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# Fundamentals of Charitable Contribution Deductions

**Friday, May 8, 2015**

**12:00 pm – 1:30 pm**

**Committee Luncheon - Estate & Gift Taxes and Fiduciary Income Tax Young Lawyers Subcommittee**

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# Presenters

Mr. Chang is a partner at Ivins, Phillips and Barker who practices in the firm's employee benefits and estate planning groups.

Mr. Chang’s employee benefits practice consists of advice to both for-profit and nonprofit/governmental employers on a wide range of matters, including welfare and retirement plan drafting, assisting with self-corrections and preparing voluntary compliance submissions, resolving disputes with the Department of Labor, counseling plan committees on fiduciary matters, payroll and employment tax issues, and handling a variety of issues that arise in acquisitions and dispositions. Some of his recent employee benefits clients include American Institutes for Research, General Electric, SABIC, and the Smithsonian Institution.

Mr. Chang’s estate planning practice focuses on charitable giving and tax-exempt organization issues. He provides tax advice to a number of the country’s largest private family foundations as well as the corporate foundations of several Fortune 500 companies. He is also actively involved in the formation and legal compliance issues of public charities, museums, schools, trade associations, cemetery companies, donor advised funds, and charitable split interest trusts.

Mr. Nicolini is a Vice President and Trust Officer with U.S. Trust in downtown Washington, D.C. As a leading provider of financial solutions to affluent individuals, U.S. Trust delivers a valuable combination of experience, access and support through our integrated Client Teams. Drawing from this strength, we take a personalized and disciplined approach to understanding and meeting high net worth individuals and families particular needs.

Mr. Nicolini focuses on a broad range of fiduciary matters and directly manages client trust and investment assets along with providing long term strategic planning solutions.

Mr. Nicolini has held a variety of senior fiduciary roles with U.S. Trust, most recently serving as a Wealth Strategies Associate where he provided comprehensive wealth planning solutions centered on developing and implementing advanced financial, tax, estate and business succession plans for individuals and families with at least $10MM of assets.

# Charitable Deductions

For federal income tax purposes, you can deduct (as an itemized deduction) a charitable contribution only if the recipient is a qualified organization. Most organizations (other than churches and governments) must apply to the IRS in order to become "qualified."

Though there are different types of organizations that can be "qualified," two of the most well-known are (i) public charities (which includes donor advised funds), and (ii) private foundations. This summary will discuss the rules limiting your federal income tax deduction for contributions to these types of qualified organizations.

The amount of your charitable contribution that is deductible for federal income tax purposes can be limited based on a combination of (i) the type of donee charitable organization; (ii) the type of property that you donate; and (iii) your adjusted gross income ("AGI").

# Limitations Based On Type Of Donee Charitable Organization

The type of donee charitable organization can affect your charitable income tax deduction. The most common types are public charities, private foundations, and donor advised funds.

**Public charity -** All non-governmental charitable organizations are presumed to be private foundations unless they can meet one of the tests to be classified as a public charity. These tests are based on the activities of the organization and the amount of support that they receive from the general public. Most organizations that we think of as charities, such as churches, schools, food banks, etc., are public charities. Once a gift is made to a public charity, you relinquish all rights to direct the use or investment of the property contributed. Although many charities are set up to receive donations of many different types of assets, some charities cannot (or will not) accept certain securities or other types of property. You should check with the charity prior to making the gift.

**Private foundation -** Private foundations are charitable organizations that are usually established by a family or small group of donors and are unable to meet the public charity support test. Private foundations can be either "operating," which means they actually conduct charitable activities, or "non-operating," which means they act as a conduit to receive charitable contributions, and later grant funds to other operating charities. Most references to the term "private foundation" refer to this latter category. Much like a public charity, a gift to a private foundation also provides an immediate income tax charitable deduction, though subject to more stringent limitations as discussed below. While public charities generally do not pay any income taxes, private foundations are subject to an excise tax of up to 2% on investment income and are subject to a number of other operating restrictions enforced through the imposition of various excise taxes. Private foundations do allow a board of trustees or directors to control the investment of the private foundation's assets as well as the determination of the ultimate charitable beneficiary of a distribution. As a member of the board, you can retain at least some level of control. However, this ability to control brings with it rules to which you, the foundation and all of its board members must adhere. For example, the foundation must annually distribute to public charities an amount equal to at least 5% of the foundation's non-charitable use assets. In addition, you must be careful to avoid running afoul of the many self-dealing and jeopardy-investment rules that govern private foundations.

**Donor Advised Funds** - A Donor Advised Fund is a hybrid type of charity that has gained popularity in recent years. For income tax purposes, a Donor Advised Fund is treated as a public charity, entitling you to higher limits on the deduction for your contribution as discussed below. In addition, it is not subject to many of the private foundation excise taxes. Operationally, it is similar to a private foundation in that it acts as a conduit for your charitable gifts, providing you with a charitable deduction in the current tax year even though your preferred charities do not receive the funds until sometime in the future. A Donor Advised Fund may also provide you with the opportunity to recommend investment strategies for the donated assets. Although a Donor Advised Fund will usually honor your recommendations for both the investment of the funds and the ultimate charitable beneficiary of a distribution, the trustees of the fund retain a veto power (although this power is rarely used).

# Limitations Based On Type Of Property Donated And Limitations Based On AGI

The amount of your charitable deduction is also affected by the type of property that you donate.

**Long-term vs. short-term**. One important distinction is whether the contributed asset is "long-term" or "short-term." "Long-term" means it would be taxed as long-term capital gain if sold, which means your holding period for that asset is more than one year. An asset would be "short-term" if your holding period for that asset is one year or less. In general, you will be entitled to an income tax deduction equal to the fair market value of the asset if it is long-term; your deduction will be limited to the cost basis of the asset if it is "short term." Similarly, if the disposition of an asset would generate ordinary income, in general your deduction will be limited to the cost basis of the asset. These differences are summarized in the chart that follows.

**Tangible Personal Property.** The law also limits the potential deduction when the type of property you contribute is property other than cash or securities. The deductible amount for contributions of tangible property (such as art works) will depend on whether the charity can use the property in performing its exempt purpose. For example, a donation of a painting to an art museum would be used by the museum as part of its exempt purpose, and therefore you could deduct the full fair market value of the art work (subject to the limitations discussed herein). In contrast, if the same painting were donated to the Red Cross, it would not be used as part of its exempt purpose and therefore you would be able to deduct an amount equal only to your tax cost basis.

Finally, the amount of your total charitable contributions that can be deducted in any given tax year will be limited to a certain percentage of your AGI, depending on the type of donee charity and the type of property donated, as discussed above.

**5-year carryover.** To the extent that the total of your charitable deductions for a given year exceed the AGI limitations described above, any "unused" amount can be carried over to future tax years. Unused amounts can be carried over for up to 5 tax years, but any amounts carried over (plus any actual contributions for those years) will be subject to similar AGI limitations applicable to those future years.

# SUMMARY CHART

The following chart summarizes the limitation on charitable deductions, depending on these three variables of (i) type of organization; (ii) type of property; and (iii) AGI.

| Type of Property[1] | Public Charity (including Donor Advised Fund) | | Private Foundation | |
|---|---|---|---|---|
| | Deductible Amount[2] | AGI % Limitation[3] | Deductible Amount[2] | AGI % Limitation[3] |
| **Cash** | Amount of cash | 50% | Amount of cash | 30% |
| **Short-term* capital gain property or ordinary income property** | Tax Cost/Basis | 50% | Tax Cost/Basis | 20% |
| **Long-term* capital gain property** | Fair Market Value | 30% | Tax Cost/Basis (Fair market value if publicly traded stock[4]) | 20% |
| **Tangible personal property (e.g. art) – If it will be used by the charity in conducting its exempt functions** | Fair Market Value | 30% | Tax Cost/Basis | 20% |
| **Tangible personal property (e.g. art) – If it will NOT be used by the charity in conducting its exempt functions** | Tax Cost/Basis | 50% | Tax Cost/Basis | 20% |

* Long-term property is property held more than one year. Short-term property is property held one year or less.

[1] Conservation easements are not discussed in this summary. Through 2013 a charitable gift of a conservation easement is deductible to the extent of 50% (100% for farmers or ranchers) of AGI, and any excess can be carried forward for up to 15 years. We have a separate Wealth Strategy Report: *Conservation Easements*.

[2] In all cases where the deduction is limited to cost basis, if the fair market value is lower (i.e, the asset has depreciated), the deduction will be the lower fair market value.

[3] Charitable contributions that are not deductible due to the AGI limitations can be carried forward for up to five years.

[4] Note: gifts of publicly traded stock may be deducted at full fair market value, but the deduction for gifts of bonds (even publicly traded bonds) is limited to tax cost/basis.

# Limitations Based On Type Of Property Donated

The amount of your charitable deduction is also affected by the type of property that you donate.

**Example 1**. Your AGI is $250,000. You donate to your alma mater, a public charity, publicly traded stock worth $10,000 with a basis of $2,000. You have owned the stock for five years. Because your alma mater is a public charity, the applicable limitations would be those in the columns in the grid above headed "Public Charity." Because the stock is publicly traded and is long-term, you would be able to deduct the fair market value of $10,000. Your AGI limitation would be 30% of $250,000, or $75,000. If this is your only charitable gift, this AGI limitation would not limit your $10,000 deduction.

**Example 2**. Your AGI is $100,000. You donate to a private foundation stock in your closely-held company worth $10,000 with a tax cost basis of $1,000. You have owned the stock for five years. Because the donee is a private foundation, the applicable limitations would be those in the columns in the grid above headed "Private Foundation." Because the stock is not publicly traded, you would be able to deduct an amount equal to your basis of $1,000, not the fair market value of $10,000. Your AGI limitation would be 20% of $100,000, or $20,000. If this is your only charitable gift, this AGI limitation would not limit your $1,000 deduction.

# The Pease Limitation

Another limitation on charitable deductions is a general phase-out of most itemized deductions, including charitable contributions. This limitation, known as the "Pease" limitation, had expired for years 2010 through 2012 but is in effect again beginning in 2013.

Subject to limitations described below, certain itemized deductions are phased out once your AGI exceeds certain thresholds, which depend on your filing status, summarized in the chart at the right.

You are required to reduce (by up to 80%) the amount of certain otherwise allowable itemized deductions by 3% of the excess of your AGI over these threshold amounts.

| Filing Status | AGI Threshold |
|---|---|
| Married filing jointly | $300,000 |
| Married filing separately | $150,000 |
| Single | $250,000 |
| Head of Household | $275,000 |

**The following itemized deductions are subject to this limitation**:

- state and local taxes;
- mortgage interest;
- charitable contributions; and
- miscellaneous itemized deductions have been taken into account.

**The following itemized deductions are not subject to this limitation**:

- medical expenses (which are already subject to a "floor" of 10%, reduced to 7.5% if one spouse is 65 or older);
- investment interest; and
- casualty, theft or wagering losses

This limitation is applied after the application of any other limitation on the itemized deduction. Thus, this limitation would apply to miscellaneous itemized deductions after the 2% floor has been taken into account. Similarly, this limitation would apply to charitable deductions after the various AGI limitations applicable to charitable deductions have been taken into account.

# Understanding The Effect Of The Pease Limitation

It is important to understand which particular deductions are affected by the Pease limitation and how they are affected, otherwise, you can mis-plan. This will depend on your particular tax situation, illustrated in the following two examples.

**Example 3**. Assume you are married filing jointly, your AGI is $650,000, and your itemized deductions that are subject to the Pease limitation are as follows:

| Itemized Deductions Subject to Pease Limitation | |
|---|---|
| State and local taxes | $20,000 |
| Mortgage interest | $15,000 |
| Charitable contributions (after AGI limitations) | $15,000 |
| Misc. itemized deductions (after 2% floor) | $ 5,000 |
| **TOTAL SUBJECT TO PEASE** | **$55,000** |

Your threshold for purposes of the Pease limitation is $300,000, and your AGI of $650,000 exceeds that by $350,000.
The amount of itemized deductions phased out is the lesser of

(i) 3% of that excess ($10,500), or

(ii) 80% of the $55,000 of deductions subject to the phase out ($44,000). As a result, $10,500 of deductions will be phased out under the Pease limitation.

In this Example 3 there are $55,000 of deductions subject to the Pease limitation, and $10,500 of deductions are phased out.
Of the four deductions totaling $55,000, which comprise the $10,500 that are phased out by the Pease limitation? There is no ordering rule required by the statute.
However, in this Example 3, state/local taxes and mortgage interest must be paid; charitable contributions and the miscellaneous deductions are optional expenditures. From that perspective, it is reasonable to view the phase-out as denying a deduction for $10,500 of the $35,000 you would have paid anyway for taxes and mortgage interest. To put it another way, given that the $35,000 you paid for taxes and mortgage interest is more than the amount of deductions phased out, your charitable contribution of $15,000 truly increased your itemized deductions by $15,000. Therefore, in this example it is reasonable to say that your charitable contributions are not affected by the Pease limitation.

# Understanding The Effect Of The Pease Limitation - continued

**Example 4**. Assume you are married filing jointly, your AGI is $650,000, and your itemized deductions are as follows:

| Itemized Deductions Subject to Pease Limitation | |
|---|---|
| State and local taxes | $0 |
| Mortgage interest | $0 |
| Charitable contributions (after AGI limitations) | $55,000 |
| Misc. itemized deductions (after 2% floor) | $0 |
| **TOTAL SUBJECT TO PEASE** | **$55,000** |

The totals are the same as from Example 3, and the Pease calculations would again phase out $10,500 of itemized deductions.

***However***, because your only deduction subject to the Pease limitation is the $55,000 charitable contribution, in this Example 4 your charitable contribution deduction has indeed been reduced by the Pease limitation.

In short, the effect of the Pease limitation will depend on the particular itemized deductions you have. You should not assume that charitable contributions will be phased out; they might be (**as in Example 4), or they might not be (as in Example 3).**

As mentioned above, to the extent that the total of your charitable deductions for a given year exceed the AGI limitations, there is a 5-year carryover. Unfortunately, any amount “denied” under the Pease limitation is lost and cannot be carried over to future tax years.

# Example Combining All Limitations

**Example 5**. Assume your AGI is $400,000, you have made a $150,000 charitable contribution of long-term appreciated securities to a public charity and that you have no other itemized deductions.

*First Limitation, based on type of donee, type of property, and AGI:*

The first limitation (based on contributing long-term property to a public charity) would limit your charitable deduction to $120,000 (30% of your $400,000 AGI). In this example, your charitable contribution exceeds this limitation by $30,000 ($150,000 - $120,000). The excess $30,000 would be carried forward and used as a deduction in succeeding tax years (maximum of five-year carryforward).

*Second Limitation, the Pease limitation:*

The $120,000 charitable deduction is now subject to the Pease limitation. Based on $400,000 of adjusted gross income, the phase-out of itemized deductions would cause you to lose another $3,000 (($400,000 - $300,000) x 3%) of your $120,000 deduction. Your net allowable charitable deduction would be $117,000.

# Section 170 Substantiation Requirements – Cash Contributions

## Contributions Less Than $250

- Section 170(f)(17) requires donor to maintain either a bank record or a written communication from the donee substantiating the gift.
- Such written record must show the name of the donee organization, the date of the contribution, and the amount of the contribution.
- A bank record includes a bank or credit card statement, EFT receipt, cancelled check, or scanned copy of check from a bank website. Prop. Reg. § 1.170A-15(b)(2).
- A written communication from the donee includes e-mail correspondence. Prop. Reg. § 1.170A-15(b)(3).
- The written record must be received by donor on or before the earlier of (1) the date donor files income tax return for year in which contribution is made, or (2) the due date (including extensions) for filing the return for that year. Prop. Reg. § 1.170A-15(c).

## Contributions $250 or More

- In addition to the written record under Section 170(f)(17), donors making contributions of $250 or greater are required under Section 170(f)(8) to obtain a contemporaneous written acknowledgement from the donee organization.
- Such acknowledgement must include:
  - the amount of the cash and a description (but not value) or any property other than cash contributed,
  - whether the donee organization provided any goods or services in consideration for the contribution, and
  - a description and good faith estimate of the value of such goods or services, or a statement that they consist solely of intangible religious benefits.
- Separate contributions of less than $250 are not subject to Section 170(f)(7), even if they total more than $250. Reg. § 1.170A-13(f)(1).
- Written acknowledgement must be received by the same deadline that applies to the written record required under Section 170(f)(17).

# Section 170 Substantiation Requirements – Noncash Contributions

| | |
|---|---|
| Contributions less than $250 in value | • Reg. § 1.170A-13(b)(1) requires donors to obtain a written receipt from the donee showing the name of the donee, date and location of the contribution, and a description of the property in detail reasonably sufficient under the circumstances.<br>• Reliable written records may be used to satisfy this requirement in circumstances where it is impractical to obtain a receipt (e.g., drop-off site donations) |
| Contributions of $250 or more | • As with cash contributions, property donations valued $250 or more must be substantiated with a contemporaneous written acknowledgement from the donee organization that satisfies the requirements of Section 170(f)(8). |
| Contributions of $500 or more | • Section 170(f)(11)(B) and Reg. § 1.170A-13(b)(3) require certain information describing the contributed property to be stated in donor's tax return.<br>• Per Prop. Reg. § 1.170A-16, this requirement is satisfied using Form 8283, which requires a description of the contributed property, the date and manner in which the property was acquired, the donor's tax basis in the property, the property's fair market value, and the method used to determine the FMV. |
| Contributions of $5,000 or more | • In order to claim a deduction for a contributed property of over $5,000 (other than publicly traded stock), Section 170(f)(11) (C) requires donor to obtain a qualified appraisal and include information about the property and appraisal on Form 8283.<br>• If the deduction claimed exceeds $500,000, a copy of the qualified appraisal must be submitted with Form 8283 per Section 170(f)(11)(D). |

# Qualified Appraisals

Section 170(f)(11)(E)(i) defines a "qualified appraisal" as an appraisal that is treated as such under the Treasury regulations and is conducted by a qualified appraiser in accordance with generally accepted appraisal standards.

- Prop. Reg. § 1.170A-17(a)(2) defines generally accepted appraisal standards as "the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation."
- The proposed regulation contains guidelines on qualified appraisal content, including information about the property's condition and any restrictions imposed on its use.

The valuation effective date must be no earlier than 60 days before the date of the contribution and no later than the date of the contribution. Prop. Reg. § 1.170A-17(a)(5).

# Qualified Appraiser Definition

Required qualifications for a "qualified appraiser" are set forth under Section 170(f)(11)(E)(ii) and Prop. Reg. § 1.170A-17. A qualified appraiser must satisfy the following requirements:

- Has earned an appraisal designation from a recognized professional appraiser organization or satisfaction of minimum education and experience requirements set forth in regulations,
- Regularly performing appraisals for compensation,
- Meets other requirements as set forth in Treasury regulations and guidance,
- Demonstrates verifiable education and experience in valuing the type of property being appraised, and
- Has not been prohibited from practicing before the IRS at any time during the 3-year period prior to the date of the appraisal.

Qualified appraisers are subject to penalties under section 6695A for valuation misstatements attributable to incorrect appraisals.

# Special Rules for Certain Categories of Property Contributions

## Unreimbursed Volunteer Expenses

- The value of volunteer time and services provided to a charity is generally not deductible under Section 170.
- However,  Treas. Reg. § 1.170A-1(g) does allow for deduction of unreimbursed expenses made incident to providing services to a charitable organization.
- No written record is required per Prop. Reg. § 1.170A-15(e) for out-of-pocket expenses less than $250, but ccontemporaneous written acknowledgement from the donee is still required for deduction of expenses greater than $250.  *See* Reg. § 1.170A-13(f)(10).

## Used Motor Vehicles, Boats and Airplanes

- Under Section 170(f)(12), the value of the deduction for contributions of vehicles valued at over $500 is limited to amount of gross proceeds of donee's subsequent sale of the vehicle.
- Special contemporaneous written acknowledgement requirements apply.

# Special Rules for Certain Categories of Property Contributions (continued)

## Taxidermy Property

- Section 170(f)(15) limits donor's basis in the property to the cost of preparing, stuffing and mounting the donated item.

## Clothing and Household Items

- Section 170(f)(16) provides that a charitable deduction is available only for clothing and household items (i.e., furnishings, electronics, appliances, linens and similar items) in good used condition or better.
- This restriction does not apply to single items valued at over $500 for which a qualified appraisal is obtained and attached to Form 8283.

# Special Rules for Certain Categories of Property Contributions (continued)

## Deductions for Contributions of Partial Interests in Property Generally Prohibited under Section 170(f)(3). Key Exceptions:

- Qualifying interests in charitable remainder trusts and charitable lead trusts.
- Remainder interest in a personal residence or farm. § 170(f)(3)(B)(i).
- An undivided portion of the donor's entire interest in the property.
  § 170(f)(3)(B)(ii).
  - Special limitations and valuation rules apply to fractional gifts of tangible personal property under Section 170(o).
- Qualified conservation contributions
  - Section 170(h) allows a deduction for contributions of partial interests in real property exclusively for conservation purposes.
  - Examples include land preservation easements and historical fascade easements.

# Example #6

You own a painting that you purchased more than 5 years ago for $5,000 that has an appraised value of $15,000 today. You decide to donate the painting to a private secondary school that qualifies as a public charity. Two years from now, the school sells the painting at auction to raise money to buy classroom equipment.

Your income tax consequences from this charitable contribution will depend on several factors (aside from the AGI limits discussed earlier):

- Because the painting is tangible personal property, you are only entitled to deduct the full $15,000 fair market value if the school will be using the painting to conduct its educational activities and provides the necessary certification on your Form 8283. Otherwise, your deduction is limited to $5,000.
- Under the recapture rule of Section 170(e)(7), you may be required to include $10,000 in ordinary income for the year in which the school disposes of the painting, since it is being sold within the 3 years of your contribution. This recapture can be avoided if the school certifies on Form 8282 that it either made substantial use of the painting for its educational purposes or that its intended use has become unfeasible.

# Example #7

You own an undeveloped piece of land worth $500,000 that includes an environmentally vital wetlands habitat. You decide to place a conservation easement on the property that prohibits any future development of the land, reducing its appraised value to $200,000, and you contribute the easement to a charitable land trust organization. In a subsequent year, you contribute the land to your family's private foundation, which utilizes the property as a public park and nature center.

If your easement contribution satisfied all of the relevant requirements of Section 170(h), you would be entitled to a $300,000 charitable deduction representing the diminished value of the property.

If your foundation's use of the subsequently donated property along with its other activities allow it to qualify it as a private operating foundation in the year of the contribution, your charitable deduction for the later gift could be based on the property's fair market value at that time rather than being limited to your tax basis.

It would still be necessary to ensure that any subsequent use of the property involving you or your family be restricted in order to avoid prohibited self-dealing transactions with the foundation.

# Questions?

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