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Primer #3: Donations of Appreciated Property-Income Tax Consequences

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Primer #3: Donations of Appreciated Property - - Income Tax Consequences.

A donation of appreciated property (i.e., property the value of which exceeds its basis in the hands of the donor) may yield income tax benefits equal to as much as 37% or 38% of the property's value (in states with relatively high personal income tax rates), or as little as nothing. Accurate prediction of the income tax effects of such a gift involves attention to the donor's overall tax situation, the nature of the property, the purpose for which the property has been held, the donor's holding period, and, at times, the use to which the donee organization may put the gift property. This primer is intended to provide a structured approach to the determination of such tax benefits.

1. Would the Property Produce Long-Term Capital Gain If Sold? It is crucial first to address that question. The elements of long-term capital gain treatment are three-fold: (i) a capital asset, (ii) a holding period of more than one year, and (iii) a sale or exchange. Since the sale or exchange is assumed, we need only be concerned with the first two requirements.

Capital assets include all personal-use assets without exception (primary and secondary residences, cars, boats, clothing, antiques, works of art, etc.); assets held for investment purposes (undeveloped land, stocks and bonds); and, effectively, real estate used in a business enterprise. The principal categories of non-capital assets are inventory properties; property held primarily for sale to customers in the ordinary course of a trade or business (lots in a real estate subdivision, condominium units); works of art created by the taxpayer; letters, memoranda, and similar properties created by or for the taxpayer; and accounts and notes receivable acquired in the ordinary course of business. In the ambit of the land trust's operations, the most difficult definitional questions are apt to involve "dealer" properties--real estate held by a person who has a significant history of dealing in such properties. The determination of whether real estate is investment property (thus a capital asset) or "held primarily for sale to customers" (thus not) is inherently and inescapably factual, involving the assessment of dozens of potentially relevant factors.

The holding period requirement is straightforward and simple: "more than one year." Thus property acquired on September 15 could be sold no earlier than September 16 of the following year for long-term capital gain or loss treatment. Note that property acquired by gift entitles the donee to add the donor's holding period to his own, and property acquired by bequest, devise or inheritance may be sold immediately by the executor or beneficiary for long-term treatment.

If the proposed donation satisfies both the capital asset and holding period requirements, it has crossed the first hurdle towards deductibility at full fair market value. If not, the deduction will be limited to the donor's basis.

Example: Individuals D and E own virtually identical adjoining 10-acre parcels, for which each paid $10,000 in 1967. Each parcel is worth $100,000. Their business and investment situations are quite different, however. D has dealt extensively in similar properties, buying and selling lots from her considerable "inventory" of such properties to produce most of her income for the past 30 years. E, on the other hand, has no history of dealing in real estate. It is exceedingly probable that, were each to donate her $100,000 parcel to the Sows Wallow Land Trust, E would be entitled to a $100,000 charitable deduction, while D's contribution deduction would be limited to basis--$10,000.

2. The Alternative Minimum Tax Bugaboo. Even assuming that a proposed gift clears the "long-term capital asset" hurdle described above, the end result may be discouragingly similar to that which attaches to "dealer" property if the taxpayer finds himself in the netherworld of the alternative minimum ("alt min") tax. It is neither possible nor desirable to describe the intricacies of the alt min tax computation here; suffice it to say that when the aggregate of certain items of "tax preference" exceeds 29.2% of a taxpayer's "regular taxable income" (gross income less all allowable deductions), the alt min system takes over, and imposes a tax at the rate of 24% on "alternative minimum taxable income." Since the current and, apparently, ever-growing statutory list of tax preference items includes such garden-
variety deductions as state and local income taxes, real property taxes, and personal exemptions, in addition to such historical tax-shelter-flavored items as intangible drilling costs and accelerated depreciation, the alt min tax exaction is no longer reserved for the aggressive taxpayer with exotic investment inclinations.

When the taxpayer is already in an alternative minimum tax posture, the effect of a donation of appreciated capital gain property will be a reduction of the contribution to basis. (This reduction is achieved, technically, by an addition to regular taxable income, as a preference item, of the appreciation element in the gift.)

**Example:** Consider again the situation of investor E in the first example, whose 10-acre parcel indubitably satisfies the long-term capital asset requirement. If E is subject to the alt min tax even were he not to make the proposed gift, her $100,000 donation will be worth a mere $2,400 in tax benefits (24% of E's basis of $10,000).

In many situations, a substantial donation of appreciated capital gain property will push the donor into the maw of the alt min tax. Where that threatens to occur, quantification of the tax benefit will require a comparison of the regular tax liability (on the assumption that the gift is not made), and the alt min liability (computed by taking into account the gift transaction).

3. **Tangible Personal Properties.** Donations of tangible personal properties such as works of art, antiques, Persian carpets, baseball cards, and other memorabilia, require the donor to confront another, quite different barrier: the necessity that the donee organization will put the donated property to an exempt-function use. The donation of a painting to an art museum will normally meet this test by inference, unless, of course, the donor has reason to suspect that the painting will be sold to produce financial sustenance. The donor of antique furniture to a land trust would be entitled to no such inferential reliance, and the land trust would undoubtedly be asked to furnish a written representation, in such circumstances, that the property would be so used (as, for example, in the office of the land trust's executive director).

The rule of related-function use is of course not applicable to real estate, whether improved or unimproved, nor does it affect donations of intangibles such as stocks, bonds, or notes. Further, it should be noted that donations of tangible personal properties made during calendar year 1991 are permitted to be taken into account at full fair market value even for taxpayers subject to the alt min tax regime. This special-interest (museum) provision will expire by its terms at the end of the current calendar year, but, according to Internal Revenue Service interpretation, carryover amounts attributable to 1991 donations of such properties will similarly be free of the alt min tax bite during the carryover (up to five-year) period.

4. **Donations to Nonoperating Private Foundations.** Finally, although it is no discouragement to the land trust community, we should mention for the sake of completeness that any donation of appreciated property to a nonoperating private foundation must be reduced, for contribution purposes, to the donor's basis. This rule of reduction applies without regard to the nature of the property, nor to the use to which it will be put. It effectively leaves such foundations—typically family and corporate grantmaking foundations—out of the competition for lifetime gifts of appreciated property entirely. (Such foundations are not similarly disadvantaged as to bequests and devises, however.)

5. **Percentage Limitations.** A donation of appreciated capital gain property which qualifies for deduction at full fair market value is nonetheless limited, in the year of the donation, to 30% of the taxpayer's adjusted gross income. Excess donations may be carried over for as long as five succeeding years, or until sooner fully utilized, subject to the same 30% limitation in each carryover year. A special statutory election allows the donor to achieve a deduction equal to that available for gifts of cash and nonappreciated property—50% of adjusted gross income— but only at the sacrifice of reducing the amount of the contribution to basis. Obviously, such an election is rarely advisable; the principal utility of the election is where the appreciation component of the gift is relatively small, as, for example, might be the case as to a gift of a conservation easement over property purchased just over a year before the date of the proposed donation. -- William T. Hutton

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