Contributions

Charitable Giving with Tangible Personal Property: A Tax Primer

by Philip T. Temple, LL.B, and Laurence C. Zale

Executive Summary

- Gifts of tangible personal property present complex philanthropic issues such as valuation and tax. Financial planners need to work closely with independent tangible personal property advisors, lawyers, and charitable organizations to be sure their clients maximize their gifting opportunities.
- Tangible personal property is broadly defined in the tax code as any property, other than land or buildings, that can be seen or touched, such as jewelry, coins, artwork, and timber, which under specific circumstances qualifies as a gift to charitable organizations. But whether a specific gift qualifies as tax deductible will depend on factors related to that specific type of property. For example, some coins may qualify as tangible personal property, while others may not.
- How the property is held by the donor, whether the property can be put to use by the charitable organization, and whether the gift is of present or future interest also affects the scope and nature of the income tax deduction.
- For example, if the donated appreciated property is related to the objectives of the public charity, the deduction is based on the fair market value and is available to the extent of 30 percent of the donor's adjusted gross income. Donated property not related to the mission qualifies for a smaller deduction.
- Tangible personal property donated in exchange for charitable gift annuities, pooled income funds, and charitable remainder and lead trusts presents an additional set of rules.
- Future interest rules do not apply to contributions of an undivided fractional interest in tangible personal property.

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Collectors of tangible personal property, unlike with other assets, often do not know the fair market value of their property. They are unaware of the opportunities to use those assets for personal or philanthropic purposes, and the tax benefits available to them.

Charitable giving for 2003 was an estimated $240.92 billion, according to Giving USA, a report released by the AAFRC Trust for Philanthropy. The study describes the source of donations: individuals, foundations, bequests, and corporations. It also lists the type of beneficiary organization. Excluded from the study, however, is the type of donation, such as cash, securities, real estate, and tangible personal property, and its value.

The collection of data on tangible personal property is accumulated by the Internal Revenue Service, the U.S. Department of Treasury's Bureau of Economic Analysis, the Foundation Center, the Independent Sector, the Council for Aid to Education, the National Center for Charitable Statistics at the Urban Institute, and the National Council of the Churches of Christ. Yet this collection of data has never accurately calculated the type and value of these multi-billion-dollar assets.

Financial planners and other professional advisors, whose clients own tangible personal property, should be able to help collectors construct a comprehensive plan for the lifetime ownership and testamentary disposition of those assets. To help them achieve those objectives, the use of an experienced independent tangible personal property advisor is crucial. Collectors will then be able to sell or donate their tangible personal property, receive tax benefits, put the cash proceeds in a trust or fund managed by financial professionals, all while fulfilling their personal or philanthropic missions.

This article examines the use of tangible personal property for personal or philanthropic purposes. It defines tangible personal property and provides examples of different types of property and how they might qualify for a tax deduction. Income tax rules are then reviewed, including the all-important related-use rule and its impact on the size of the allowable deduction. Future interest rules and gifts of undivided interests are examined, as well as the transfer of tangible personal property to such income-producing entities as charitable gift annuities, pooled income funds, and charitable remainder and lead trusts. Finally, the article explores the emotional involvement many collectors have with their collections, and the importance of proper planning for the lifetime ownership and testamentary disposition of a collection.

Tangible Personal Property Defined

Tangible personal property is one of the most interesting types of property contributed to charity because of its infinite varieties and how it's collected. The Internal Revenue Code and Regulations applicable to charitable contributions do not provide a definition of tangible personal property, and neither does Section 48, which deals with investment credits. But an earlier version of Section 48 broadly defined tangible personal property as "any property, other than land or buildings, that can be seen or touched. It includes artworks; jewelry and gems; coins; cars, boats and aircraft; and timber." Consequently, specific assets require special consideration in order to determine whether they qualify as tangible personal property that can be contributed to a related-use charitable organization (explained in "Income Tax Considerations") and qualify for a full fair- market-value deduction.

Artworks. Artworks can be broadly described as objects with visual content that elicit an aesthetic response from viewers while providing a social function. Examples include fine art (such as paintings, drawings, prints, sculpture, and photography), decorative art, and collectibles. A collection (or any part of it), with its copyright, can be contributed to a related-use charitable organization and qualify for a full fair-market-value deduction.

The Copyright Act of 1976, which became effective January 1, 1978, differentiates between original artwork and its copyright. "Section 202 of the Copyright Act provides the following: Ownership of a copyright, or any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied."[1] Therefore, an original work of art and its copyright are considered separate property for gift and estate tax deduction purposes.[2]

But the transfer of artwork to charity with the copyright retained by the donor constitutes a nonqualified gift of a partial interest and therefore produces no income tax deduction.[3]

Jewelry and gems. Jewelry and gems vary widely and are generally thought of as decorative, precious, and long lasting. Occasionally, they also serve as sculptural statements of importance. "Jewelry and gems are of such a specialized nature that it is almost always necessary to get an appraisal by a specialized jewelry appraiser. Sentimental personal value has no effect on fair market value. But if the jewelry was owned by a famous person, its value might increase."[4] A collection (or any part of it) can be contributed to a related-use charitable organization and qualify for a full fair- market-value deduction.

Coins. Coins have two distinct characteristics that enhance their value. First, coins function as money, are mass-produced, and are widely available. Second, they are issued with the image of a ruler, leader, or important figure, giving them the status of collectible public art. Therefore, it's important to differentiate between coins that are currency and those that are tangible personal property.

Cars, boats, and aircraft. Donors should consult market guides to determine the approximate fair market value of cars, boats, and aircraft. Each guide will provide high and low values, with additions for extra equipment and in superior condition. But "the prices are not official, and these publications are not considered an appraisal of any specific donated property."[5] To determine fair market value, donors should have their cars, boats, and aircraft appraised by experts who specialize in this area.

Timber. Timber can be land covered with trees and shrubs or the wood of trees cut and prepared for use as building material. It also can function as a beam or post made of wood. Contributions of timber, therefore, are one of the most complex property gifts. Factors that determine the tax treatment of charitable contributions of timber include whether the timber is standing and being contributed with the land, or has been cut and is being contributed separately. Likewise, it is important to distinguish whether the donor holds the timberland primarily for investment purposes or is engaged in the sale of timber to customers in the ordinary course of a trade or business.

If timberland and its standing timber, held for investment long term, are contributed to charity, the donor's deduction is based on the fair market value of the entire property, subject to the 30 percent deduction limitation (explained below).

The rules applicable to taxpayers engaged in the timber business are extremely complex and can vary depending on state law. Those interested in contributions of timber should consult with tax and legal counsel who specialize in this area.

Income Tax Considerations

Transfers of tangible personal property present special issues for income-tax charitable deduction purposes. To determine the allowable income-tax charitable deduction, the following questions should be asked:

- Can the property be put to a use that is related to the charitable donee's tax-exempt purpose?
- Is the property held by the donor for investment purposes, held primarily for sale to customers in the ordinary course of a trade or business, or held as qualified research property?
- Is the gift of a present or future interest?

Related-use rule. It is only where the use of the donated appreciated tangible personal property is related to the tax-exempt purposes of the donee charity that the donor is allowed a fair-market-value deduction for the contribution of that property.

Based on the language of two Regulation Sections, the term "unrelated use" means a use that is unrelated to the purpose or function constituting the basis of the charitable organization's exemption under Section 501 or, in the case of a contribution of property to a governmental unit, the use of such property by such unit is for other than exclusively public purposes.

The regulations further require the taxpayer to provide proof that the property is in fact not being placed to an unrelated use by the charity, or that it is reasonable to anticipate that the property will not be put to an unrelated use. For example, if an individual donates a painting to a museum and it is of the type normally retained by the museum, it is reasonable for the donor to anticipate, unless he or she has actual knowledge to the contrary, that the painting will not be put to an unrelated use by the donee. Whether or not the object is later sold or exchanged by the donee is immaterial.

The IRS, in a series of private letter rulings, has given guidance as to when the gift will be deemed one for a related use. The citations for those rulings are Ltr. Rul. 7751044; Ltr. Rul. 8247062; Ltr. Rul. 8204167; Ltr. Rul. 8016116; Ltr. Rul. 8143029; Also see Ltr. Ruls. 9131052; 9833011; Ltr. Rul. 8009027.

If appreciated property is considered related to the public charity's exempt purpose, the deduction is based on fair market value and available to the extent of 30 percent of the donor's adjusted gross income (AGI). If property is considered unrelated to the public charity's exempt purpose, the deduction is based on the lesser of its fair market value or its cost basis, and is available to the extent of 50 percent of the donor's contribution base.[6]

Any amount that exceeds the 30 or 50 percent ceiling may be carried forward for five years.[7] If the contributed property satisfies the related-use rule, the taxpayer may elect to increase the 30 percent limitation to 50 percent of his or her AGI. But if that election is made, the amount of the deduction must be reduced by 100 percent of the appreciation in value of the property.[8] Thus, the deduction is limited to the donor's cost basis.

For example, a collector has an AGI of $150,000. He contributes to museum a long-term capital gain visual arts collection with a fair market value of $90,000, and a cost basis of $40,000. If the donor has a qualified appraisal prepared by a qualified appraiser, he has made a gift of $90,000, of which $45,000 (30 percent of $150,000) is deductible in the year of the gift.

But if that visual arts collection is donated to a charity but not related to the charitable purposes or functions of that charity, the collector's deduction will be the cost basis of $40,000; that amount is fully deductible under the 50 percent ceiling, with no carryover.

Table 1 compares donors holding two long-term assets: stock, which has a maximum capital gains rate of 15 percent, and tangible personal property, which has a maximum rate of 28 percent. Both assets have a fair market value of $90,000 and a cost basis of $40,000. By donating tangible property to charity rather than stock, the donor could save an additional $6,500 of capital gains tax when the asset is sold because of the higher tax rate associated with tangible personal property.

TABLE 1

Capital Gains Tax Comparison for Stock and Artwork

	Stock	Artwork
FMV	$90,000	$90,000
Cost Basis	$40,000	$40,000
Net Long-Term Capital Gains	$50,000	$50,000
Maximum Capital Gains Tax Rate	15%	28%
Capital Gains Tax	$7,500	$14,000
Additional Savings		$6,500

Future interest rule. A charitable contribution that consists of a future interest in tangible personal property is treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in IRC Sections 267(b) or 707(b).[9]

Future interests include situations in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, whether written or oral, with the charitable organization that allows the donor the right to the use, possession, or enjoyment of the property.[10] Outright contributions do not run afoul of the future-interest rule as long as the property is physically delivered to the charitable donee.

The application of the rules regarding gifts of a future interest are illustrated by the following examples:

Example 1. On December 31, 2000, William, an individual who reports his income on a calendar-year basis, conveys by deed of gift to a museum title to a painting, but reserves to himself the right to the use, possession, and enjoyment of the painting during his lifetime. It is assumed that there was no intention to avoid the application of Section 170(f)(3)(A) by the conveyance. At the time of the gift the value of the painting is $90,000. Since the contribution consists of a future interest in tangible personal property in which the donor has retained an intervening interest, no contribution is considered to have been made in 2000.

Example 2. Assume the same facts as in example 1 except that on

December 31, 2001, William relinquishes all of his right to the use, possession, and enjoyment of the painting and delivers the painting to the museum. Assuming that the value of the painting has increased to $95,000, William is treated as having made a charitable contribution of $95,000 in 2001, for which a deduction is allowable without regard to Section 170(f)(3)(A).

Example 3. Assume the same facts as in example 1 except William dies without relinquishing his right to the use, possession, and enjoyment of the painting. Since William did not relinquish his right to the use, possession, and enjoyment of the property during his life, he is treated as not having made a charitable contribution of the painting for income tax purposes.

Income-Producing Gifts

Application of related-use and future-interest rules to charitable gift annuities. Transfers of tangible personal property in exchange for an immediate or deferred payment charitable gift annuity are not considered a gift of a future interest because such transfers are considered part outright gift and part sale. Although there are no rulings directly on point, if the property can be placed to a related use by the donee, we presume the donor can claim a deduction based on the related-use percentage limitations as described above. Furthermore, because the gift portion of the transfer is one of a present interest, the income tax deduction generated by the transfer can be used immediately by the donor regardless of the timing of the subsequent disposition of the property.

Application of related-use and future- interest rules to pooled income funds and charitable remainder trusts. The use by a trust of tangible personal property contributed to it for the benefit of a charitable organization is an unrelated use if the use by the trust is one that would have been unrelated if made by the charitable organization.[11] Presumably, because a pooled income fund or charitable remainder trust will not place the property to a related use but, rather, will most likely sell it in due course, such a use normally falls outside the tax-exempt purpose of most organizations.

Special rule: An income tax charitable contribution deduction may not be available if the charitable remainderman buys tangible property from the trust and a related individual or entity as described in IRC Section 267 has direct or indirect control of the recipient tax-exempt organization.[12]

Gifts of tangible personal property made to a pooled income fund or charitable remainder trust are considered gifts of a future interest. Arguably, because the income interest is retained in the fund or trust and not in the tangible property, the donor's interest should expire when the fund or trust sells the property to an unrelated party. The IRS has finally validated this argument for charitable remainder trusts. In Ltr. Rul. 9452026, the taxpayer contributed publicly traded stock and a musical instrument. Regarding the deductibility of the gift of the instrument, the IRS states:

> Because the musical instrument is tangible personal property, section 170(a)(3) of the Code prevents any deduction for the remainder interest so long as Taxpayer retains an income interest in the musical instrument. However, an income tax deduction would be allowed under section 170(a)(3) when the trustee sells the musical instrument. When the musical instrument is sold, Taxpayer no longer retains an intervening interest in the tangible personal

> property as contemplated under section 170(a)(3), that is, Taxpayer is only holding an income interest in the sale proceeds from the musical instrument. Accordingly, Taxpayer's intervening interest in the musical instrument is treated as terminated upon its sale.

In its ruling, the IRS also cited the example of the regulations applicable to pooled income funds. We surmise that the IRS would reach the same conclusion regarding contributions of tangible personal property to pooled income funds.

Gifts of undivided interests. The future- interest rule does not apply to contributions of an undivided fractional interest in tangible personal property. For example, an individual contributes an undivided one-quarter interest in a painting of which the donee is entitled to possession during three months of each year. The transfer is evidenced by a formally executed and acknowledged deed of gift. In such a case, the donor is entitled to a charitable contribution deduction for the one-quarter interest in the painting—provided that the period of initial possession by the donee is not deferred for more than one year.[13]

Nontax Issues

Previous sections discussed the application of the income tax deduction rules to transfers of tangible personal property to charitable remainder trusts, pooled income funds, and charitable gift annuities. Are there nontax issues that make one charitable vehicle more attractive or compatible than another?

Charitable gift annuity and pooled income fund. There are no restrictions that prohibit the transfer of tangible personal property in exchange for an immediate or deferred payment charitable gift annuity or to a pooled income fund. But the charitable organization will not likely accept such property if it believes the property may not be accurately valued or easily sold. This is due to the fact that the charitable organization is obligated to make annuity payments regardless of whether the transferred property is sold. If the charity ultimately sells the gift property for less than the amount on which the annuity payments are based, the gift to charity will be reduced, eliminated, or result in a net loss. As an alternative, the charity may accept the property at a conservatively lower value that it believes will compensate it for market risk, and then sell it in due course.

In the pooled income fund, if the charity does not believe the transferred property can be readily converted to cash or that it may not be accurately valued, accepting such a gift would place other fund participants at risk. Similar to the gift annuity, the charity may accept the property at a conservatively lower value that it believes will compensate it for this risk, purchase it from the fund, and then sell it in due course.

Charitable remainder trusts. A charitable remainder trust may be the ideal vehicle to accept tangible personal property. In general, a "flip" unitrust can accept the property and not be required to make any income distributions until the property is sold, at which time the trust converts from a net income to a standard payout format.

As an alternative, a net income unitrust (with or without make-up provision) can also insulate the trustee from having to make distributions from the trust while it holds nonincome-producing property. The net income unitrust is a less attractive alternative to the flip unitrust, however, from the perspective of the trustee's ability to reinvest the proceeds from the sale of the property to produce trust accounting (distributable) income.

A standard unitrust also may be a suitable candidate to accept tangible personal property, provided that the property can be quickly converted to cash or the trust possesses other liquid assets with which to make income distributions until the property is sold. As an alternative, if other liquid assets are unavailable, the donor can make timely additional cash contributions to the trust in the amount of the required income distributions until the tangible property is sold. These additional contributions are returned to the donor in satisfaction of the trust's payment obligation. But this method may be unnecessarily burdensome from an administrative standpoint.

The least attractive type of charitable remainder trust for use with tangible personal property is the charitable remainder annuity trust. The reason is that such trusts are unable to receive additional contributions. If the trust is unable to sell the property and has no other assets with which to make distributions, the trustee will be forced to distribute an undivided fractional interest in the property to the income recipient. Such distributions are treated for income tax purposes as though the trust had sold that portion of the property and distributed cash.

Gifts of remainder interests in tangible personal property not in trust. It is clear from previous discussions that a gift of a future interest in tangible personal property is not deductible for income tax purposes until the expiration of all intervening interests held by the donor. In the case of a gift of an irrevocable remainder interest in such property, if the measuring term of the agreement is based on the donor's life, not only will no income tax deduction be generated, the transfer will also be considered a taxable transfer for gift and estate tax purposes.

In Rev. Rul. 76-165, a taxpayer bequeathed a remainder interest in his personal residence to charity, conveying a life estate to his wife. Included with the gift were all of the household furnishings. The ruling held that because the remainder interest in the household furnishings transferred to charity after the death of the noncharitable life tenant was not a remainder interest in a personal residence or farm or an undivided portion of the decedent's entire interest in property, and because it was not a remainder interest in a charitable remainder annuity trust, in a charitable remainder unitrust, or in a pooled income fund, no estate tax charitable deduction was allowable under Section 2055(a) of the Code for the household furnishings. As an alternative, donors considering such arrangements should do so by bequest.

Gifts of tangible personal property to charitable lead trusts. The use of tangible property to fund a charitable lead trust must be accomplished with care. For example, if the property is non-income producing and highly appreciated, either the trust or the grantor will pay capital gains tax on the sale. Tangible personal property is ordinarily a hard-to-value asset. Therefore, a charitable lead annuity trust may be preferable. In all events, careful analysis of all issues must be accomplished before any such funding.

Post-mortem considerations for tangible personal property. Post-mortem steps can be beneficial where tangible personal property is bequeathed to family members or friends but there is no firm understanding that they wish to keep the property—particularly where there will be substantial estate tax.

The draftsperson of the will or trust should include a right to disclaim, followed by a gift to charity if the disclaimer is made. Then a full estate tax charitable deduction will be allowed. **Note:** the related-use issue does not apply to the estate tax charitable deduction for a bequest of tangible personal property, so the gift can be made to any qualified charity.

Guidance for Lifetime Ownership of Tangible Personal Property and Its Disposition

> Art is long, and Time is fleeting,
> And our hearts, though stout and brave,
> Still, like muffled drums, are beating
> Funeral marches to the grave.
> *A Psalm of Life—Longfellow*

Collectors of tangible personal property generally feel an emotional involvement with their collections. Others view their collections as disposable assets like stocks, bonds, and real estate. Some will consider them both. Regardless of their relationships with their property, collectors will be affected by the inevitable and unpredictable life forces of dollars, disputes, divorce, and death.

It is therefore important for collectors with philanthropic objectives to plan properly for the lifetime ownership and testamentary disposition of their collections. Before making firm plans, however, collectors should first consult with their financial advisors and legal counsel. If there is agreement from a tax, trust, and estate standpoint that their collections (or any part of it) should be sold, used for a lifetime annuity or another income stream, or donated, finding an advisor who specializes in tangible personal property is crucial. The advisor should be independent and not represent museums, auction houses, dealers, or artists.

He or she should be able to work harmoniously with financial advisors and legal counsel in creating a realistic comprehensive plan that implements the tax, trust, and estate objectives of collectors and their estates.

For collectors who feel an emotional involvement with their collections, the advisor can arrange for them to donate a collection (or any part of it) to an appropriate charitable organization, receive an income tax deduction for fair market value, avoid capital gains taxes, and reduce their estate taxes.

Caveat donor. To claim a charitable deduction for the full fair market value of a donated collection, the taxpayer generally must comply with four specific requirements. Before donating a collection to a charitable organization, the donor must determine the following:

1. The status of the charitable organization: the collection must be contributed to a public charity, not a private foundation
2. The type of property being contributed: the collection must be long-term capital-gain-type property and not ordinary-income-type property
3. Whether the collection satisfies the related-use rule: the use of the collection by the donee charity must be related to the tax-exempt purpose of the charity
4. Whether there is a qualified appraisal prepared by a qualified appraiser[14]

For others who view their collections as disposable assets, the advisor, together with financial advisors or legal counsel who specialize in planned giving, can arrange for collectors or their estates to make a gift of appreciated property to a charitable organization. For their gift, they can receive a lifetime annuity that will generate income from a nonproductive asset, receive annual payments, spread the tax on capital gains over a lifetime, receive a tax deduction for a portion of the value for the transferred property and reduce their estate taxes.

Moreover, the advisor should be able to assist with appraisals, insurance, storage, and make arrangements for the sale of tangible personal property.

Magnanimous donor. Current tax laws favor collectors who donate or offer tangible personal property for lifetime annuities or other income streams to museums or other qualified charitable organizations. According to the 2003 report released by the Trust for Philanthropy of the American Association of Fundraising Counsel, individuals, foundations, and corporations—encouraged by the generosity of those laws—last year donated over $12 billion to the arts, culture, and the humanities.

Tangible personal property is sui generis among assets. Its unlimited varieties, the way it's collected, and the vital role it often plays in lives of collectors, requires the combined expertise of a financial planner, legal counsel, and an independent tangible personal property advisor. Together, this constituency can advise collectors—large and small alike—of the opportunities to use their collections for personal or philanthropic purposes during their lifetime and as part of their estate.

Endnotes

1. Ralph Lerner and Judith Bressler, Practising Law Institute, *Art Law*, 2 (1998): 1242.
2. IRC Sections 2055(e)(4);2522(e)(3); Reg. Sections 20.2055-2(e)(1)(ii); Reg. Section 20.2522(c)-3(c)(ii)(1).
3. Reg. Section 1.170A-7(b)(1).
4. IRS Pub. 561 (Rev Feb 2000): 4.
5. IRS Pub. 561 (Rev Feb 2000): 5.
6. IRC Section 170(e)(1)(B).
7. IRC Section 170(d)(1)(A),(b)(1)(ii).
8. IRC Section 170(b)(1)(C)(iii), (e)(1).
9. IRC Section 170(a)(3).
10. Reg. Section 1.170A-5(a)(5).
11. Reg. Section 1.170A-4(b)(3)(i).
12. IRC Section 170(a)(3); Section 267(b)(9); Reg. Section 1.267(b)-1(a)(3).
13. Reg. Section 1.170A-5(a)(2).
14. Ralph Lerner and Judith Bressler, Practising Law Institute, *Art Law*, 2 (1998): 1183.