3 Charitable Contributions

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Planning for Tax Law Changes

- As of the date of printing, the following provisions have expired and not been extended:
  – Charitable contributions of IRA distributions.
  – Charitable contributions of food inventory.
  – Conservation contribution increase in AGI limitation.
  See *TheTaxBook* Update Service at www.thetaxbook.com for information about late breaking legislation.

Charitable Contribution Planning Tips

EO Select Check. Exempt Organizations Select Check is an online search tool that allows users to search for and select an exempt organization and check certain information about its federal tax status and filings. It consolidates three former search sites into one, providing expanded search capability and a more efficient way to search for organizations. www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check.

Standard mileage rate. The standard mileage rate for volunteer charitable miles is 14¢ per mile.

Actual vehicle expenses. Instead of the standard mileage rate, the taxpayer can deduct actual expenses for use of the taxpayer's vehicle for volunteer charitable work. Include gas and oil only, not insurance, maintenance, depreciation, etc.

Meals. Travel expenses for doing volunteer work include meals and lodging. Deduct 100% of the cost of meals, not 50%.

Deduction for out-of-pocket volunteer work. Deduct as a cash contribution—not a noncash contribution.

$250 rule. A donation of $250 or more to any single charity in one day requires an acknowledgement statement from the charity. This includes out-of-pocket expenses for doing volunteer work.

Benefit the organization rule. To be deductible, a cash donation (including out-of-pocket expenses for doing volunteer work) must be made to a charitable organization. Expenses incurred that benefit an individual rather than the organization are nondeductible. Instead of giving cash to an individual in need, donate to a qualified charitable organization that will then use the money to help the individual. ***Example:*** Instead of giving money to a missionary, donate cash to a church that will use the money to support the missionary.

Depreciation. Depreciation is allowed only for the use of property in a trade or business. A depreciation deduction is not allowed for the use of property in doing volunteer work for a charity.

Time and use of property. No deduction is allowed for the time spent by an individual doing volunteer charitable work or for allowing a charity to use property owned by the taxpayer.

Charitable Contribution Planning Strategies

Following is a summary of planning strategies used in this Tab.

- Taxpayers should verify an organization is a qualified charitable organization if they wish to deduct volunteer expenses as a charitable contribution. Visit the IRS website at:
  www.irs.gov/Charities-&-Non-Profits
  See *Volunteer Expenses for Charity,* page 3-2.
- Out-of-pocket volunteer expenses are deductible as charitable contributions only if the taxpayer establishes a verifiable relationship with the charitable organization, the taxpayer keeps a detailed record of all expenditures incurred, the taxpayer obtains a proper and timely acknowledgment from the charity for each expenditure of $250 or more, and if the expense is for the cost of attending a convention, the taxpayer must be a chosen representative of the charity. See *Volunteer Expenses for Charity,* page 3-2.
- If the taxpayer wishes to help another person do volunteer work for a charitable organization (such as help support a missionary), make sure the donation is made to the qualified charity rather than the individual doing the volunteer work. See *Volunteer Expenses for Charity,* page 3-2.
- Turn a charitable contribution (subject to various limitations) into a business advertising expense by structuring the contribution as an expenditure for the purchase of advertising space. See *Turning Charitable Contributions Into Advertising Expenses,* page 3-5.
- Rather than take an IRA distribution and donate to charity, have the IRA trustee directly pay the IRA distribution to the eligible charitable organization. Taxes are reduced to the extent the IRA distribution would otherwise increase AGI and thus decrease allowable medical and miscellaneous itemized deductions. Taxes are also reduced to the extent the IRA distribution would otherwise increase taxable Social Security benefits. ***Caution:*** As of the date of printing, this provision expired at the end of 2014 and has not been extended. See *Charitable Contributions of IRA Distributions,* page 3-7.
- Make a charity the beneficiary of an IRA. An IRA or other retirement asset is included in the taxpayer's gross estate for estate tax purposes. The IRA is also taxable income to

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the recipient. If an IRA is paid to a charity, the IRA is not subject to either estate or income tax. See *Transfers to Charity at Death,* page 3-10.
- Transfer property to a charitable remainder trust. A charitable remainder trust allows a taxpayer to give an appreciated asset to charity while keeping an income stream. The taxpayer receives a current income tax deduction. The capital gains tax on the sale of the asset is deferred, and in some cases reduced, allowing the trust to invest the entire proceeds of the sale. A charitable remainder trust can increase the amount of the gift passing to charity. See *Transfers to Charity at Death,* page 3-10.

Volunteer Expenses for Charity

Cross References
- Schedule A (Form 1040), *Itemized Deductions*
- IRS Pub. 526, *Charitable Contributions*
- IRS Pub. 1771, *Charitable Contributions: Substantiation and Disclosure Requirements*
- IRC §170, *Charitable, etc., contributions and gifts*

Tax Issue
IRS regulations allow taxpayers who volunteer for charitable organizations to claim certain unreimbursed expenses as charitable contributions on Schedule A, *Itemized Deductions* [Reg. §1.170A-1(g)]. A volunteer might incur out-of-pocket expenses for mileage and other travel, meals, lodging, various supplies, convention or conference fees, uniforms, etc. Volunteers occasionally pay for dependent care or for substitute labor at their regular jobs in order to be free to perform services for the charitable organization. Sometimes volunteer activities have both a charitable and a personal aspect. Determining which volunteer activities and expenses may qualify as charitable donations is not always easy, and qualifying expenses are subject to specific recordkeeping requirements.

Applicable Tax Law
- Only donations made to, or for the use of, qualified organizations may be claimed as charitable contributions. Qualified organizations are defined in IRC section 170(c) and an up-to-date list is maintained on the IRS website at www.irs.gov/Charities-&-Non-Profits.
- Expenses incurred by the taxpayer in performing voluntary service to a qualified organization may be deductible if the following four conditions are met.
  1) The taxpayer receives no reimbursement, or if partially reimbursed, reduces the amount to be deducted by the reimbursement amount,
  2) The expenses are directly connected with services performed for the organization,
  3) The expenses are incurred solely because of the services given, and
  4) The expenses are not personal, living, or family expenses.
- Volunteer expenses are treated as contributions of cash or money, not as noncash donations.
- The value of a taxpayer's time or services is never deductible.
- No deduction is allowed for paying another person's volunteer expenses.
- Unreimbursed expenses incurred in attending a convention are deductible only if the taxpayer is a chosen or designated representative of a qualified organization.
- Necessary travel expenses incurred while performing services for a qualified organization are deductible only if there is no significant element of personal pleasure, recreation, or vacation in the travel and if the taxpayer was on duty in a genuine and substantial sense throughout the trip. The deduction will not be denied simply because the taxpayer enjoyed the trip. Deductible travel expenses include:
  – Air, rail, and bus transportation.
  – Taxi fares or other transportation between an airport or station and a hotel.

  – Car expenses, computed either at the flat mileage rate of $.14 per mile or as the cost of gas and oil directly related to the use of the car in giving service, but not insurance, routine maintenance, interest, vehicle registration, or depreciation.
  – Parking fees and tolls.
  – Lodging and meal costs, but only if the taxpayer must be away from home overnight. Meals are not subject to the business meal limitations but are deductible at 100%.
- The taxpayer must keep written records of the time, place, date, amount, and nature of qualifying expenses. Receipts, cancelled checks, and credit card statements should be retained to prove the amounts and dates of the qualifying expenses.
- For each volunteer expenditure of $250 or more, the taxpayer must obtain an acknowledgment from the qualified organization on or before the date the return is filed claiming the volunteer expense deduction, but no later than the due date (including extensions) for filing the return. The acknowledgment must contain the following:
  – A description of services provided by the taxpayer, and
  – A statement of whether the organization provided reimbursement in any form, and
  – A description and good faith estimate of the value of any reimbursement provided, and
  – A statement that the only benefit in excess of reimbursements (if any) received by the taxpayer was an intangible religious benefit, if that was the case.

- A taxpayer who claims expenses directly related to the use of his or her car in giving services to a qualified organization must keep reliable written records of the car expenses. The records must show the name of the organization, dates, and mileage or actual costs of operating the car each time the car was used for a charitable purpose.

Tax Planning Strategies

Taxpayers who wish to claim volunteer expenses that will hold up under examination should plan to establish a chain of evidence to support their deductions.

- The taxpayer verifies that the organization for which he or she is volunteering qualifies at the time the service occurs. ***Note:*** Because an organization's tax-exempt status is automatically revoked due to failure to file the required Form 990, 990-EZ, 990-PF, or 990-N for three consecutive years, the taxpayer should consult the IRS website at www.irs.gov/Charities-&-Non-Profits and previously issued IRS determinations should not be relied on. (Rev. Proc. 2011-33)
- The taxpayer establishes a verifiable relationship with the qualified organization. Establishing the relationship could be as simple as signing up as a volunteer on a list that can be checked by an IRS auditor.
- The taxpayer keeps a detailed record of all expenditures incurred in connection with the volunteer service, including receipts, cancelled checks, credit card statements, and mileage logs, as well as a record of how the expenses relate to the volunteer service.
- For each expenditure of $250 or more, the taxpayer obtains a proper and timely acknowledgment from the organization for which the service is performed.
- If the taxpayer wishes to deduct the cost of attending a convention connected to the volunteer service, he or she arranges to attend as a chosen representative of a qualified organization.
- If the taxpayer wishes to deduct contributions made to support volunteer efforts of other people, unrestricted donations must be made directly to the qualified organization. The organization has control of the contribution and chooses how to allocate funds among its volunteers.

Examples

Example #1: Sarah lives in California and wants to help with flood recovery efforts in Duluth, Minnesota, but she also wants to claim a tax deduction for expenses she will incur. Instead of merely showing up with a shovel, she identifies a qualified organization (such as a church or the American Red Cross) doing the kind of work she wants to do. Sarah signs up with the qualified organization, participates in the clean-up work with the organization, logs in her time with the other volunteers, and works under the direction of the organization. If she has an expenditure of $250 or more, she obtains a proper and timely acknowledgment from the organization. She's doing the same kind of work she might have done as an individual, but now she can deduct her documented mileage, meals and lodging, and other directly connected out-of-pocket expenses.

As additional documentation, Sarah saves newspaper clippings about the organization's service in Duluth, photos of herself and the other volunteers in action, and any related items such as a T-shirt issued to volunteers or a letter of thanks from the city.

Example #2: Dave has been volunteering with a local council of the Boy Scouts of America in Idaho for years and has properly deducted volunteer expenses such as meeting supplies, uniforms, and mileage. In 2014, Dave attended a week-long volunteer conference at Philmont Scout Ranch in New Mexico. The objective of the conference is to provide Boy Scout leaders with training that they can use to strengthen their home council and district units. Participation in the conference is by invitation only, and Dave attended because his local Boy Scout council added his name to the invitation list. He was not a delegate or agent for his council and had no responsibilities in connection with the conference.

Dave had an understanding with his local council that he will return to assist the council and district with training programs, but he was under no obligation to do so. Even though his attendance at the conference might make him a more effective volunteer, he is the primary beneficiary of the mileage and travel expenses. He may not deduct mileage, travel, or other expenses incurred in attending the conference.

In 2015, Dave is again invited to attend Philmont. This time, Dave teaches various training sessions each morning and afternoon of the conference. He is also in charge of conducting a problem-solving workshop specifically for scout leaders who work with at-risk youth. In 2015, the BSA is the primary beneficiary of Dave's volunteer service, and he may deduct volunteer expenses for which he has proper documentation and any necessary acknowledgments.

Example #3: John loves to sing and has joined his church choir. He drives to choir practice each Wednesday evening, often giving rides to other choir members. His activity is considered to be primarily a personal religious pursuit, and the church's benefit is only incidental. He may not claim a deduction for volunteer miles in connection with being a choir member.

In 2015, the pastor asks John to serve as the choir director. This is an unpaid position that requires considerable effort on John's part. He selects and arranges the music and composes choral works for the church's use on special occasions. He attends every choir practice, drives to music supply stores to make purchases relating to his service as choir director, and

keeps copies of church bulletins noting his service as choir director. John is reimbursed for purchased sheet music but not for paper and copies used for his compositions.

John's service directly benefits the church. If he keeps adequate records and obtains any necessary acknowledgments, he may deduct mileage and other unreimbursed expenses he incurs as choir director. It does not matter that he enjoys his service and is improving his musical skills.

Example #4: Julie speaks Romanian and travels to Romania to volunteer with a qualified American charitable organization that provides services to Romanian orphans. Julie is an accountant and spends eight hours a day for two weeks auditing the organization's Romanian books and procedures. At her own expense, she makes long-distance calls to the American headquarters of the organization to get additional information. During the final days of the two-week period, she composes a lengthy report detailing her recommendations to the organization. She receives no compensation or reimbursement of any kind for this work.

After her service is complete, Julie spends an additional month in Eastern Europe improving her language skills. She also has hired a temporary employee to work in her accounting business for the six weeks of her absence. If properly documented and acknowledged, Julie may deduct her own travel, meals, lodging, telephone calls, and other unreimbursed expenses related to her two weeks of service to the organization. Neither her expenses during the additional four weeks, her airfare to and from Romania, nor the wages for the temporary employee are deductible as volunteer expenses because Julie herself is the primary beneficiary of those expenses.

Example #5: Doug sponsors and coaches a hockey team in a qualified organization's league organized for inner-city families. Doug is a single parent and hires a baby sitter for his 5-year-old daughter so that he can volunteer. In his capacity as sponsor, he pays entry fees directly to exempt organizations. He also pays for team uniforms, equipment, team travel, and snacks and receives no reimbursement of any kind. Only his entry fees qualify as volunteer expenses because they directly benefit the organizations. The other expenses primarily benefit the players on his team, not the charity, and are therefore not deductible as volunteer expenses. In any case, Doug's childcare costs are not deductible as volunteer expenses.

✎ **Author's Comment:** In Example #5 above, Doug should instead contribute money to the league as a deductible charitable contribution and have the league purchase the team uniforms, equipment, etc.

Possible Risks

- The taxpayer may fail to keep adequate records or obtain necessary acknowledgments from the organization. It is common for taxpayers to omit these steps and reconstruct mileage or other expenses when doing the tax return.
- Unbeknownst to the taxpayer, the organization for which the taxpayer volunteers may have had its exempt status revoked.
- The IRS may determine that the qualified organization is not the primary beneficiary of the taxpayer's service.
- A taxpayer who volunteers for a qualified organization away from home for more than a year may be deemed by the IRS to have moved to the location of the services. Thus the taxpayer will not be "away from home" and no deduction will be allowed for travel costs.
- The taxpayer may improperly report volunteer expenses as noncash contributions, triggering the $500 or $5,000 thresholds for substantiation. Volunteer expenses are treated as contributions of cash or money.

Court Cases

Court Case: A husband and wife were active in their church and properly deducted their own volunteer expenses. They had two sons who lived away from home and served as unpaid church missionaries. The parents provided funds directly to their sons to help pay for living expenses and claimed a charitable deduction for the amounts. The IRS disallowed the deduction and the Supreme Court agreed. Money deposited into the sons' bank accounts directly benefitted the sons, not the church, even though it was spent in the course of the sons' volunteer work. The payments were not made to, or for the use of, the church, and did not qualify as donations of money to the church. In addition, the parents were not entitled to a volunteer expense deduction for the payments because the parents did not render the service themselves. *(Davis,* Supreme Court of the United States, May 21, 1990)

Court Case: A taxpayer incurred unreimbursed volunteer expenses for veterinary services, pet supplies, cleaning supplies, and household utilities while caring for foster cats in her private residence. The IRS denied her deduction for the expenses, but the Tax Court disagreed. The taxpayer's services were directed by Fix Our Ferals, a qualified organization that specialized in neutering wild cats. Her expenses were incurred in the course of her service to Fix Our Ferals. The court determined that her records substantially met the requirements of IRC section 1.170A-1(a), which sets forth recordkeeping rules for money contributions. Although some expenses (such as vacuum cleaner repairs and a Costco membership) were disallowed as being insufficiently related to foster cat care, the taxpayer was allowed to deduct her foster cat care expenses of less than $250. However, the taxpayer had failed to obtain contemporaneous written acknowledgment of any of her expenses from Fix Our Ferals. She was not allowed to

deduct any foster cat expenses of $250 or more. Disallowed expenses included large veterinary bills that would have been fully deductible had she obtained timely acknowledgment from Fix Our Ferals. *(Van Dusen,* 136 T.C. No. 25, June 2, 2011)

Turning Charitable Contributions Into Advertising Expenses

Cross References

- Form 990-T, *Exempt Organization Business Income Tax Return*
- IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations*
- IRC §162, *Trade or business expenses*
- IRC §170, *Charitable, etc., contributions and gifts*

Tax Issue

Charitable contributions made by businesses do not receive the same tax treatment as advertising expenses. Contributions are subject to various limitations and restrictions at both the entity and personal tax level. Carryovers are generally limited to five years and unused deductions are forfeited. Partners, S corporation shareholders, and sole proprietors deduct charitable donations on Schedule A. Any tax benefit depends on the taxpayer's marginal tax bracket, potentially resulting in unequal tax treatment among shareholders or partners. The charitable contribution loses its value as a tax deduction for individuals who don't itemize. In contrast, amounts spent by businesses for advertising generally are fully deductible by the business.

Applicable Tax Law

- Only contributions to qualified charitable organizations, listed on the IRS website at www.irs.gov/Charities-&-Non-Profits, may be considered for a charitable contribution deduction. All of the rules for recordkeeping, substantiation, and donee acknowledgments that apply to individuals also apply to businesses.
- C corporations may deduct charitable contributions up to 10% of taxable income, computed without considering deductions for the charitable contribution, dividends received, IRC section 249 bond premiums, and domestic activities, or NOL or capital loss carrybacks.
- The deduction for contribution of property by a C corporation is generally limited to the adjusted basis of the property. An exception exists for donation of inventory. The qualified organization must use the donated inventory solely for the care of the ill, the needy, or infants, and must provide a statement to the C corporation to the effect that the inventory will not be transferred in exchange for money, services, or other property. In this case, the C corporation may increase its charitable contribution deduction by one-half the amount that would have been ordinary income had the inventory been sold, but limiting the deduction for the donated inventory to no more than twice its cost. As of the date of printing, a similar exception for the charitable donation of food inventory expired at the end of 2014 and has not been extended.
- Charitable contributions that are unused by C corporations because of the 10% limit may be carried forward for a maximum of five years, but may not be used to increase an NOL carryover. Charitable contributions that remain undeducted due to these restrictions are lost. In particular, they may not be deducted as business expenses. (Reg. §1.162-15)
- Individuals deduct charitable contributions on Schedule A, *Itemized Deductions.* Contributions deducted on Schedule A may have been made personally by the taxpayer, by the taxpayer's sole proprietorship, or by an entity taxed as an S corporation or partnership that passes the deduction through to the taxpayer on a K-1.
- Total charitable contributions deducted by individuals as itemized deductions are generally limited to 50% of the taxpayer's adjusted gross income. Limitations of 30% and 20% of AGI apply in certain situations.

- Charitable contributions that are unused on Schedule A because of the AGI limitations are carried over for a maximum of five years (other than qualified conservation contributions). Carryover contributions retain their character as 50%, 30%, or 20% limit contributions, with oldest amounts deducted first after current year charitable contributions.
- Taxpayers who do not itemize deductions in a carryover year must reduce the carryover amount by the amount that would have been deductible had the taxpayer itemized. Charitable contributions that remain undeducted due to these restrictions are lost.
- Business entities, including sole proprietorships, may deduct costs to advertise a business product or service as ordinary and necessary business expenses. Any limitations are imposed on net business loss rather than on the advertising expense.
- Charitable organizations with gross income of $1,000 or more from unrelated business activities must file Form 990-T, *Exempt Organization Tax Return.* Unrelated business income tax (UBIT) is assessed at corporate tax rates. If the organization is a trust, then trust tax rates apply instead.

Tax Planning Strategies

- A C corporation can make a donation of inventory or other qualifying property. Such items are often labeled with company information, serving as a *de facto* advertisement. If the conditions are satisfied, the C corporation can claim

a deduction that is greater than the basis in the donated inventory or property, subject to the usual 10% limitation for C corporations.

- Contributions to a qualified organization may involve the purchase of advertising space, display of company information at organization events, inclusion in a directory, etc. If the organization uses the contribution in such a way that the business is promoted instead of merely including the company name on a list, the business has purchased advertising.
- Pass-through entities and sole proprietorships can reduce taxable pass-through income (and AGI of shareholders, partners, or owners) while assisting qualified organizations by buying advertising and sponsoring organization efforts. Deductible advertising costs can also reduce income subject to self-employment tax for sole proprietorships and partners.
- Donations to nonqualified organizations may qualify as advertising expenses.

Examples

Example #1: Nice, Inc., a C corporation, sells toys and clothing. All the products carry the Nice, Inc. logo and are recognizable as being Nice, Inc. products. In 2015, Nice, Inc. makes the following donations.

1) Toys are donated to a homeless shelter for the use of the children who stay there. The corporation's basis in the toys is $500, and the fair market value is $1,600.
2) Clothing is donated to the same shelter. The corporation's basis in the clothing is $800, and the fair market value is $2,600.

Item	*Basis*	*Ordinary Income if Sold at FMV*	*Tentative Deduction*	*Allowable Deduction*
Toys	$500	$1,100	$500 + ½ ($1,100) = $1,050	$1,000
Clothing	$800	$1,800	$800 + ½ ($1,800) = $1,700	$1,600
Totals	$1,300	$2,900	**Total allowable deduction**	$2,600

The amount that Nice, Inc. will deduct on its 2015 corporate return is limited to 10% of taxable income computed without regard to the charitable contribution, dividends received, IRC section 249 bond premiums, and domestic activities, or NOL or capital loss carrybacks. Not only will Nice, Inc. have helped those in need, but the corporate name and logo is on every product donated, and its allowable charitable contribution deduction is almost twice its cost basis in the donated items.

Example #2: Pizza LLC is taxed as a partnership. The company wants to assist a sports league that benefits inner-city children and their families. The league is a qualified organization so cash donations to the league by Pizza LLC would be classified as charitable contributions and passed through to the LLC members to be deducted on their individual tax returns. However, donations that benefit the children or their families directly do not qualify as charitable contributions, but may instead become advertising expenses. Pizza LLC decides to sponsor a team. The company buys team uniforms and bleacher cushions embellished by a large Pizza LLC logo, pays for printing of player rosters that include pizza coupons, and provides pizza for post-game parties. Pizza LLC's sponsorship of the team is an advertising expense and reduces income passed through to the LLC members.

Example #3: Jennifer sells homemade jams and jellies through her sole proprietorship "Jen's Jellies." Jennifer's daughter is involved in fundraising for her high school's theater productions and she asks her mother to make a donation. Donors' names will be listed in the printed program. The program will also include a section that displays the business cards of donors who pay for advertising space. Instead of making a personal donation, Jennifer uses the business checking account for Jen's Jellies and buys the advertising space. Theater patrons will see her business card in the program and know how to contact her in order to buy her products. Jen's Jellies can deduct the cost of the ad, reducing income subject to self-employment tax, as well as income tax.

Example #4: A bus company donates $5,000 to an organization that does not qualify under the rules of IRC section 170(c). The donation is not deductible as a charitable contribution. However, the organization is bringing a large convention to the city where the bus company operates and will provide bus information to the attendees. The bus company reasonably expects that the convention will increase its business and deducts the $5,000 as advertising.

Possible Risks

- The charitable organization and the business may have conflicting interests in the classification of donations. The business may want to report an advertising expense instead of a donation. But, a charitable organization generally does not pay tax on outright contributions. Receipts from the sale of advertising may be classified as unrelated business income, subjecting the organization to unrelated business income tax (UBIT).
- The IRS may reclassify business advertising as a donation, or vice versa. For example, the IRS could determine that expenditures that are supposed to be for advertising may not actually be made with a reasonable expectation of financial return to the business.
- Donations that benefit individuals instead of qualified organizations are not deductible as charitable contributions. If such donations do not also promote the donor's business, they aren't advertising expenses either.

Court Cases

Court Case: A State Police Association was a labor organization exempt from taxation and thus a qualified organization under the rules of IRC section 170(c). In order to raise money and pay for an annual yearbook, the Association contracted with an outside company to do funds solicitations. The Association reported all money realized through this effort as contributions. The yearbooks included two sections: one containing articles and editorials, and the other containing display ads. The display ad section included advertisements and an alphabetical index of donors similar to that found in telephone directories. The IRS determined, and the Tax Court agreed, that the Association had been in the business of selling advertising and was not merely soliciting tax-deductible contributions. The intent of the donors did not matter. The donors received advertising benefits in exchange for their contributions. The advertising was unrelated business income and the Association was subject to unrelated business income tax. In addition, the donors lost their charitable contribution deductions and had to recalculate net business income for the years in question. *(State Police Association of Massachusetts,* T.C. Memo 1996-407)

Charitable Contributions of IRA Distributions

Cross References

- Schedule A (Form 1040), *Itemized Deductions*
- IRS Pub. 526, *Charitable Contributions*
- IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*
- IRC §170, *Charitable, etc., contributions and gifts*

Note: At the time this publication went to print, the provision allowing for charitable contributions of IRA distributions had not been extended for tax years beginning after 2014. See *TheTaxBook* Update Service at www.thetaxbook.com for new information about extension of this provision.

Tax Issue

A participant in a traditional IRA must begin receiving distributions from the IRA by April 1 of the year following the year the participant turns age 70½. If the taxpayer does not need the IRA distribution to cover living expenses, and the taxpayer wishes instead to donate the IRA distribution to charity, the taxpayer may find that all or a portion of the donation does not reduce tax. Charitable contributions are deductible only if the taxpayer itemizes deductions. Even if the taxpayer has enough deductions to itemize, a portion of the charitable contribution might not receive a tax benefit to the extent it represents the standard deduction portion of total itemized deductions. Taxable IRA distributions also increase a taxpayer's AGI. Medical deductions and miscellaneous itemized deductions are subject to AGI limitations. Thus, an IRA distribution may decrease the amount of allowable itemized deductions. Taxable IRA distributions may also increase taxable Social Security benefits.

Applicable Tax Law

- Distributions from IRAs are generally taxable to the extent the funds in all of the taxpayer's IRAs represent tax deductible contributions and tax deferred earnings.
- Charitable contributions are deductible for federal tax purposes as itemized deductions. Thus, if a taxpayer does not itemize (due to the standard deduction being greater than itemized deductions), there is no tax benefit for making a charitable contribution.
- Charitable contributions are generally limited by the 50%, 30%, or 20% of AGI limitation rules. If total charitable contributions for the year exceed these limits, the excess must be carried over to the following year until used up. The carryover period cannot be longer than the next five years after the contribution year.
- A qualified charitable distribution (QCD) is a nontaxable distribution made directly by the trustee of an IRA (not including an ongoing SEP IRA or SIMPLE IRA) to an eligible charitable organization. For purposes of the prohibition against using an ongoing SEP IRA or a SIMPLE IRA to do a QCD, a SEP IRA or a SIMPLE IRA is treated as ongoing if it is maintained under an employer arrangement under which an employer contribution is made for the plan year ending with or within the IRA owner's taxable year in which the charitable contributions would be made (Notice 2007-7). Thus, for example, a SEP IRA that is no longer receiving yearly employer contributions could be used to do a QCD if in fact no employer SEP contributions were made to it during the year.
- The taxpayer must be age 70½ or older at the time of the distribution to do a QCD.
- QCD distribution amounts are allowed up to $100,000 per taxpayer.
- QCD distributions must be paid directly by check from the trustee to the charity. It is not a QCD if the check is made out to the IRA owner and then the IRA owner writes out a check in the same amount to the charity. However, if the check from an IRA is made payable to a charitable organization and is delivered by the IRA owner to the charitable organization, it is considered a direct payment to the charity and qualifies as a QCD. (Notice 2007-7)
- Charities must receive QCD funds in the same year it was distributed from the IRA.
- Donor-advised funds and certain private foundations are not eligible charities for QCD purposes.

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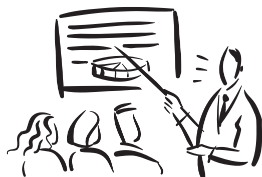
- The QCD distribution, although not taxable, qualifies as the taxpayer's required minimum distribution (RMD) for the year, up to $100,000 per person.
- QCDs that are excluded from income cannot also be used as an itemized deduction on Schedule A (Form 1040).
- QCDs are not eligible if the entire distribution would not be allowed, determined without regard to the 50%, 30%, or 20% of AGI limitations. For example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion of income is not available with respect to any part of the IRA distribution.
- A QCD is also allowed for distributions from an IRA maintained for the benefit of a beneficiary after the death of the IRA owner if the beneficiary has attained age 70½ before the distribution is made. (Notice 2007-7)
- The IRA trustee, custodian, or issuer may rely upon reasonable representations made by the IRA owner that the charity is a qualified charity for purposes of the QCD rules. If an IRA distribution is paid directly to a charity, but fails to satisfy any of the QCD rules, the amount is treated as (1) a taxable distribution from the IRA, and (2) a charitable contribution subject to the rules under IRC section 170 for deducting contributions as itemized deductions. (Notice 2007-7)
- If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that would otherwise be includible in gross income and thus eligible for QCD treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income if the aggregate balance of all IRAs having the same owner were distributed during the same year.



Tax Planning Strategies

Note: At the time this publication went to print, the provision allowing for charitable contributions of IRA distributions had not been extended for tax years beginning after 2014. See *TheTaxBook* Update Service at www.thetaxbook.com for new information about extension of this provision.

Rather than take an IRA distribution and donate it to charity, have the IRA trustee directly pay the IRA distribution to the eligible charitable organization. Taxes are reduced to the extent the charitable contribution represents the taxpayer's standard deduction. Taxes are also reduced to the extent the IRA distribution would otherwise increase AGI and thus decrease allowable medical and miscellaneous itemized deductions. Taxes are also reduced to the extent the IRA distribution would otherwise increase taxable Social Security benefits.

Examples

Example #1: Mark and Heidi are married and both over age 70½. They have the following income for 2015.

Interest income	$ 2,000
Taxable IRA distribution that represents all of their RMD for the year	10,000
Taxable pension distribution	40,000
Taxable Social Security ($20,400 gross benefit)	17,340
AGI	$69,340

Mark and Heidi have the following itemized deductions for 2015.

State income tax deduction	$ 3,400
Property tax deduction	3,000
Charitable contribution to their church	9,000
Total itemized deductions	$15,400

Their tax for 2015 is calculated as follows:

AGI	$69,340
Minus itemized deductions	(15,400)
Minus personal exemption	(8,000)
Equals taxable income	$45,940
Federal tax before credits and payments	$ 5,966

Example #2: Assume the same facts as Example #1, except that instead of receiving all their RMD from their IRAs by having the IRAs issue checks, Mark and Heidi direct their IRA trustees to pay $9,000 of their RMD directly to their church as a qualified charitable distribution (QCD). The QCD is not included in taxable income and the church donation is not deducted as a charitable contribution. Their income for 2015 is as follows:

Interest income	$ 2,000
Taxable IRA distribution	1,000
Taxable pension distribution	40,000
Taxable Social Security ($20,400 gross benefit)	13,820
AGI	$56,820

Mark and Heidi have the following itemized deductions for 2015.

State income tax deduction	$ 3,400
Property tax deduction	3,000
Charitable contribution to their church	0
Total itemized deductions	$ 6,400

Their tax for 2015 is calculated as follows:

AGI	$56,820
Minus standard deduction (greater than itemized deductions)	(15,100)
Minus personal exemption	(8,000)
Equals taxable income	$33,720
Federal tax before credits and payments	$ 4,136

By doing a QCD, Mark and Heidi save $1,830 in taxes for 2015 (the difference between $5,996 and $4,136). The QCD reduces tax by lowering the amount of Social Security benefits subject to tax. The QCD also reduces tax by being able to exclude all the charitable contribution from income, including the portion that otherwise makes up a portion of their standard deduction.

Example #3: Erma is age 73 and single. She has the following income for 2015.

Interest income	$ 1,000
Taxable IRA distribution that represents all her RMD for the year	5,000
Taxable pension distribution	18,000
Taxable Social Security ($14,400 gross benefit)	3,100
AGI	$27,100

Erma has the following itemized deductions for 2015.

Deductible medical expenses after 7.5% AGI limit ($6,000 total expenses)	$ 3,968
State income tax deduction	1,200
Property tax deduction	2,000
Charitable contribution to her church	5,000
Total itemized deductions	$12,168

Her tax for 2015 is calculated as follows:

AGI	$27,100
Minus itemized deductions	(12,168)
Minus personal exemption	(4,000)
Equals taxable income	$10,932
Federal tax before credits and payments	$ 1,178

Example #4: Assume the same facts as Example #3, except that instead of receiving her RMD from her IRA by having the IRA issue her a check, she directs her IRA trustee to pay the distribution directly to her church as a qualified charitable distribution (QCD). The QCD is not included in taxable income and the church donation is not deducted as a charitable contribution. Her income for 2015 is as follows:

Interest income	$ 1,000
Taxable IRA distribution	0
Taxable pension distribution	18,000
Taxable Social Security ($14,400 gross benefit)	600
AGI	$19,600

Erma's itemized deductions for 2015 are as follows:

Deductible medical expenses after 7.5% AGI limit ($6,000 total expenses)	$ 4,530
State income tax deduction	1,200
Property tax deduction	2,000
Charitable contribution to her church	0
Total itemized deductions	$ 7,730

Her tax for 2015 is calculated as follows:

AGI	$19,600
Minus standard deductions (greater than itemized deductions)	(7,850)
Minus personal exemption	(4,000)
Equals taxable income	$ 7,750
Federal tax before credits and payments	$ 778

By doing a QCD, Erma saves $400 in taxes for 2015 (the difference between $1,178 and $778). The QCD reduces tax by lowering the amount of Social Security benefits subject to tax and increasing the deductible amount of medical expenses.

Example #5: Bruce has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. Bruce has no other IRA. In a distribution to a qualified charitable organization, $80,000 is distributed from the IRA. The distribution is treated as consisting of income first, up to the total amount that would be includible in gross income if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions.

The total amount that would be includible in income if all amounts were distributed from the IRA is $80,000. Accordingly, the entire $80,000 distributed to the charitable organization would ordinarily be included in income. However, because it is a qualified charitable distribution, no amount is included in Bruce's income and the distribution is not taken into account in determining the amount of his charitable deduction for the year. The $20,000 remaining in the IRA is treated as Bruce's nondeductible contributions and is not subject to tax upon distribution in future years.

✎ **Author's Comment:** Example #5, above, illustrates how a QCD accelerates the withdrawal of the taxable portion of an IRA with a nondeductible basis, leaving the rest of the nondeductible funds inside the IRA for tax-free distributions in future years. However, by doing a QCD when the taxpayer has a nondeductible basis in his/her IRA, tax for the current year will be increased. For example, assume Bruce does not make a direct transfer of the IRA to a charity. Instead, he deposits the IRA distribution into his checking account and then writes out an $80,000 check to the charity. Bruce would report $64,000 of his IRA distribution as a taxable distribution, $16,000 as a nontaxable return of basis, and $80,000 as a charitable contribution deduction (assume $80,000 is under the AGI limitations for charitable contributions for the year). If Bruce is looking for the lowest tax in the current year, and does not care about the taxable portion of the remaining IRA account balance in future years, it would be advisable for him not to make a direct transfer from the IRA to the charity.

Possible Risks

- As illustrated in the author's comment to Example #5, a QCD could actually increase tax for the current year when there is a nondeductible basis in the taxpayer's IRA.
- This provision was originally a temporary provision for tax years 2006 and 2007. Although Congress has extended the provision in the past, the temporary status of the provision makes the planning strategy difficult to implement, especially if Congress does not extend the provision for 2015 after it expired in 2014. For example, the provision expired at the end of 2013 and the law that extended it for 2014 was not passed until December 16,

2014, or 15 days before the end of the year, the last possible date RMD needed to be distributed for that year. Taxpayers who want to use the provision for 2015 may have to wait until the end of 2015 before knowing whether it is allowed.

✎ **Author's Comment:** After the law was extended for tax years 2010 and 2011 on December 17, 2010, many taxpayers who had already taken their RMD for 2010 wanted to know if they could roll distributions back into their IRAs so that they could re-do their 2010 RMD as a QCD. Normally, taxpayers have 60 days to roll over an IRA distribution tax free, including a rollover back into the same IRA. The problem is, under the rollover rules, any amounts distributed to satisfy the RMD rules do not qualify for tax-free rollover treatment. On January 5, 2011, the IRS released a statement through a spokesman citing the law, which prohibits required payouts from being rolled back into an IRA for any reason. According to the IRS, the law doesn't allow taxpayers to return payouts taken in order to make direct charitable IRA donations for 2010. The law did allow a one-time temporary extension for the 2010 RMD distribution rules that gave taxpayers until January 31, 2011 to take their 2010 RMD distributions. This allowed taxpayers who had not yet taken an RMD for 2010 until January 31, 2011 to do a QCD. The problem is this rule did not help taxpayers who had already taken their 2010 RMD prior to the passage of the new law. This situation illustrates the difficulty in tax planning when Congress delays making decisions on whether or not to extend temporary tax laws.

Transfers to Charity at Death

Cross References

- Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*
- IRC §664, *Charitable Remainder Trusts*
- IRC §2001 – IRC §2058, *Estate Tax*
- Reg. §20.2031-1

Tax Issue

A gift to charity at death is deductible for estate tax but generally not for income tax. Lifetime gifts to charity, on the other hand, reduce the taxable estate and also provide an income tax deduction. The problem with a sizable lifetime charitable gift, however, is that it may leave the donor uncertain about their future financial security. The safest course is to wait until death to be sure that the money will not be needed.

Applicable Tax Law

- Most gifts to charity, regardless of the amount, are fully deductible for both gift and estate tax.
- Income in respect of the decedent (IRD) remains taxable after death. Tax is paid by the recipient at his or her tax rate. IRD includes IRAs, qualified plans, and the earnings portion of a nonqualified annuity.
- A charitable remainder trust is an irrevocable trust that makes annual payments to one or more beneficiaries for life or for a fixed term of up to 20 years. At the death of the last beneficiary or at the end of the term, the trust's remaining assets pass to charity.
- The remainder interest passing to charity must be at least 10% of the initial value of all property placed in the trust.
- The probability that the trust will actually make a charitable gift at the end of its term must be at least 95%.
- A charitable remainder trust must have at least one income beneficiary who is not a charitable organization.
- Annual payments from a charitable remainder annuity trust (CRAT) must be at least 5% and not more than 50% of the initial value of all property placed in the trust. Income beneficiaries receive a fixed amount annually. If trust earnings are insufficient, payment is made from principal.
- Annual payments from a charitable remainder unitrust (CRUT) must be at least 5% and not more than 50% of the value of trust assets, revalued annually. Income beneficiaries receive variable amounts. CRUTs can include make-up provisions that allow an annual payment to be reduced if the trust's current earnings are less than the required payment. The difference is made up when earnings are available.

- The transfer of property into a charitable remainder trust qualifies for an income tax charitable deduction equal to the present value of the remainder interest. The calculation is based on the adjusted payout rate, the age of the measuring life, the federal interest rate, and other factors. The deduction for a CRAT is generally lower than for a similar CRUT because the CRAT bears the investment risk.
- A charitable remainder trust that meets the requirements of IRC section 664 is tax exempt. The trust does not pay tax on its income, including capital gains from the sale of assets transferred to the trust.
- Trust income, however, is distributable to the beneficiaries each year up to the amount of their income payments. Capital gains, including undistributed gains from prior years, are distributable income. Trust income is distributed on a worst first basis—ordinary income, capital gains (including undistributed gains from prior years), tax-exempt income, and then nontaxable principal. If the trust sells an appreciated asset, distributions

to beneficiaries will remain taxable until the entire capital gain is distributed.
- Charitable remainder trusts file Form 5227 and pass income to beneficiaries on Schedule K-1 (Form 1041).
- Basis of appreciated property received as a gift is generally the donor's adjusted basis at the time of the gift. The recipient's holding period also includes the donor's holding period.

Tax Planning Strategy #1—Make a Charity the Beneficiary of an IRA

An IRA or other retirement asset is included in the taxpayer's gross estate for estate tax. The IRA is also taxable income to the recipient. If an IRA is paid to charity, the IRA is not subject to either estate or income tax.

Example: Anita has an $8 million estate. She included a $500,000 gift to charity in her will and left all her other assets to her children. Anita's estate pays federal estate tax of $828,000.

Anita's estate includes an IRA of $350,000 that passes to her children by beneficiary designation. The IRA is taxable income as they take distributions. The children are allowed an income tax deduction of $38,668 for the portion of the estate tax allocated to the IRA.

The children will pay income tax on the inherited IRA in an amount that depends on the choices they make for taking the proceeds from the IRA. At an assumed tax rate of 25%, the children will pay $87,500 in federal income tax. This amount of federal tax will be reduced by the estate tax deduction for the tax allocated to the IRA.

Anita could have saved her children the full amount of the income tax by naming the charity as beneficiary of the IRA and reducing the charitable gift made by will to $150,000. Anita's children receive other assets from the estate that are not taxable income. The charity receives the taxable asset but is exempt from income tax.

Possible Risks

- A gift to charity made by will can be a fixed amount or percentage of the assets remaining at death. Naming a charity as the direct beneficiary of an asset passes that asset to charity regardless of the amount. The charity's share of the estate can be much larger or smaller than the taxpayer intended.

Tax Planning Strategy #2—Transfer Property to a Charitable Remainder Trust

A charitable remainder trust allows a taxpayer to give an appreciated asset to charity while keeping an income stream. The taxpayer receives a current income tax deduction for the remainder interest passing to charity. The capital gains tax on the sale of the asset is deferred, and in some cases reduced, allowing the trust to invest the entire proceeds of the sale. A charitable remainder trust can increase the amount of the gift passing to charity.

Example: Perry and Della are a retired couple in their 70's. They own a vacation home valued at $800,000 that has a tax basis of $200,000. Perry and Della recently relocated to be near their son, which makes using the vacation home impractical. Instead of selling the home and paying capital gains tax, Perry and Della decide to transfer it to a charitable remainder trust. They will increase their retirement income and also make a sizable gift to a local charity that they have supported for years.

Perry and Della work with an attorney recommended by the charity. They sign a trust agreement setting the terms of the trust. Perry and Della choose a 5% charitable remainder annuity trust (CRAT). They will receive $40,000 each year, paid quarterly, for life. They transfer ownership of their vacation home to the trust. The trustee sells the home and reinvests the entire $800,000 proceeds in a diversified portfolio. The trust is tax exempt so it does not pay tax on the $600,000 capital gain.

The payments from the trust are taxable each year to Perry and Della. In the first year, for example, the trust has net earnings of $19,500. The trust issues Schedule K-1 to Perry and Della. They report interest of $12,500, ordinary dividends of $7,000, and a long-term capital gain of $20,500. The trust has $579,500 of undistributed capital gain from the sale of the vacation home going into the second year. Perry and Della are also allowed an income tax deduction for the value of the remainder interest passing to charity. The amount of the deduction is the difference between the value of the vacation home and the present value of the income stream generated by the payments from the trust. Perry and Della may be able to take a substantial current year income tax deduction.

The FMV of remainder interest is calculated under Regulation section 20.2031-7. Table S is available at www.irs.gov, search for "Actuarial Tables." Find applicable federal rates at: www.irs.gov/app/picklist/list/federalRates.html.

Perry and Della die after 12 years, and the trust's remaining assets pass to charity. The income tax savings, plus earnings received by Perry and Della, and the earnings on the sum that would have otherwise been paid in capital gains tax are more than the amount Perry and Della would have accumulated had they sold the property and invested the after-tax amount.

Possible Risks

- The taxpayers cannot access the principal of the trust if they unexpectedly need additional income.
- Charitable remainder trusts are complicated and must meet IRS tests. Set-up and administrative costs are high. Less expensive alternatives include pooled income funds established and maintained by charities that hold contributions from multiple donors and charitable gift annuities that provide fixed annuity payments for life in exchange for a transfer of cash or property to a charity.
- If the taxpayer dies soon after establishing a charitable remainder trust, family members or other estate beneficiaries may receive less than the taxpayer expected. To reduce this risk, a life insurance trust is often used in combination with a charitable remainder trust.
- Trust assets have investment risk. If the investments in a CRUT perform poorly, annuity income shrinks. If the market drops after a CRAT is established, the trust assets could be exhausted before the end of the trust term.

- Although IRS rules allow a payout rate of up to 50%, the actual rate must be set considerably lower when the federal interest rate is low. If the payout rate is too high, a 10% gift to charity with a 95% probability is not possible.
- The charitable deduction is calculated when the trust is established. If the federal rate is low at that time, the deduction is likely to be lower than the actual amounts received by charity.
- If the taxpayer's charitable deduction is limited by income and carried forward, it can be lost if the taxpayer dies early in the trust term.
- Calculations used to choose trust options are based on life expectancy and estimates of future earnings. The information needed to calculate the relative benefits of the trust to the taxpayers and to the charity is not available until the trust ends.

Charitable Contributions of Noncash Items

Cross References

- Schedule A (Form 1040), *Itemized Deductions*
- Form 8283, *Noncash Charitable Contributions*
- IRS Pub. 526, *Charitable Contributions*
- IRS Pub. 561, *Determining the Value of Donated Property*
- IRS Pub. 1771, *Charitable Contributions: Substantiation and Disclosure Requirements*
- IRS Pub. 4303, *A Donor's Guide to Vehicle Donation*
- IRC §170, *Charitable, etc., contributions and gifts*

Tax Issue

It is common for taxpayers to donate unwanted used items to charity rather than try to sell them. A common belief is that the tax savings from donating a used car to charity often exceeds the cash one may receive from selling the car in the used car market. During an IRS audit, problems usually center around two issues.

- Meeting the substantiation requirements for claiming a charitable contribution of noncash items.
- Establishing the actual fair market value of an item at the time it is donated.

To reap the tax benefits from donating noncash items to charity, the taxpayer must plan ahead to make sure the donation deduction will withstand an IRS audit.

Applicable Tax Law

Itemized deductions for charitable donations other than cash include items such as clothes, furniture, household appliances, cars, real estate, stock, and other personal property.

Only donations made to, or for the use of, qualified organizations may be claimed as charitable contributions. Qualified organizations are defined in IRC section 170(c) and an up-to-date list is maintained on the IRS website at:

www.irs.gov/Charities-&-Non-Profits

Clothing and household items. A taxpayer cannot claim a deduction for donated clothing or household items unless the items are in good used condition or better.

Vehicles. For donated vehicles with a claimed value of more than $500, the taxpayer can deduct the smaller of the vehicle's FMV on the date of the contribution or the gross proceeds received from the sale of the vehicle.

Exception: The deduction is not limited to the gross proceeds received from the sale, and the taxpayer may instead deduct the vehicle's FMV on the date of the contribution if:

- The organization makes a significant intervening use of the vehicle before transferring it,

- The organization makes a material improvement to the vehicle before transferring it, or
- The organization gives or sells the vehicle to a needy individual for a price significantly below FMV.

A taxpayer cannot claim a deduction for the donation of a vehicle with a FMV greater than $500 unless he or she attaches to their return a copy of contemporaneous written acknowledgment received from the donee organization. Generally, the donee organization uses Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes,* as the acknowledgement, and it is considered contemporaneous if the donee organization furnishes it to the taxpayer no later than 30 days after the date of sale or the

date of contribution, if the vehicle will not be sold by the organization.

50% AGI limitation. The total deduction for all charitable contributions is limited to 50% of the taxpayer's AGI. Contributions in excess of 50% of AGI are carried over to the next tax year.

30% AGI limitation. The 30% AGI limit applies to the following:

- Donations to organizations that are not 50% limit organizations, such as veteran's organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.
- Donation of property that is used by a charity, other than capital gain property donated to a non 50% limit organization.
- Deduction for student living expenses.

20% AGI limitation. The 20% AGI limitation applies to all donations of capital gain property to or for the use of a charity that is not a 50% limit organization.

Capital gain property. The deduction for capital gain property (stocks, bonds, jewelry, furniture) is generally the FMV of the property when contributed. Capital gain property donated to a 50% limit organization is subject to the 30% AGI limitation, unless the taxpayer elects to reduce the FMV of the property by the amount that would have been long-term capital gain if the property were sold. Additionally, the FMV is reduced if the donated tangible property is put to an unrelated use by the charity.

Ordinary income property. The deduction for a contribution of self-created property and capital assets held less than one year is FMV less the amount of ordinary income or short-term capital gain that would result if the property was sold for its FMV. Usually, the taxpayer's deduction is equal to his or her basis in the property, with an exception if the taxpayer includes gain in income, which could happen if the taxpayer transfers an installment note or assigns income to a charitable organization.

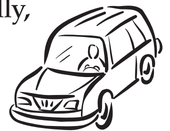
Carryover from prior year. Excess contributions carried over from a prior year because of the AGI limitations are entered on line 18, Schedule A. The following rules apply to excess carryover contributions.

- An excess contribution can be carried over until it is used up, but for no longer than the next five years after the contribution year (other than qualified conservation contributions).
- Carryover amounts are subject to the same percentage limits in the year to which they are carried. For example, contributions subject to the 20% limit in the year in which they are made are 20% limit contributions in the year to which they are carried.
- For each category of contributions, deduct carryover contributions only after deducting all allowable contributions in that same category for the current year.
- A carryover of a contribution to a 50% limit organization must be used before a current year contribution to organizations other than 50% limit organizations.
- If carryover amounts are from two or more prior years, use the carryover from the earlier year first.
- Carryover rules apply even if the taxpayer elects to take the standard deduction in the contribution year or any carryover year. Amounts carried over must be reduced by the amount that would have been deductible if itemized deductions were claimed. (Reg. §1.170A-10)

Tax Planning Strategies

Advantages of donating noncash items to charity. Generally, greater tax benefits come from a contribution of capital gain property because the taxpayer can potentially deduct the fair market value (FMV) of the contributed property. Tax-exempt charities may sell appreciated property without paying income tax, and the gain on the sale will generally not be taxed to the donor.

FMV less than basis. If the FMV of stock is less than its basis, it would be better to sell the stock at a loss and donate the cash to the charity rather than give the stock to the charity.



Automobiles, boats, and aircraft. Generally, a taxpayer receives a deduction limited to the amount for which a charity sells a donated vehicle.

For donated vehicles with a claimed value of more than $500, the taxpayer can deduct the smaller of the vehicle's FMV on the date of the contribution or the gross proceeds received from the sale of the vehicle.

Therefore, it is beneficial to check out various charities and find those that give vehicles to needy individuals rather than selling the donated vehicles. This information can help maximize a taxpayer's charitable deduction by being able to deduct the FMV of the donated vehicle, which is usually greater then when a charity sells a vehicle.

Year-end. If a taxpayer has a fluctuating income and determines that he or she will have a significant increase in income at the end of the year, the taxpayer will want to be sure to make the donation before December 31 in order to help offset the increased income.

Documentation. In the event of an audit, the IRS would request written records substantiating noncash charitable contribution deductions. Simply saving a receipt, for example, from Goodwill, only proves the donation was made on a particular date. A taxpayer should generate an itemized list of objects donated each time. Additionally, the IRS only allows deductions for items that are in good

or better condition. Therefore, taking pictures of the items donated with a digital camera or cell phone can provide proof of the condition the items were in when donated.

If a taxpayer is donating a new item, he or she should keep the price tag or store receipt to prove the item's value.

Recordkeeping Requirements for Charitable Contributions

Do not combine separate contribution amounts for reporting requirements

Contribution	Noncash
Less than $250	All of the following: Receipt from charitable organization showing: • Name of organization. • Date and location of contribution. • Reasonably detailed description of property contributed. The taxpayer must also have documentation of: • FMV and method used to determine it. • Cost or basis of appreciated property. • Amount claimed in current year if contribution is less than taxpayer's entire interest. • Terms of any conditions attached to the donation.
$250 to $500	Written acknowledgement from the charitable organization showing (1) the date and location of the contribution, (2) a reasonably detailed description of the contributed property, (3) whether any goods or services other than intangible religious benefits were provided by the charitable organization (including a good faith estimate of the value), and (4) a statement that the only benefit the taxpayer received was an intangible religious benefit if that is the case. The written acknowledgement does not need to state fair market value.
$501 to $5,000	Same as above, plus: • How property was acquired (purchase, gift, inheritance, etc.). • Approximate date property was obtained or produced. • Cost or other basis and basis adjustments. If information about the date acquired or basis of the property is not available due to reasonable cause, attach an explanation to the return.
Over $5,000	Same as above. A written appraisal is generally required.

Examples

Example #1: Helga owns a piece of investment real estate located near her church. She purchased the property three years ago for $100,000. The current value is $90,000. Helga is considering giving the land to her church. The deduction for her gift will be limited to $90,000 if she contributes the property itself. However, if Helga instead sells the property for $90,000 to a developer interested in building a school and donates the proceeds to the church, she will have a $10,000 loss deduction available, in addition to the $90,000 charitable contribution.

Example #2: Billy is an artist and contributes a new painting to his university's art sale. The painting is valued at $3,000, but Billy only has a basis of $400 in the painting. In addition, Billy donates an installment note to his church with a FMV of $3,000 and a basis of $2,000. He includes the $1,000 of short-term capital gain in his taxable income for the year. His charitable contribution is $400 (basis in self-created art) plus $3,000 (FMV of the note because of his inclusion of gain in taxable income) for a total deduction of $3,400.

Example #3: Jennie is an attorney, and during the course of her representation of a client in a high-profile federal tax evasion prosecution, she acquired a lot of interesting discovery material, which included copies of FBI witness statements, FBI lab reports, notes, photographs, transcripts of correspondence, and audio files. After the conclusion of the trial, Jennie contributed the materials to the University of Kansas Wheat Law Library. Jennie cannot take a charitable deduction for the property she contributed because it is not capital gain property as it is within the capital asset exclusion relating to letter, memorandum, or similar property that is prepared or produced for a taxpayer, and any sale of the discovery material would produce only ordinary income. In that case, Jennie is limited to her basis in the property, which is zero.

Example #4: Holly donates her 2000 Dodge Neon to a charity. She bought the Neon new for $10,000. A used vehicle pricing guide (such as Kelley Blue Book) shows the FMV of her car is $2,200. Holly receives a Form 1098-C from the charity showing the car was sold for $1,200. Holly can deduct $1,200 on her Form 1040 and must attach Form 1098-C to her return.

Example #5: Assume the same facts as Example #4, except the charity instead sold the car to Jill for a heavily discounted price of $300 so that Jill can get back and forth to her new job. Holly, however, can deduct the FMV of $2,200 on her Form 1040 instead. If the donee organization sells the vehicle at significantly below FMV, the gross proceeds limitation will not apply if it was a gratuitous transfer to a needy individual in line with the purpose of the charity to provide transportation to the poor.

Possible Risks

Disallowance of donation due to improper documentation. The taxpayer may fail to keep adequate records or obtain necessary acknowledgments from the organization. It is common for taxpayers to omit these steps and then have to reconstruct the information later when doing the tax return.

To help substantiate a deduction for the fair market value of used items donated to charity, a taxpayer should make a list of each item donated on a separate sheet of paper, along with the following information.

• Name and address of charity.
• Date items were donated to the charity.
• Description of each item donated.
• Fair market value of each item at the time they were donated.
• Date each donated item was originally purchased or acquired.
• Cost or other basis of each item donated.

Taxpayer makes a deduction to nonqualifying charity. Contributions are not tax deductible if donated to any of the following nonqualifying charities.
• Civic leagues, social and sports clubs, labor unions, chambers of commerce.
• Foreign governments.
• Political parties, political campaigns, or political action committees.
• Individual people.
• Groups that are run for personal profit.
• Homeowners' associations.
• Fees or dues paid to country clubs, lodges, fraternal orders, professional associations, or similar groups.
• For-profit schools and hospitals.
• Cost of raffle, bingo, or lottery tickets.
• Tuition.
• Fines or penalties paid to local or state governments.
• Value of time or services rendered to a non-profit.
• Value of blood given to a blood bank.

Unbeknownst to the taxpayer, the organization to which the taxpayer donates may have had its exempt status revoked. If this happens, a taxpayer cannot claim a charitable deduction for an organization that no longer qualifies. An up-to-date list of qualified organizations is maintained on the IRS website at:
www.irs.gov/Charities-&-Non-Profits

Unrelated use of donated property can reduce the deduction. An unrelated use of property occurs when property is not used to fulfill the purpose of the organization. For example, if a rare book is donated to a university library for use by students, then the use is related to the library's purpose; however, if the book is sold by the university to build a new student center, the use is unrelated and the charitable deduction is reduced. If the book is used by the library but later sold to raise money for a new building, then the related use criteria is still met.

✎ **Author's Comment:** Not every old or rare book or other type of property is necessarily valuable just because it is old or rare. Therefore, a value for such property must be established to support any deduction.

Court Cases

Court Case: For tax year 2005, Mr. Roberts claimed $28,655 of noncash charitable contributions and included with his tax return a self-prepared substitute Form 8283 in which he claimed to have contributed more than 450 items of property. His descriptions of the items were vague and included self-assigned estimates of their value. Although Mr. Roberts provided copies of five Goodwill receipts, only one receipt had a signature indicating actual receipt by Goodwill. The other receipts provided vague references to items donated, such as men's boots, ladies' clothes, men's clothes, boy's clothes, women's clothing, and four bags of clothes.

For charitable contributions made in property other than cash, the value of the contribution is generally the fair market value at the time of contribution, and a taxpayer must maintain for each contribution a receipt from the donee showing the name of the donee, the date and location of the contribution, and a description of the property in detail reasonably sufficient under the circumstance. However, a donor who claims a charitable contribution deduction for an item of property that exceeds $5,000 in value generally must obtain a qualified appraisal for the contributed property.

A taxpayer must substantiate amounts claimed as deductions by maintaining the records necessary to establish that he is entitled to the deductions. The receipts and the self-prepared substitute Form 8283 that petitioner submitted to substantiate the noncash charitable contributions do not meet the statutory requirements. Moreover, Mr. Roberts neither attached to his federal income tax return nor proffered an appraisal summary to establish the values of the items he allegedly donated. In fact, when asked how he determined the values of the items reported on his substitute Form 8283, he responded:

> "That's determined by looking at going shopping, looking at the ads when I purchase clothes, cutting it as by some value depending upon the wear. When my children were young I would buy the, you know, I'd buy my daughter a brand-new dress and she'd wear it two or three times and grow out of it. So it'd still have a lot of value in it. So it depends upon the condition of the materials, an estimate."

The court also determined that the copies of the five receipts from Goodwill neither reconcile with his substitute Form 8283 nor provide anything more than vague descriptions of the items donated. Accordingly, the court found that Mr. Roberts failed to establish, by proper and adequate substantiation, entitlement to a charitable contribution deduction for the noncash items he claimed to have donated to charity. *(Roberts,* T.C. Summary 2010-76)

Qualified Conservation Contribution

Cross References

- Schedule A (Form 1040), *Itemized Deductions*
- Form 8283, *Noncash Charitable Contributions*
- IRS Pub. 526, *Charitable Contributions*
- IRS Pub. 561, *Determining the Value of Donated Property*
- IRS Pub. 1771, *Charitable Contributions: Substantiation and Disclosure Requirements*
- IRC §170, *Charitable, etc., contributions and gifts*

Tax Issue

The decline in real estate values has made it difficult to sell tracts of land. Even if the landowner has a chance to sell, the landowner might want privacy and not like the idea of a housing development on the property next to his residence. Or, the landowner may be interested in conservation and does not want to see the wildlife habitat on his property destroyed by development. Normally, a donation of a future interest in property to charity does not qualify as a charitable contribution deduction. The entire interest in property must be transferred to qualify for a deduction. However, there is an exception if the donation is a qualified conservation contribution.

Applicable Rules

- A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as (1) the entire interest of the donor other than a qualified mineral interest, (2) a remainder interest, or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.
- Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.

- Conservation purposes include (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public, (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem, (3) the preservation of open space (including farmland and forestland) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy, and (4) the preservation of an historically important land area or a certified historic structure.
- Significant habitats and ecosystems include, but are not limited to, habitats for rare, endangered, or threatened species of animal, fish, or plants; natural areas that represent high quality examples of a terrestrial community or aquatic community, such as islands that are undeveloped or not intensely developed where the coastal ecosystem is relatively intact; and natural areas which are included in, or which contribute to, the ecological viability of a local, state, or national park, nature preserve, wildlife refuge, wilderness area, or other similar conservation area.
- Qualified conservation contributions of capital gain property are subject to the same AGI limitations and carryover rules of other charitable contributions of capital gain property. For tax years 2006 through 2014, the 30% AGI limit for capital gain property was raised to 50% (100% of AGI for qualified farmers or ranchers). As of the date of printing, the conservation contribution increase in AGI limitation expired at the end of 2014 and has not been extended.
- Qualified conservation contributions are not subject to the partial interest rule, which generally bars deductions for charitable contributions of partial interests in property.

Tax Planning Strategies

Rather than selling or gifting an entire interest in property, consider donating an easement for qualified conservation purposes. The landowner retains ownership and some use of the land, while receiving a current charitable contribution deduction for the easement. The landowner can also help preserve natural wildlife habitat and prevent future generations from developing the land.

Examples

Example #1: The State of New York contains many large tract forests that are desirable recreation and scenic areas for the general public. The forests' scenic values attract millions of people to New York. However, due to the increasing intensity of land development in New York, the continued existence of forestland parcels greater than 45 acres is threatened. Joe grants a perpetual easement on a 100-acre parcel of forestland that is part of one of New York's scenic areas to a qualifying organization. The easement imposes restrictions on the use of the parcel for the purpose of maintaining its scenic values. The restrictions include a requirement that the parcel be maintained forever as open space devoted exclusively to conservation purposes and wildlife protection, and that there be no commercial, industrial, residential, or other development use of such parcel. New York law recognizes a limited public right to enter private land, particularly for recreational pursuits, unless such land is posted or the landowner objects. The easement specifically restricts Joe from posting the parcel, or from objecting, thereby maintaining public access to the parcel according to the custom of New York. Joe's parcel provides the opportunity for the public to enjoy the use of the property and appreciate its scenic values. Accordingly, Joe is allowed to deduct the donation as a qualified conservation contribution.

Example #2: Kathy owns 5,000 acres of bottomland hardwoods property along a major watershed system in the southern part of the United States. Agencies within the Department of the Interior have determined that southern bottomland hardwoods are a rapidly diminishing resource and a critical ecosystem in the south because of the intense pressure to cut the trees and convert the land to agricultural use. These agencies have further determined (and have indicated in correspondence with Kathy) that bottomland hardwoods provide a superb habitat for numerous species and play an important role in controlling floods and purifying rivers. Kathy donates to a qualified organization her entire interest in this property, other than her interest in the gas and oil deposits that have been identified under Kathy's property. Kathy covenants and can ensure that, although drilling for gas and oil on the property may have some temporary localized impact on the real property, the drilling will not interfere with the overall conservation purpose of the gift, which is to protect the unique bottomland hardwoods ecosystem. Accordingly, Kathy is allowed to deduct the donation as a qualified conservation contribution.

Example #3: Andrew lives in a house in a certified historic district. The entire house, including its interior, has architectural features representing classic Victorian period architecture. Andrew donates an exterior and interior easement on the property to a qualified organization but continues to live in the house with his family. The house is surrounded by a high stone wall which obscures the public's view of it from the street.

Pursuant to the terms of the easement, the house may be opened to the public from 10 a.m. to 4 p.m. on one Sunday in May and one Sunday in November each year for house and garden tours. These tours are to be under the supervision of the donee organization and open to members of the general public upon payment of a small fee. In addition, under the terms of the easement, the donee organization is given the right to photograph the interior and exterior of the house and distribute such photographs to magazines, newsletters, or other publicly available publications. The terms of the easement also permit persons affiliated with educational organizations, professional architectural associations, and historical societies to make an appointment through the donee organization to study the property.

Andrew is not aware of any facts indicating that the public access to be provided by the donee organization will be significantly less than that permitted by the terms of the easement. The two opportunities for public visits per year, when combined with the ability of the general public to view the architectural characteristics and features that are the subject of the easement through photographs, the opportunity for scholarly study of the property, and the fact that the house is used as an occupied residence, will enable Andrew to deduct the donation as a qualified conservation contribution.

Example #4: Casey owns a 200-acre estate containing a house built during the colonial period. At its highest and best use, for home development, the fair market value of the property is $300,000. Casey donates an easement (to maintain the house and property in its current state) to a qualifying organization for conservation purposes. The fair market value of the property after the donation is reduced to $125,000. Accordingly, the value of the easement and the amount eligible for a deduction is $175,000 ($300,000 less $125,000).

Example #5: Denny owns property with a basis of $20,000 and a fair market value of $80,000. Denny donates to a qualifying organization an easement for conservation purposes that is determined to have a fair market value of $60,000. The amount of basis allocable to the easement is $15,000 ($60,000 ÷ $80,000 X $20,000). Accordingly, the basis of the property is reduced to $5,000 ($20,000 minus $15,000).

Possible Risks

- The value of land donated for conservation purposes could be significantly less than selling the land for development.
- If the taxpayer retains significant use of the land, the IRS may claim it does not qualify for a qualified conservation contribution deduction.
- There must be a conservation benefit to the transaction. The IRS is increasingly challenging easements on lands with little or no conservation value or benefit, regardless of whether the easement lowers the value of the land.
- The IRS may attempt to challenge the valuation of the land. Appraisals for conservation purposes are highly subjective. Appraisals should be completed only by appraisal firms that have the experience and qualifications necessary to render opinions of value for complex instruments, such as easements.
- Conservation easements are complicated legal instruments that require a great deal of thought before entering into.
- Easement donors have found that some land trusts are confrontational, bureaucratic, inflexible, or lack a realistic understanding of agriculture or forestry practices. It is important to work with a conservation organization that knows what they are doing.
- The property owner still owns the property after the easement. The ability to sell the land after placing a conservation easement on it will limit the pool of potential buyers.
- The easement could create hurdles in a loan or refinancing situation for the property owner.

Court Cases

Court Case: The taxpayers contributed a conservation easement of plantation property to a qualified organization and claimed a charitable contribution deduction on their joint return. The taxpayers were not interested in selling their land to developers because they wanted to preserve it.

The IRS claimed that the taxpayers failed to establish that their contributions were qualified conservation contributions under IRC section 170(h). Although the conservation deeds significantly restricted the taxpayer's use of the property, the deeds permitted limited agricultural and recreational use and also reserved a total of 12 lots for development.

For example, the deeds said: "[the taxpayer could] conduct small scale farming, ranching, or other agricultural activities, including raising, managing and breeding livestock and planting, raising and harvesting agricultural crops. However, there shall be no large scale agricultural activities permitted on the property such as feedlots, pig farms, commercial poultry farms, or similar uses which have the potential to negatively impact the conservation values."

The deeds also said the taxpayers could engage in commercial timber harvesting provided that the conservation organization approves the timber management plan submitted by the taxpayers. The deeds also permit the removal of trees for agricultural or aesthetic purposes and the planting of non-native species without any approval from the conservation organization.

The deeds also permit a wide variety of recreational activities such as noncommercial hunting, fishing, horseback riding, boating, and hiking; the construction of fences provided that they do not result in demonstrable degradation to the conservation values; the construction of roads and trails to access permitted building sites and to accommodate timber management; and the use of agrichemicals using methods and dosages which achieve the desired result while minimizing the impact upon non-noxious foliage and vegetation.

An environmental report with respect to the property said: "Overall, the property provides a significant wildlife resource for the region and enhances the natural aesthetics of the area. With access to a major waterway corridor and a variety of ecological communities, this site offers forage, nesting habitat, and shelter. All these functions and values are also beneficial to the public in the form of cleaner air and water, plentiful game for hunting, and natural beauty in the area."

The IRS contended that the reserved rights are inconsistent with the conservation purpose, but they offered no expert witness testimony to support the contention. Instead, they claimed the reserved rights could be exercised in ways that would destroy the habitats and high-quality ecosystems on the property. However, the IRS did not introduce any evidence in support of that argument or any evidence that the conservation organization would be likely to fail to enforce its rights granted under the conservation deeds or that they would permit the taxpayer to use the land in a manner inconsistent with the conservation purpose.

The court concluded that the taxpayer presented credible evidence in the form of expert testimony. The court also noted that the conservation organization was granted the right to periodically enter and inspect the property to ensure compliance with the terms of the conservation deeds. The IRS failed to establish that the conservation deeds did not protect significant habitat. The deeds therefore qualified as qualified conservation contributions. *(Butler,* T.C. Memo 2012-72)

~ End ~