that year would fall below 50 percent of his contribution base and would be deductible. Therefore, his carryover must be considered deducted in 1975.

47. INT. REV. CODE OF 1954, § 170(b)(1)(D)(ii).

48. Treas. Reg. §§ 1.170A-8(d)(2)(i)(a)-(c) (1972). For example, Davis had a contribution base of $50,000 in 1972. He contributed 30 percent capital gain property valued at $20,000 with a basis of $15,000. His deduction in 1972 was limited to $15,000 (30 percent of $50,000) and $5,000 was carried over as 30 percent capital gain property. Assume in 1973, that he had a contribution base of $50,000 and that he contributed 30 percent capital gain property valued at $25,000 with a basis of $20,000. He could have elected to disregard the 30 percent rule, but he must have taken the appreciation into account in 1973 as well as in 1972. The deduction for 1973, before the carryover is considered, was $22,500 [$25,000 less $2,500 (50 percent of $5,000 appreciation)]. The carryover would then have to be recomputed as if he had elected to consider the appreciation in 1972. Disregarding the 30 percent rule, his deduction would have been $17,500 [$20,000 less $2,500 (50 percent of $5,000 appreciation)]. He actually deducted $15,000 in 1972; therefore, his recomputed carryover was $2,500 ($17,500 less $15,000). His total deduction in 1973 would be $25,000.

could be the object of the gift, and if so, make the donation in kind as opposed to selling the asset and donating the proceeds.[49] If the capital asset has decreased in value below the taxpayer's basis, the asset should be sold and the proceeds donated. In this way the taxpayer receives both the benefit of the loss and the charitable donation.

One of the most forgotten assets which may be the subject of a charitable contribution is a life insurance policy. Life insurance is often purchased by the donor when he is young and without a substantial estate. If the donor has been financially successful, the protective aspect of life insurance may no longer be significant. Nevertheless, a careful analysis of the donor's holdings should be undertaken to insure that he has sufficient liquid assets to pay his estate and inheritance taxes and to immediately provide for the security of his spouse on his death.

Since the sale of life insurance at a gain will produce ordinary income, the reductive provision of section 170(e) will apply. The amount deductible will be the lesser of the cost basis (total premiums paid) or the policy's value.[50] Therefore, the cost basis and fair market value should be carefully analyzed. If the value is higher than the donor's cost basis, the policy should not be donated. The value of a paid up policy is "replacement cost"; that is, what the insurance company would charge on the transfer date to issue a similar policy.[51] The policy value on which future premiums are payable is the interpolated terminal reserve plus that part of the last prior premium payment attributable to the period subsequent to the gift.[52] In making the gift, all of the donor's rights and incidents of ownership should be transferred to the charity. If his ownership is completely severed, the benefits paid under the insurance policy to the charity will not be included in the estate.[53]

49. For example, if Mr. Hatcher wished to donate 1,000 shares of General Cable having a fair market value of $10,000 and basis of $2,000 to his college, a gift in kind would put $10,000 in the hands of the college and allow him a deduction of $10,000 (assuming he has the appropriate contribution base). If, however, he sold the securities and donated the proceeds, he would ordinarily have to pay a maximum tax of 25 percent on the profit, or approximately $2,000. After the tax, only $8,000 could have been donated; thus, $8,000 would have been the amount of his deduction.

50. Rev. Rul. 145, 1959-1 CUM. BULL. 18, provides that the gift tax regulation, Treas. Reg. § 25.2512-(6)(a) (1963), shall be followed in determing the value of the policy.

51. Treas. Reg. § 25.2512-(6)(a) (1963).

52. *Id.*

53. INT. REV. CODE OF 1954, § 2042(2).

No deduction is allowed under section 170 for a contribution of services[54] nor for free use of a taxpayer's property.[55] However, expenditures made incidentally to the rendition of services to a charitable organization may constitute a deductible contribution,[56] provided there is no reimbursement.[57] Such out-of-pocket expenses are considered "for the use of" the charity.[58] Thus, the 20 percent limitation is applicable.

Realizing that testamentary gifts to charity are excluded from the gross estate for estate tax purposes,[59] many potential contributors make testamentary charitable gifts. However, if they can afford to be without the property during life, a charitable inter vivos gift will allow the donor a double benefit since he will be entitled to both an income tax and estate tax deduction.[60] Thus, valuable books, art, etc., which are not desired by the donor's family make excellent inter vivos gifts to charity. However, many taxpayers either cannot afford or do not desire to be without such major assets during life; thus, their major gifts are made by will.

Prior to the passage of the Tax Reform Act of 1969,[61] deferred giving was a simple matter, based upon the legal concept that the property interest could be divided into a life estate and a remainder interest. Transfer of the remainder interest to charity and retention of a life estate in that property for the donor was a practical method for making a charitable contribution. Upon transferring the remainder to charity, the donor was allowed a charitable deduction equal to the present value of the remainder interest computed on an actuarial basis which would take into account the life expectancies of the life tenants. The donor received substantial benefits, including

54. Treas. Reg. § 1.170A-1(g) (1975).

55. INT. REV. CODE OF 1954, § 170(f)(3).

56. Treas. Reg. § 1.170A-1(g) (1975).

57. For example, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenses for meals and lodging necessarily incurred while away from home in the course of performing donated services are also deductible. For the purpose of this paragraph, the phrase "while away from home" is equivalent to the use of the term in section 162. Deductibility for attendance at a convention requires that the taxpayer be acting in a representative capacity and not merely as a member of the convening organization. Rev. Rul. 46, 1961-1 CUM. BULL. 52.

58. Rev. Rul. 279, 1958-1 CUM. BULL. 145.

59. INT. REV. CODE OF 1954, § 2055.

60. *Id.* § 170.

61. Pub. L. No. 91-172, tit. II, 83 Stat. 487.

an income tax deduction, exclusion of the entire property from his estate for estate tax purposes, and virtually unrestricted use of the donated property during his life. Congress believed that such charitable contributions were being abused by life tenants who wasted the asset.[62] The Tax Reform Act of 1969[63] partially severed traditional property law and placed strict limitations on charitable gifts of remainder interests. In the case of real estate, the traditional treatment of gifts of remainder interests was maintained[64] if the subject matter of the gift was either the personal residence[65] or farm[66] of the donor. However, in determining the value of the remainder interest in real property, depreciation (computed on the straight line method) and depletion of such property must be taken into account, and such value discounted the value at a rate of 6 percent per year.[67]

The inter vivos gift of a remainder interest in a farm or personal residence may constitute an excellent gift. The donor removes the asset from his estate for estate tax purposes, obtains an income tax deduction which will decrease his net income, and retains virtually unrestricted use of the property for life.[68]

62. *See* H.R. REP. No. 413, 91st Cong., 1st Sess. (1969); S. REP. No. 552, 91st Cong., 1st Sess. (1969); CONFERENCE COMM. REP. No. 782, 91st Cong., 1st Sess. (1969).

63. Pub. L. No. 91-172, tit. II, 83 Stat. 487.

64. INT. REV. CODE OF 1954, § 170(f)(3)(B)(i). The Code also provides for a deduction for the donation of an undivided portion of the taxpayer's interest, such as 50 of taxpayer's 100 acre farm or the donation of an undivided tenancy in common by the creation of such tenancy between the charity and the taxpayer. *Id.* Additionally, a donation in trust for the taxpayer's life or a donation of a remainder interest will create an income tax deduction if the interest or part thereof donated is his entire interest and the aforesaid interest was not created to avoid section 170(f)(3)(A). Treas. Reg. §§ 1.170A-7(a)(2), (b) (1972). For example, if A gave a life interest in securities to B and a remainder to C, and if B or C transferred his interest to charity, then the transferor would be entitled to a charitable deduction from income.

65. The regulations define "personal residence" as any property used by the taxpayer as his personal residence even though it is not used as his principal residence. The term includes stock owned by the taxpayer as a tenant-stockholder in a cooperative housing corporation if used as his personal residence. Thus, a vacation home would qualify. Treas. Reg. § 1.170A-7(b)(3) (1972).

66. A "farm" is defined as any land and improvements used by the taxpayer or his tenant for the production of crops, fruits or other agricultural products or for the sustenance of livestock (cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry). Treas. Reg. § 1.170A-7(b)(4) (1972).

67. INT. REV. CODE OF 1954, § 170(f)(4).

68. For example, Mill Hatcher has decided to give a remainder interest in his personal residence to the University of Richmond, reserving for himself a life estate. He and his wife want to retain the property as a personal residence during his lifetime, but Mrs. Hatcher feels

If the taxpayer does not transfer a remainder interest in a farm or personal residence, he still may enjoy the same benefits by making a gift of a remainder interest in trust.[69] However, the trust must be either a charitable remainder annuity trust,[70] a charitable remainder unitrust,[71] or a pooled income fund.[72]

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that she would not wish to live alone in the residence after the death of her husband. It is determined that the proprty has a fair market value of $60,000, all of which is allocable to the land, and that the building will be fully depreciated at the end of the period that represents the life expectancy of the donor. The applicable table published by the Internal Revenue Service [Treas. Reg. § 20.2031-10(f), Table A(1) (1970)] shows the value of a remainder interest with a life estate vested in a male, 63 years of age, computed on the basis of a six percent return is .49046 of the value of the property as a whole. Hatcher would therefore, be entitled to a deduction of $29,428 ($60,000 x .49046).

69. INT. REV. CODE OF 1954, § 170(f)(2)(A).

70. *Id.* § 664(d)(1). A charitable remainder annuity trust is a trust from which a sum certain (not less than 5 percent of the net fair market value of its assets initially placed in trust) is to be paid, not less than annually, to one or more persons (at least one of which is not a section 170(c) charitable organization and in the case of individuals, only to an individual living at the time of the trust's creation) for a term not to exceed 20 years or the lives of such individual or individuals. *Id.* § 664(d)(1)(A). No amount may be paid from the trust, other than the payments to the individuals described above, to or for the use of any person other than a charitable section 170(c) organization. *Id.* § 664 (d)(1)(B). On termination of the payments, the remainder interest must be transferred to or for the use of a charitable section 170(c) organization or retained by the trust for such use. *Id.* § 664(d)(1)(E). No additional payments may be made to the charitable remainder annuity trust after the initial contribution. Treas. Reg. § 1.664-2(b) (1972).

71. INT. REV. CODE OF 1954, § 664(d)(2). A charitable remainder unitrust is a trust from which a fixed percentage (not less than 5 percent) of the net fair market value of its assets (valued annually) is to be paid, not less than annually, to one or more persons (at least one of which is not a charitable section 170(c) organization). In the case of individuals only, the payment should be to an individual(s) living at the time of the trust's creation for a term not to exceed 20 years of the life (lives) of such individual(s). *Id.* In the alternative, the trust instrument may provide for the distribution to the income beneficiary of the lower of (1) trust income, *id.* § 643(b); or, (2) 5 percent of the net fair market value of the trust assets valued annually. *Id.* § 664(d)(3)(A); Treas. Reg. § 1.664-3(a)(1)(i)(b)(1) (1972). Where payable to the income beneficiary, such deficiency can be made up in a later year when the trust income exceeds the amount otherwise payable to the beneficiary in that year. INT. REV. CODE OF 1954, § 664(d)(3)(B).

No amount may be paid from the unitrust, other than the payments to the individual(s) described above, to or for the use of any person other than a charitable section 170(c) organization. On termination of the payments to the individual(s), the remainder interest in the trust must be transferred to or for the use of a charitable section 170(c) organization or retained by the trust for such use. *Id.* § 664(d)(2)(C). Unlike the annuity trust, the same trust can be used for making additional contributions under the unitrust arrangement if the governing instrument so provides. Treas. Reg. § 1.664-3(b) (1972).

72. INT. REV. CODE OF 1954, § 642(c)(5); Treas. Reg. § 1.642(c)-5 (1971). Many 50 percent charities maintain their own pooled income fund since this encourages donations by taxpayers who would prefer to donate a remainder interest and retain the income interest but are

## Conclusion

For those who counsel taxpayers who sincerely desire to help a charitable organization, it is hoped that this article assists in explaining the intertwining complexities of section 170. With this understanding and proper planning, charitable gifts may be maximized and the donor's costs minimized, by full utilization of available tax benefits.

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deterred because of the expense and complexities of having a charitable remainder annuity trust or unitrust drafted. However, the donor should have his attorney examine the terms and operation of the fund to assure that the fund is a properly functioning pooled income fund. If the fund is in major violation of its rules, then it may be treated as an association taxed as a corporation which may cause substantial tax leading to a decrease in the amounts paid the donor.

A pooled income fund is a trust to which the donor contributes an irrevocable remainder interest to or for the use of an organization qualifying for the 50 percent charitable deduction, except organizations described in section 170(b)(vii) and (viii). The donor retains an income interest for the life of one or more beneficiaries living at the time of transfer. INT. REV. CODE OF 1954, § 642(c)(5)(A). Additional requirements include: commingling with property transferred by other donors, no power to invest in tax-exempt securities, *id.* § 642(c)(5)(C); only amounts received from transfers meeting the pooled income fund requirements can be included, *id.* § 642(c)(5)(D); the fund is maintained by the organization to which the remainder interest is contributed and no donor or income beneficiary can be a trustee, *id.* § 642(c)(5)(E); each income beneficiary receives income determined by the rate of return earned by the trust for such year, *id.* § 642(c)(5)(F).

Provided the above requirements are met, the donor is entitled to deduct as a charitable contribution the fair market value of the remainder interest in a pooled income fund [the valuation is computed under Treas. Reg. § 1.664(c)-6 (1971); Treas. Reg. § 1.170A-6(b)(2) (1975)], a charitable remainder annuity trust [the valuation is computed under Treas. Reg. § 1.664-2 (1972); Treas. Reg. § 1.170A-6(b)(2) (1975)], and in a charitable remainder unitrust [the valuation is computed under Treas. Reg. § 1.664-4 (1972); Treas. Reg. § 1.170A-6(b)(2) (1975)]. However, in some instances the value of the remainder interest donated to charity must be reduced by section 170(e). Treas. Reg. § 1.170(A-6)(b)(2) (1975). As with the donation of a remainder interest in a personal residence or farm, the donor receives approximately the same benefits: the donor will remove the asset from his estate for estate tax purposes, obtain an income tax deduction which will increase his net income, and still have income on which to live or supplement his other income.

The unitrust and pooled income fund are likely the best vehicles for the donor who wishes to make a charitable contribution of a remainder interest, since the income paid to the beneficiary is a percentage of the contributed assets valued annually (quarterly for a pooled income fund).