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CHARITABLE GIFTS OF APPRECIATED PROPERTY

by

*J. David Tracy**

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THE charitable contribution deduction has its roots in the philosophy that philanthropy should be financed by private enterprise rather than governmental subsidy. However, some individuals, more specifically the wealthy, have been able to take advantage of the tax system so as to make a profit on the contribution of property to a charity (as opposed to its sale and retention of the proceeds). In its zeal to curtail this advantage, Congress provided a reduction provision that forces a donor to reduce his charitable gift by the amount of any appreciation which would have been ordinary income if the property had been sold.¹ Additionally, the individual donor must reduce his charitable contribution by fifty percent of the capital gain appreciation for gifts of tangible personal property which are put to an unrelated use by the exempt organization, and for gifts to certain private foundations.² Although the theory behind this congressional tightening-up is quite commendable, the ambiguity of the statutory language chosen, coupled with the obscure interaction of these new provisions, has left a myriad of problems for the tax practitioner. Guideposts have been erected by the Treasury in its proposed regulations, but these regulations are not the complete answer, and they actually cause some confusion themselves. In ferreting through this maze, it is clear that many questions remain unanswered, all the tax advantages of charitable contributions have yet to be eliminated, and some new inequities have been born.

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

² *Id.* § 170(e)(1)(B).

I. TRADITIONAL FOUNDATIONS FOR THE CHARITABLE DEDUCTION

A. *Theoretical Justifications*

The usual justification given for the allowance of an income tax deduction for contributions to charities is that such activity is socially desirable and should be encouraged. In this day of rising costs for charitable organizations, the argument for the use of tax incentives to further private philanthropy does make sense.³ These contributions support many organizations that would otherwise have to be state-supported, and in this manner help to relieve the budgetary crises of every state and the federal government. This reliance upon the individual citizen to circumvent the political pressures inherent in any social welfare system is undoubtedly a result of the individualistic attitude which has viewed certain areas as appropriate for private, not governmental, financial aid.

On the other hand, it can be argued with equal force that if government-supported, many charities would either not receive any money at all or their programs would be more closely scrutinized to eliminate "wasteful" activities and to continue "worthwhile" ones. This argument would point to the deduction as a disguised form of federal assistance, delegating the expenditure of public funds to private persons. Obviously, charities favored by the wealthy are subsidized more under this system,⁴ and the allocation of funds by way of a tax deduction is less costly to the upper bracket taxpayer.

Whatever one's conclusion concerning the desirability of allowing the taxpayer to effectively choose the purpose and the organization to which the federal government will make a partially matching gift, the consensus has been that such a system is to be encouraged. In addition, a diversity and independence in the maintenance of charitable organizations has been produced that would not otherwise have been obtainable.⁵

However, even if the arguments for the continuation of the charitable deduction are accepted,⁶ these philosophical postulates do not justify the maintenance of the present system if it can be shown that the amount of giving encouraged by the tax incentive is small when compared to the revenue loss

³ For a critical analysis of the effectiveness of tax incentives in promoting a governmental policy, see Surrey, *Tax Incentives—Conceptual Criteria for Identification and Comparison with Direct Governmental Expenditures*, in TAX INCENTIVES 3 (1971).

⁴ For figures showing the skewing of heavy charitable contributors toward the upper income brackets, see H. KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX 46-91, 208-11, 216-29 (1960); STUDIES IN SUBSTANTIVE TAX REFORM 52 (A. Willis ed. 1969) [hereinafter cited as STUDIES].

⁵ R. GOODE, THE INDIVIDUAL INCOME TAX 169-71 (1964).

⁶ Some commentators have developed their own income tax systems with varying approaches for the charitable deduction. These include: R. GOODE, *supra* note 5, at 168-75; J. PECHMAN, FEDERAL TAX POLICY 78 (1966); D. SMITH, FEDERAL TAX REFORM 101-07 (1961); Gelfand, *The Individual Income Tax Base and the Charitable Contributions Deduction*, in HOUSE COMMITTEE ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 441 (Comm. Print 1959). Presumably, the charitable deduction would also be a relic of the past if the comprehensive tax base proposals were codified into the revenue laws. See generally A COMPREHENSIVE INCOME TAX BASE? A DEBATE (1968); C. GALVIN & B. BITTKER, THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE? (1969); H. SIMONS, PERSONAL INCOME TAXATION (1938); THE FEDERAL INCOME TAX (R. Haig ed. 1921); Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967).

involved. In 1954 the charitable contribution amounted to one-third of all the deductions taken by living donors,⁷ while in 1965 the fraction was estimated to be approximately one-fourth.⁸ After breaking down the taxpaying populace into income types, the introduction of the standard deduction in 1940 did not seem to have any measurable effect on charitable giving. Thus, the inference is that the tax incentives of the charitable contribution do not have an effect on those in the twenty- to thirty-percent tax bracket.⁹ For those donors in the higher income tax brackets, the charitable deduction amounts to a larger percentage of total deductions.¹⁰ Although the effect of reform on the contribution habits of these donors is not yet known, it is clear that a reduction in their charitable deductions will greatly increase tax revenue.¹¹

B. Historical Development

The basic congressional approach toward charitable contributions from 1917 to 1969 has been one of expansion. The Revenue Act of 1917¹² for the first time added a provision that would allow a taxpayer to deduct a charitable contribution from his net income.¹³ It was feared that without this provision, such contributions would decline because of high tax rates,¹⁴ and coupled with this was the fear that the amount which the charity might otherwise receive from governmental support would not be great.¹⁵ The Revenue Act of 1918¹⁶ extended charitable contributions to include gifts to a special fund for vocational rehabilitation, the Revenue Act of 1924¹⁷ introduced the unlimited deduction, and the Revenue Act of 1936¹⁸ authorized corporations to deduct their contributions to charities.

The expanding liberalization of a deduction for charitable gifts paused briefly in 1938. In that year the House Ways and Means Committee proposed that the allowable deduction for a gift of property be limited to the lesser of the donor's adjusted basis therein or the fair market value of the property contributed.¹⁹ Although the House argued that such a proposal was necessary in view of the practice of allowing a deduction in the year of contribution for untaxed income,²⁰ the Senate deleted this provision, believing that charitable gifts ought to be encouraged.²¹

Having weathered the 1938 storm, the charitable deduction continued on a generally liberalized course. In 1952 the maximum charitable deduction limit

⁷ H. KAHN, *supra* note 4, at 72.

⁸ R. GOODE, *supra* note 5, at 171.

⁹ *Id.* at 172; STUDIES 52.

¹⁰ A graph depicting a correlation of charitable contribution deductions as a percentage of the total personal deductions to the different classes of adjusted income can be derived from the tabular computations as set forth by R. GOODE, *supra* note 5, at 324.

¹¹ STUDIES 50-51.

¹² Ch. 63, § 1201(2), 40 Stat. 330.

¹³ A similar provision was proposed for the Revenue Act of 1913, but it did not pass the Congress. 50 CONG. REC. 1259 (1913) (remarks of Congressman Rogers).

¹⁴ H. KAHN, *supra* note 4, at 6-7, 46-47.

¹⁵ 55 CONG. REC. 6728 (1917) (remarks of Senator Hollis).

¹⁶ Ch. 18, § 214(a)(11), 40 Stat. 1069.

¹⁷ Ch. 234, § 214(a)(10), 43 Stat. 253.

¹⁸ Ch. 690, § 23(g), 49 Stat. 1648, 1661.

¹⁹ H.R. REP. NO. 1860, 75th Cong., 3d Sess. 35 (1938).

²⁰ *Id.*

²¹ S. REP. NO. 1567, 75th Cong., 3d Sess. 14 (1938).

was increased from fifteen to twenty percent,²² and in 1956 the unlimited deduction was liberalized.²³ Thus, prior to the Tax Reform Act of 1969,²⁴ it could be generally said that the contribution of appreciated property to a charity gave rise to a charitable deduction for the full fair market value of the property contributed²⁵ with no taxation with respect to its appreciation,²⁶ except to the extent that the gain would have been subject to sections 1245(a),²⁷ 1250(a),²⁸ or 617(d).²⁹

Following the trend of legislative history reflecting a congressional intent of encouraging charitable giving to the institution of the taxpayer's choice, while rewarding him at the same time,³⁰ the courts took the position that the charitable contribution provisions of the revenue acts should be liberally construed.³¹ From this background Congress engrafted new concepts in 1969 upon the basic rationale that the charitable contribution should be encouraged via a tax incentive, but at the same time that the flagrant advantages available to the high income bracket donor on the contribution of property, as opposed to cash, should be eliminated.³²

II. ORDINARY INCOME PROPERTY

A. Provisions Applicable to All Ordinary Income Property

1. *The Problem.* Prior to the Tax Reform Act of 1969 the contribution of property to a charity that possessed only ordinary income appreciation allowed the donor to bypass tax on this appreciation and yet obtain a charitable deduction for the full fair market value of the property. Thus, the contribution of property with a fair market value of \$10,000, a basis of \$4,000, and \$6,000 ordinary income appreciation would allow the donor a \$10,000 charitable contribution. This contribution would be worth \$7,000 to him, if he were in the

²² Act of July 8, 1952, Pub. L. No. 82-465, § 4(b), 66 Stat. 443.

²³ Act of February 15, 1956, Pub. L. No. 84-1022, § 1, 70 Stat. 1117.

²⁴ Tax Reform Act of 1969, 83 Stat. 487 (codified in scattered sections of INT. REV. CODE of 1954).

²⁵ L.O. 1118, II-2 CUM. BULL. 148 (1923); Rev. Rul. 55-410, 1955-1 CUM. BULL. 297; Treas. Reg. § 1.170-1(c)(1), T.D. 6605, 1962-2 CUM. BULL. 76. However, if there was an agreement that the taxpayer would repurchase the property, then the amount paid to repurchase the property from the charity would be regarded as a charitable contribution rather than as giving the donor a step-up in basis. Rev. Rul. 67-178, 1967-1 CUM. BULL. 64. *But cf.* Sheppard v. United States, 176 Ct. Cl. 244, 361 F.2d 972 (1966).

²⁶ Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954); White v. Brodrick, 104 F. Supp. 213 (D. Kan. 1952).

²⁷ Act of December 31, 1962, Pub. L. No. 87-834, § 13(d), 76 Stat. 1034.

²⁸ Act of December 31, 1963, Pub. L. No. 88-272, § 231(b)(1), 78 Stat. 105.

²⁹ Act of September 12, 1966, Pub. L. No. 89-570, § 1(b), 80 Stat. 762.

³⁰ Custy, *The Deduction of a Charitable Contribution of the Use of Property Under the Federal Income Tax*, 40 MISS. L.J. 329, 336-38 (1969).

³¹ Judicial expressions giving a liberal construction to the charitable contributions of the Code include: *Old Colony Trust v. Commissioner*, 301 U.S. 379 (1937); *Helvering v. Bliss*, 293 U.S. 144 (1934); *United States v. Provident Trust Co.*, 291 U.S. 272 (1934); *Edwards v. Slocum*, 264 U.S. 61 (1924); *Faulkner v. Commissioner*, 112 F.2d 987 (1st Cir. 1940); *Harrison v. Baker Annuity Fund*, 90 F.2d 286 (7th Cir. 1937); *Cochran v. Commissioner*, 78 F.2d 176 (4th Cir. 1935); *Sheppard v. United States*, 176 Ct. Cl. 244, 361 F.2d 972 (1966); *Beggs v. United States*, 89 Ct. Cl. 39, 27 F. Supp. 599 (1939); *Bowman v. Commissioner*, 16 B.T.A. 1157 (1929).

³² For an insight into how tax measures become part of the Code, see Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745 (1955); Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957).

seventy-percent tax bracket.³³ This situation is contrasted to the donor's selling the asset and retaining the proceeds. In this latter circumstance the seventy-percent tax levied upon the \$6,000 appreciation would amount to \$4,200, which would leave the donor \$5,800 after taxes as compared to \$7,000 net in the case of a contribution.³⁴ Obviously, the donor was able to profit taxwise from his charitable inclinations.³⁵

2. *Congressional Response.* In order to eliminate these advantages to the donor, the Treasury recommended to the House Ways and Means Committee that the charitable contribution be reduced by that amount which would have been ordinary income or short-term capital gain if the property had been sold at its fair market value rather than donated.³⁶ This proposal would have effectively limited the donor's charitable contribution to his adjusted basis in such property.

However, the House Ways and Means Committee went beyond the Treasury recommendations and proposed that on the charitable contribution of property, which contained ordinary income appreciation, the donor be required to either: (a) reduce the charitable contribution to his cost or other basis in the property, or (b) take a charitable contribution for the full fair market value of the property and include the untaxed appreciation in income.³⁷ The proposal was

³³ If the donated property consisted of inventory the cost of which was included in the donor's inventory at the beginning of the year of contribution, there would have to be a removal of the cost of the contributed item from inventory. Otherwise the cost of goods sold account would be excessive, thereby improperly reducing the income attributable to the inventory sold during the contribution year. Rev. Rul. 55-138, 1955-1 CUM. BULL. 223.

³⁴ The tax savings to the donor in such a circumstance, as initially viewed by the House, H.R. REP. NO. 91-413 (Part 1), 91st Cong., 1st Sess. 51-52 (1969), was \$11,200 consisting of \$7,000 effective value of the charitable deduction and \$4,200 which the donor did not have to pay in income taxes. Although this same viewpoint was carried forward by the Senate, S. REP. NO. 91-552, 91st Cong., 1st Sess. 80 (1969), it relates only to the cost of the gift to the Government. The example in the text sets forth the donor's *net worth* increment as being \$1,200 ahead in the case of a contribution as opposed to a sale. This net worth figure, and not the amount of tax which would or would not have been paid, is the important computation for the donor.

With ordinary income property a donor, prior to the Tax Reform Act, could calculate when a contribution would give him a greater net worth increment (as opposed to a sale of the asset with the retention of the proceeds) by the following formula: $S = (V + T) - F$. Here S is the savings to the donor by making a contribution rather than a sale, V is the value of the charitable contribution to the donor, T is the amount of tax which would have to be paid on the appreciation if the property had been sold, and F is the fair market value of the property in question. With the fact situation portrayed in the text, the formula would yield:

$$S = (\$7,000 + \$4,200) - \$10,000 = \$1,200.$$

When S is a positive number, there is a greater savings by the contribution route; when it is a negative number, there is a greater savings by the sale of the asset with a retention of the proceeds. It might also be noted that for the donor in the 70% tax bracket, the ordinary income appreciation must be at least 43% of the fair market value of the property for a greater savings to be gained by the contribution route. As the tax bracket of the donor decreases, the appreciation must be a larger portion of the fair market value of the property. For a similar formula concerning capital gain property see notes 77-78 *infra*.

³⁵ The implication that tax avoidance is the purpose of every gift is erroneous because it assumes that the taxpayer would have sold the property in any event. If this property had been retained, the donor would have had \$10,000. However, since ordinary income property is usually designed to be sold, Congress was justified in seeking to overturn the old rules. Myers & Quiggle, *Charitable Contributions and Bequests by Individuals: The Impact of the Tax Reform Act*, 39 FORDHAM L. REV. 185, 194 (1970).

³⁶ *Hearings on H.R. 13270 Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess. 5152-53 (1969) [hereinafter cited as 1969 *House Hearings*].

³⁷ H.R. REP. NO. 91-413 (Part 1), 91st Cong., 1st Sess. 54-55 (1969).

based upon three objectionable features of allowing the donor to realize greater benefits on the contribution of the appreciated property to a charity as opposed to its sale and retention of the proceeds: (1) the charitable motive for giving seems to be lacking, (2) the government is almost the sole contributor in such circumstances, and (3) the only donors to gain this benefit are usually in the very high tax brackets.³⁸

The view of the evils available on the contribution of ordinary income property to a charity as espoused by the House Ways and Means Committee was basically concurred in by the Senate Finance Committee. Under the Senate version of the Act³⁹ ordinary income appreciation would go to reduce the value of the donor's charitable contribution, but there would be no election available to deduct the full fair market value of this property and include the appreciation in income.⁴⁰ The same view was accepted by the conference committee.⁴¹

The statutory product of this congressional attempt to limit the advantages available to high income donors on the contribution of appreciated ordinary income property to a charity found fruition in section 170(e)(1)(A).⁴² The pertinent provision states:

The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the sum of—

(A) the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).⁴³

(a) "*Would Not Have Been Long-Term Capital Gain.*" Section 170(e)(1)(A) plainly provides that a charitable contribution to any charity, including a public charity,⁴⁴ is reduced by the amount of appreciation which would have been ordinary income if the property had been sold at its fair market value rather than donated. Thus, for ordinary income property⁴⁵ which has a fair

³⁸ *Id.* at 54.

³⁹ S. REP. NO. 91-552, 91st Cong., 1st Sess. 81-82 (1969).

⁴⁰ The deletion of the provision to allow the inclusion of the appreciation in the donor's tax base and a charitable contribution for the full fair market value of the property was most probably based upon the argument that this was a significant departure from the accepted practice of not taxing unrealized appreciation as income. *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess. 47 (1969) [hereinafter cited as *1969 Senate Hearings*]. *But see* S. REP. NO. 91-552, 91st Cong., 1st Sess. 334-36 (1969).

⁴¹ H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 293-94 (1969).

⁴² INT. REV. CODE OF 1954, § 170(e)(1)(A).

⁴³ *Id.*

⁴⁴ The term "public charity" is a shorthand expression for the charities which a contribution thereto allows a deduction for the donor in an amount up to 50% of his contribution base. These types of organizations are set out in § 170(b)(1)(A).

⁴⁵ "Ordinary income property" is defined as property where any portion of the gain on which would have not been long-term capital gain if it had been sold by the donor at its fair market value at the time of the contribution to the charity. This includes: property held by the donor primarily for sale to customers in the ordinary course of business, works of art created by the donor, manuscripts prepared by the donor, capital assets held by the donor for less than 6 months, § 306 stock, and stock to which §§ 341(a) and 1248(a) apply. However, this does not include an income interest for which a deduction is allowed under § 170(f)(2)(B). Proposed Treas. Reg. § 1.170A-4(b)(1), 36 Fed. Reg. 6091 (1971). *But see* H.R. 9505, CCH 1972 STAND. FED. TAX REP. § 6161. Under this pending legislation all those not eligible for capital gain treatment in accordance with § 1221(3), will have to reduce the ordinary appreciation in their charitable donation of copyrights, literary, musical, or artistic compositions, etc. by only 50%. The donee, which must be described in §§ 170(b)(1)(A)(ii), (v), or (vi), must give the donor a written statement that the property is of historical or artistic significance and that it will be put to a related

market value of \$10,000 and a basis of \$4,000, the charitable contribution is reduced by the amount of the ordinary income appreciation (\$6,000) to \$4,000.⁴⁶ The value of this contribution to a donor in the seventy-percent tax bracket is \$2,800.⁴⁷ The same principle applies to the ordinary income appreciation of \$6,000 or one dollar. Thus, with only one dollar of ordinary income appreciation involved (if the property had been sold at its fair market value), the entire amount of the property would be viewed as ordinary income property,⁴⁸ and the reduction provisions of section 170(e)(1)(A) would apply to the one dollar appreciation.⁴⁹

(b) "*If the Contributed Property Had Been Sold.*" This seeming simplistic operation of the statute contains a flaw in the instance of transfers of property to a charity in which income must be recognized by the donor on the gift of his appreciation in the property. Under a literal reading of the statute the amount of the charitable contribution is reduced by the amount of appreciation which would not have been long-term capital gain if the property had been sold, so that the recognition of income by the donor on a "disposition" of the property would still give rise to a reduction for the amount of the appreciation in the property contributed.⁵⁰ Thus, the contribution of an installment obligation to a charity (which would give rise to ordinary income under section 453(d))⁵¹ would still require a reduction in the amount of the charitable contribution by the amount of that ordinary income appreciation.

The proposed regulations attempt to solve this problem by providing that if gain or income is recognized in the same year as the charitable contribution, the amount of the contribution is not reduced under section 170(e)(1).⁵² This will take care of the situation in which income is recognized to the donor under section 453(d) upon the transfer of an installment obligation to a charity and for the recognition of income to the donor under section 454(b)⁵³ upon the transfer of an obligation issued at a discount. Such is only fair, since penalizing the donor doubly by having him taxed on the appreciation and at the same time cause a reduction in the amount of his charitable contribution seems hardly equitable. As the donor will have been taxed on the amount of the appreciation involved, he will be in the same position as a donor who has contributed cash to the charity in after-tax dollars.

"use." Not covered by this new exemption are papers of public officials collected in office or appreciation covered by § 170(e)(1)(B). Thus, it would seem that a "softening" in tax reform has already begun.

⁴⁶ See Proposed Treas. Reg. § 1.170A-4(d), example (1), 36 Fed. Reg. 6092 (1971).

⁴⁷ The net worth increment which would have been available to the donor on the contribution of this property to a charity before the Tax Reform Act is set forth in note 34 *supra*. This change in treatment under the Tax Reform Act will put the donor of \$10,000 in wages and the donor of \$10,000 (consisting of the \$4,000 basis here plus \$6,000 of cash) in the same tax position if they are in the same tax bracket. Of course, the assumption must be made that the \$4,000 of basis also represents after-tax dollars.

⁴⁸ Proposed Treas. Reg. § 1.170A-4(b)(1), 36 Fed. Reg. 6091 (1971).

⁴⁹ Of course, if only \$1 of the \$6,000 appreciation is ordinary income, then the remaining \$5,999 would not be subject to reduction under § 170(e)(1)(A).

⁵⁰ Taggart, *The Charitable Deduction*, 26 TAX L. REV. 63, 109-13 (1970).

⁵¹ INT. REV. CODE of 1954, § 453(d).

⁵² Proposed Treas. Reg. § 1.170A-4(a), 36 Fed. Reg. 6090 (1971).

⁵³ INT. REV. CODE of 1954, § 454(b).

B. Section 306 Stock

Prior to the Tax Reform Act a taxpayer could donate section 306 stock⁵⁴ on which he had paid no income taxes at its receipt⁵⁵ to a charity and receive a charitable contribution for the full fair market value of this property without recognizing any income on the contribution or the subsequent sale of the property by the charity.⁵⁶ The abuses inherent in section 306 stock took the form of an outright contribution to the charity rather than a bargain sale because the bargain sale route would not have been a totally effective means of sheltering this section 306 stock from ordinary income taxation. The problem with the bargain sale, as with other sales, redemptions, or dispositions, was that ordinary income was generated in the sum of the amount realized rather than just the gain element.⁵⁷

The Act has essentially eliminated this method of relieving the section 306 stock classification.⁵⁸ Since section 170(e)(1)(A) requires a reduction of the charitable contribution in the amount of gain which would have been ordinary income if the property were sold, the value of the charitable contribution of this stock will be zero. (This assumes that the amount which would have been realized upon a sale is not in excess of the amount which would have been considered a dividend if money had been distributed by the corporation rather than stock when the donor first received this section 306 stock.)⁵⁹ However, the question remains whether the unused portion of the section 306 stock basis should be added back to the basis of the common stock with respect to which the dividend was declared. The regulations provide for this in the case of a sale,⁶⁰ and it would seem that the same treatment should prevail in the instance of a charitable gift which has been reduced by the amount of its inherent ordinary income element.⁶¹

C. Stock Rights

Prior to the Act the taxpayer could purchase for \$1,000 stock in a corporation which had announced that it would declare a dividend and then sell the shares in the market at their discounted value (*e.g.*, \$900) after the stock had gone ex-rights. The taxpayer could then take a \$100 loss, contribute the rights

⁵⁴ *Id.* § 306(c).

⁵⁵ INT. REV. CODE of 1954, ch. 736, § 305(a), 68A Stat. 90. Now a preferred stock dividend is taxed as ordinary income if there is a disproportionate distribution. Tax Reform Act of 1969, Pub. L. No. 91-172, § 421(a), 83 Stat. 614, *amending* INT. REV. CODE of 1954, § 305(b)(2), (3).

⁵⁶ Rev. Rul. 57-328, 1957-2 CUM. BULL. 229.

⁵⁷ INT. REV. CODE of 1954, §§ 306(a)(1)(A), (a)(2); Treas. Reg. § 1.306-1(b)(1) (1955).

⁵⁸ Presumably, the gift of § 306 stock will result in a reduction of the contribution by the amount which would have been ordinary income if the property had been sold to an unrelated party. In this way it would seem that the exception of § 306(b)(1) providing that the termination of the taxpayer's entire interest in this stock eliminates § 306 classification would not apply (assuming that the charity would be classified as an unrelated party so as to cause the non-application of § 170(e)(1)(A)). However, it is submitted that a taxpayer's contribution of § 306 stock, which terminates his entire interest in the corporation, should not be subject to reduction under § 170(e)(1)(A). Any other result is extremely inequitable.

⁵⁹ *Id.* §§ 306(a), (c).

⁶⁰ Treas. Reg. § 1.306-1(b)(2) (1955).

⁶¹ Taggart, *supra* note 50, at 112.

to a charity, and receive a \$100 charitable deduction. Since the rights would normally have been ordinary income if sold,⁶² section 170(e)(1)(A) eliminated the charitable deduction.

If the taxpayer elects, however, under section 307(b)(2)⁶³ to allocate a portion of the stock basis to the rights, then the reduction under section 170(e)(1)(A) would be minimal; but at the same time, the loss on the sale would also be minimal.⁶⁴ If alternatively this election were not made, a taxpayer in the seventy-percent bracket could wait more than six months to contribute the stock rights to a public charity, then as long as the capital gains tax on the appreciation was less than an effective rate of thirty percent, he would be better off to sell the rights and retain the proceeds.⁶⁵ Thus, no substantial loophole remains in the area of the contribution of stock rights.

D. Nonresident Aliens

The phrase "would not have been long-term capital gain"⁶⁶ does not seem to present interpretative problems for those such as the nonresident alien, to whom the ordinary rules of income taxation do not apply. In general, the gross income of a nonresident alien⁶⁷ can be reduced for those deductions attributable to income effectively connected with a trade or business within the United States.⁶⁸ However, the nonresident alien's charitable contributions are taken into account without regard to this limitation after meeting the requirements of section 170.⁶⁹

If the nonresident alien contributes ordinary income property which is used in his business within the United States, then the reductions of section 170(e)(1)(A) work no hardships on him, since he will be taxed at the normal progressive rates in any event.⁷⁰ As in the instance of a United States citizen, a nonresident alien's contribution of wages will not be subject to a reduction. However, the nonresident alien, because of the maximum tax limitation upon wages which are not effectively connected with a trade or business within the United States, would be in a better net position by not making any contribution, when compared to a United States citizen who has the same income.⁷¹

⁶² The holding period will start with the acquisition of the stock and normally will be less than 6 months in such cases. INT. REV. CODE of 1954, § 1223(5).

⁶³ *Id.* § 307(b)(2).

⁶⁴ Myers & Quiggle, *supra* note 35, at 196.

⁶⁵ See notes 77-78 *infra*.

⁶⁶ INT. REV. CODE of 1954, § 170(e)(1)(A).

⁶⁷ *Id.* § 872.

⁶⁸ *Id.* § 873(a).

⁶⁹ *Id.* § 873(b)(2).

⁷⁰ *Id.* § 871(b). Ordinary income property for the nonresident alien will most probably consist of inventory. It may be, however, that a nonresident alien who is not a painter by profession, could sell one of his paintings in the United States and be subject to a maximum tax of 30% for income which is not "effectively connected" with a United States trade or business under section 871(a)(1). In such a situation the entire ordinary income appreciation would still be subject to reduction under § 170(e)(1)(A) even though a United States citizen with the same amount of income could be subject to a higher percentage tax rate. Under § 170(e) the donor's tax bracket is irrelevant.

⁷¹ Assume that an unmarried United States citizen has \$100,000 in wages and is subject to a 70% tax rate, while a nonresident alien has \$100,000 in wages which is not "effectively connected" so as to be subject to only a 30% tax rate under § 871(a)(1). A gift of \$1,000 in wages would cost the citizen only \$300, while it would cost the nonresident alien \$700.

E. Observations on Ordinary Income Property

Congress has effectively limited the charitable contribution to the amount of the donor's basis therein in the instance of the contribution of ordinary income property. These rules do not apply to a gift of depreciated property, since there would have been no gain realized upon the sale of such property;⁷² however, no loophole exists here because the donor would always be in a better position by retaining the proceeds of a sale rather than contributing the property or the sale proceeds to a charity.⁷³ Therefore, the contribution of ordinary income property to a charity is no longer appealing, even though such a gift to a public charity would be limited to fifty rather than thirty percent of the donor's contribution base.⁷⁴

III. Capital Gain Property

As a general proposition capital gain property⁷⁵ is not subject to a reduction upon its contribution to a charity.⁷⁶ The theoretical mainspring of this congressional decision would appear to lie in the realization that with a maximum capital gains tax of twenty-five percent, it would always be to the taxpayer's advantage to sell this property and keep the proceeds rather than give it to a charity.⁷⁷ However, with a maximum capital gains tax of, for example, thirty-

⁷² As was the case prior to the Tax Reform Act, the charitable transfer of property which has depreciated in value is not considered to be a realization, and, therefore, will not produce a deductible loss. See Lerner, *Charitable Contributions*, N.Y.U. 28TH INST. ON FEDERAL TAXATION 135, 144 (Supp. 1970).

⁷³ For the purposes of the following illustration, assume that the property in question was purchased for \$1,000 and is now worth \$800. The donor is in the 70% tax bracket.

	<i>Sale of Assets Plus Retention of Proceeds (Proceeds Plus Value of Loss)</i>	<i>Sale of Assets Plus Donation of Proceeds (Value of Loss Plus Value of Contribution)</i>	<i>Value of Donation of Asset</i>
1. Loss Deductible at 70% Rate	\$940	\$700	\$560
2. Loss Deductible at 25% Rate	\$850	\$610	\$560
3. Loss not Deductible	\$800	\$560	\$560

Therefore, it would never be to the advantage of this donor to donate the property to a charity. *Contra*, Bransom, *Charitable Contributions: New Law Hampers Tax Planning But Savings Are Still Available*, 5 TAX ACCOUNTANTS 324, 325 (1970).

⁷⁴ INT. REV. CODE of 1954, §§ 170(b)(1)(A), (D). This, however, is small consolation to the donor, since his contribution has been limited to his basis in the property.

⁷⁵ "Capital gain property" is property where any portion of the gain thereon would have been long-term capital gain if the property had been sold at the date of contribution at its fair market value, and is not "Section 170(e) capital gain property." See INT. REV. CODE of 1954, § 170(b)(1)(D)(iv). "Section 170(e) capital gain property" is capital gain property which is: (1) contributed to a private foundation other than a foundation described in § 170(b)(1)(E), (2) tangible personal property which is put to an unrelated use by the charitable organization, or (3) 30% capital gain property which is subject to an election under § 170(b)(1)(D)(iii).

⁷⁶ For the exceptions to this general rule see the text accompanying notes 79-113 *infra*.

⁷⁷ The formula in use prior to the Tax Reform Act, as set out in E. GRISWOLD, CASES ON FEDERAL TAXATION 463 (6th ed. 1966), for the determination of when the donor might be better off to make a charitable contribution than to sell the property and keep the proceeds is when the value of the property exceeds the product of its

$$\text{Basis} \times \left(\frac{.25}{\text{top marginal rate less } .75} \right)$$

Of course, while the maximum ordinary income rates are only 70%, it would never be better (as regards net gain) for the taxpayer to give the property away rather than selling it

two and one-half percent,⁷⁸ the wealthy individual who owns property possessing substantial appreciation will still be able to profit by giving this property to a charity. Ironically, this is what Congress sought to cure in its reform proposals.

A. Tangible Personal Property

1. *The Problem.* For tangible personal property that would have produced ordinary income upon its sale the charitable contribution reduction rules of section 170(e)(1)(A) adequately handle any problems thus engendered. For other tangible personal property the problem visualized by Congress appears to have been that such property usually consisted of works of art, papers, etc. The only discernible rationale for special treatment of such property appears to be the large appreciation inherent in these gifts, the problem of overvaluation, and the fact that only certain donors would be able to take advantage of using such gifts.⁷⁹

2. *Congressional Response.* The problem of the contribution of tangible personal property (other than ordinary income property) was not a target of reform under the Treasury proposals for the Nixon Administration.⁸⁰ However scant the explanation of the reasoning process involved, the House Ways and

and keeping the proceeds. If he were to make a charitable contribution due to one of those intangible qualities of goodness, then the best alternative would be to make the gift by means of appreciated property rather than cash. The rationale is that giving cash is the giving of after-tax dollars, while the giving of appreciated property allows a full charitable contribution for the appreciation without having that appreciation taken into income.

⁷⁸ After the Tax Reform Act if the taxpayer has over \$50,000 in capital gain and assuming a 32½% capital gains tax, the effective tax rate on the appreciation (the numerator of the percentage fraction) would be:

$$\frac{12,500 + .325X}{50,000 + X}$$

Here, X equals the appreciation in excess of \$50,000. When X equals \$100,000 of appreciation (\$150,000 total appreciation) the effective tax rate becomes 30%. The formula now becomes:

$$\frac{.30}{\text{top tax rate less } .70}$$

Therefore, as the appreciation increases from \$150,000 to that amount of appreciation which would yield an effective tax rate of 32½%, the donor will retain a greater net amount by giving the property to a charity than by selling the property and retaining the proceeds. (Note that the numerator of the fraction must be recalculated for each specific amount of appreciation involved, and that this also causes an appropriate reduction in the minus figure of the fraction's denominator.)

⁷⁹ H.R. REP. NO. 91-413 (Part 1), 91st Cong., 1st Sess. 55 (1969). With such property, the only way for the donor to be in a better position by the contribution of this property rather than its sale and retention of the assets would be for the value of the charitable contribution (at the donor's top marginal tax rate) plus the tax on the appreciation to exceed the value of the property. In this regard, see notes 77-78 *supra*. However, if the donor could overvalue the property by only a slight amount, his savings could equal or exceed the net available from the sale of the property, with a retention of the proceeds. The formula to determine the overvaluation necessary for the donor to gain more from the contribution rather than the sale is: $Y = A/B$. Y is the total overvalued price (which presumably is not fair market value as no willing buyer would pay that price for the property), A is the amount the donor would retain on the sale of the property, and B is the donor's top marginal tax bracket. For property with a fair market value of \$100,000 and a basis of \$10,000, the taxpayer would receive a net amount of \$70,750 after a 32½% capital gains tax. For the donor to come out ahead on the contribution of this property, it only needs to be overvalued to $Y = 70,750/.70 = \$101,108$.

⁸⁰ 1969 House Hearings 5152, 5375.

Means Committee added a reduction for the appreciation inherent in *all* donations of tangible personal property.⁸¹

Before the Senate Finance Committee the Treasury noted that the House solution went beyond its own proposals and took the position that such a treatment was unduly severe. The Treasury based its position on the dependence of art galleries and museums for such gifts, the irrationality of distinguishing these gifts from gifts of securities to other charities, and the more efficient procedures which had been developed to prevent the overvaluation of such gifts.⁸² In response to this argument the Senate Finance Committee deleted the provision for a reduction of capital gain appreciation in tangible personal property, pointing out that the same valuation problem would be present if the appreciation were taken into account for tax purposes.⁸³ For the committee the proper remedy to control overvaluations would have been a strengthening of the revenue service's audit procedures.⁸⁴

In conference committee the unusual step was taken of compromising the House's inclusion and the Senate's deletion of rules covering the appreciation of tangible personal property by providing that such property be subject to special rules of reduction, if the use by the donee of this property was unrelated to its tax-exempt function.⁸⁵ The pertinent provisions of the statute are:

The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the sum of—

....

(B) in the case of a charitable contribution—

(i) of tangible personal property, if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption . . . 50 percent (62 1/2 percent, in the case of a corporation) of the amount of gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).⁸⁶

(a) *Unrelated Use and Ordinary Business Operations.* On purely pragmatic grounds the broad question of the advisability of this provision can be raised. However, since section 170(e)(1)(B)(i) has been enacted, there is nothing to do at this point but to either advocate its repeal or live with the consequences of its ambiguous language. The provision is likely to be in the Code for a while, so the alternative of clarification by the regulations is mandatory.

Obviously, the critical language is "unrelated to the purpose or function constituting the basis for its exemption."⁸⁷ The ordinary meaning of the word "use" is "to employ for some purpose"⁸⁸ so that it seems fairly clear that the contribution of a painting to a museum would constitute a related use, while the

⁸¹ H.R. REP. NO. 91-413 (Part 1), 91st Cong., 1st Sess. 55 (1969); 1969 *Senate Hearings* 249.

⁸² 1969 *Senate Hearings* 570-71.

⁸³ However, Senator Albert Gore's argument was that the placing of this appreciation into income would alleviate and not retain the valuation problem. S. REP. NO. 91-552, 91st Cong., 1st Sess. 336 (1969).

⁸⁴ *Id.* at 82.

⁸⁵ H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 294 (1969).

⁸⁶ INT. REV. CODE OF 1954, § 170(e)(1)(B)(i).

⁸⁷ *Id.*; see Taggart, *supra* note 50, at 119-23.

⁸⁸ THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1573 (1970).

contribution of the same painting to the Red Cross to be sold with the proceeds going to purchase medical supplies would not be a related use.⁸⁹

Some less obvious related uses have been set forth in the proposed regulations. The regulations take the position that the contribution of furniture which is used in the charity's offices during the regular course of its operations is a related use.⁹⁰ However, it becomes difficult conceptually to distinguish the contribution of furniture, which presumably is to support the bodies of Red Cross workers while they perform their daily tasks (a related use), from the contribution of a painting to the Red Cross, which is to be immediately sold and the proceeds used for the benefit of those individuals in need (an unrelated use). Presumably, if the furniture contributed to the Red Cross qualifies for the charitable deduction, then so would the value of a dishwasher which is to be used in the everyday course of the Red Cross' business to wash dirty coffee cups.⁹¹ If the whole purpose of the unrelated use section is to guarantee that the donor does not obtain a charitable deduction for the amount of the property contributed unless it is of the same genus as the charity itself, then this end should be pursued with at least a sense of logic.

Surely the selling of a painting and the "use" of the proceeds therefrom to aid individuals is an "act of employing" that piece of property for the general charitable purposes of the Red Cross. However, the "act of employing" a chair to allow an employee of the Red Cross to sit down does not seem to be related to the purpose of that organization in aiding the people of the world who are in need. Of course, the chair would aid the employee who needs to sit down, but this does not seem to be the logical inference which is to be derived from the word "use" as set out in the statute.

(b) *Unrelated Use and the Reasonable Inference.* The regulations do not give much guidance because of their brevity and opaque distinctions, forcing the donor in the "gray area" of charitable giving to proceed on a case-by-case basis. To aid in this determination the donor is allowed to treat the property as being used in a related capacity by the donee if he can prove in fact that the property was not put to an unrelated use, *or* if at the time of the contribution it was reasonable to anticipate that the property would not be put to an unrelated use by the donee.⁹² Because the proposed regulations use the word "or," the contribution of a Rembrandt painting to a museum which later sells the painting to purchase a Goya would not cause a reduction in the amount of the contribution, if there were not a prior agreement concerning the sale. In such a situation it would have been reasonable for the donor to anticipate that in due course the painting would have been displayed in the museum in accordance with its exempt purpose.

⁸⁹ Taggart, *supra* note 50, at 119-20. Even when medical supplies are donated to a hospital, other surrounding circumstances may prevent a deduction from being taken. See Roger I. Goodman, 29 CCH Tax. Ct. Mem. 30,121(M) (1970).

⁹⁰ Proposed Treas. Reg. § 1.170A-4(b)(3)(i), 36 Fed. Reg. 6091 (1971).

⁹¹ The distinction drawn by the proposed regulations becomes even less tenable, as it allows an individual who purchases an office building which is completely furnished and who then donates that furniture to the Red Cross to obtain a full deduction for the fair market value of that furniture.

⁹² Proposed Treas. Reg. § 1.170A-4(b)(3)(ii), 36 Fed. Reg. 6091 (1971).

However, this provision would not seem to provide any assistance in the situation of the contribution of a painting to the Red Cross, even if the donor were convinced that the Red Cross did not plan to sell the painting. The hanging of a painting in the Red Cross headquarters surely would not be a related use, but then again the contribution of a chair or a desk would be a related use. Thus, the donor might argue that the painting will be hung in the Red Cross headquarters to give moral support to the employees in order to allow them to better fulfill their jobs in helping mankind, much in the same way that the chair contributed to the organization would take a load off their feet. In this way, it was reasonable for him to anticipate that the Red Cross would use the painting in a use related to its exempt function—or was it?

B. Gifts to Private Foundations

Because gifts of appreciated property to private foundations are governed by such a large and completely interrelating set of rules, a comprehensive study of their provisions is beyond the scope of this Article.⁹³ The basic provisions of the operative statute remained virtually unchanged in its journey through the House, Senate, and conference Committees.⁹⁴ The basic reduction provision here is that of fifty percent of the amount that would have been long-term capital gain if the property had been sold rather than donated.⁹⁵ Private foundations not subject to this limitation include operating, pass-through, or pooled-income foundations.⁹⁶

One observation to be made with respect to these provisions is that the apparent intent of Congress was to curtail certain types of private foundations in response to the adverse criticism they had been receiving. However, this approach accomplishes nothing more than the elimination of the symptoms rather than the cause of the disease. The better approach would have been to impose stricter performance requirements on private foundations. Since such measures were proposed and enacted, section 170(e)(1)(B)(ii)⁹⁷ would not seem to be necessary.⁹⁸

C. Section 1231 Assets

Section 1231 property⁹⁹ can be used advantageously since it is treated for charitable contribution purposes as a capital asset, regardless of the net effect

⁹³ See generally INT. REV. CODE of 1954, §§ 501-15, 4940-48; Denny, *Investments Which Jeopardize Charitable Purpose*, 24 TAX LAWYER 113 (1970); DeWind & Luey, *Some of the Things You Always Wanted To Know About Private Foundations*, 24 TAX LAWYER 551 (1971); Field, *Tax Exempt Status of Universities: Impact of Political Activities by Students*, 24 TAX LAWYER 157 (1970); Halperin, *Private Foundations—Definition and Termination*, N.Y.U. 29TH INST. ON FED. TAX. 1783 (1971); Lehrfeld, *The Annual Tax on Foundation Income; Rules Governing Distributions of Income*, N.Y.U. 29TH INST. ON FED. TAX. 1799 (1971); Moorehead, *The Tax Future of Private Foundations: Penalties for Self-Dealing and Jeopardy Investments*, N.Y.U. 29TH INST. ON FED. TAX. 1869 (1971); Troyer, *Private Foundations and the Tax Reform Act of 1969: New Program Restrictions; Business Limitations*, N.Y.U. 29TH INST. ON FED. TAX. 1909 (1971); Myers & Quiggle, *supra* note 35, at 198-201.

⁹⁴ H.R. REP. NO. 91-413 (Part 1), 91st Cong., 1st Sess. 54-55 (1969); H.R. REP. NO. 91-413 (Part 2), 91st Cong., 1st Sess. 34-35 (1969); S. REP. NO. 91-552, 91st Cong., 1st Sess. 81-82 (1969); H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 293-94 (1969).

⁹⁵ INT. REV. CODE of 1954, § 170(e)(1)(B)(ii).

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ See 1969 Senate Hearings 1362.

⁹⁹ INT. REV. CODE of 1954, § 1231.

of the taxpayer's other section 1231 dispositions during the taxable year.¹⁰⁰ Of course, the rationale for this treatment is that the donor would not know the treatment to be given this section 1231 property until the tax year was over, as it would not be until that time that the "hotchpot" classification would be complete. Since the section 1231 property is given capital asset treatment, for planning purposes the donor would be well-advised to give such property to a fifty-percent charity if he already had section 1231 losses, rather than sell the property and keep the proceeds or give the proceeds to a charity. By giving the property to a fifty-percent charity, there will be a charitable deduction for the full fair market value of the property (assuming no recapture), and there will not be a reduction of the section 1231 ordinary losses because of the gain realized on the sale of this property.¹⁰¹

D. Nonresident Aliens

For capital gains not effectively connected with a trade or business within the United States the nonresident alien pays no tax on such gains if he is present in the country for less than 183 days during the taxable year. If present more than 183 days, he pays a tax of thirty percent on both long-term and short-term capital gains.¹⁰² For the nonresident alien who has been in the United States less than 183 days the most reasonable reading of section 170(e)¹⁰³ is that there would be no reduction for short-term capital gain property or long-term capital gain property because section 170(e) specifically relates the amount of gain subject to reduction to that obtainable "if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution)."¹⁰⁴ Since the nonresident alien would have recognized no gain, there should be no reduction. This is the interpretation accepted by the Treasury.¹⁰⁵ An alternative interpretation is that there should be a reduction in any event on these facts by emphasizing the word "gain."¹⁰⁶ The only rationale for the alternative position would be that under section 170(e)(1)(A) there is a reduction for "the amount of gain which would not have been long term capital gain" if the property had been sold. Here the gain would not have been long-term capital gain, so the reduction rules should apply. The obvious flaw in this argument is that the gain would not have been taxable at all, thereby making a mockery of the congressional purpose underlying section 170(e).

The Treasury has also provided that short-term capital gains for a nonresident alien in the United States more than 183 days will not be treated as ordinary income property, but will be subject to reduction only under section 170(e)(1)(B) as long-term capital gains.¹⁰⁷ This is an equitable result, since the nonresident alien would be subject to a thirty-percent tax and not a progressive

¹⁰⁰ *Id.* § 170(e)(1). The only exception is to the extent that the gain from this property would be ordinary income under the recapture provisions; it is then subject to § 170(e)(1). See Proposed Treas. Reg. § 1.170A-4(b)(4), 36 Fed. Reg. 6091 (1971).

¹⁰¹ Taggart, *supra* note 50, at 113.

¹⁰² INT. REV. CODE of 1954, § 871(a)(2).

¹⁰³ *Id.* § 170(e).

¹⁰⁴ *Id.* §§ 170(e)(1)(A), (B).

¹⁰⁵ Proposed Treas. Reg. § 1.170A-4(b)(5), 36 Fed. Reg. 6091 (1971).

¹⁰⁶ Taggart, *supra* note 50, at 118.

¹⁰⁷ Proposed Treas. Reg. § 1.170A-4(b)(5), 36 Fed. Reg. 6091 (1971).

tax rate, if he had sold either the long- or short-term capital gain property.¹⁰⁸ This is not a situation envisioned by Congress in the enactment of section 170(e)(1), and the proposed regulations have adequately resolved the inherent ambiguity of the statute.

E. *The Percentage Limitations*¹⁰⁹

In general contributions to public charities are deductible in the year of contribution up to a maximum aggregate of fifty percent of the donor's contribution base.¹¹⁰ Contributions to organizations which are not public charities are limited to the lesser of twenty percent of the donor's contribution base or the excess of fifty percent of the donor's contribution base less his fifty-percent contributions for the year.¹¹¹ This latter calculation is made without regard for the thirty-percent contribution limits, so that the donor's thirty-percent contributions for the year, even though not allowable in the current year, go to reduce the amount of twenty-percent contributions allowable in the current year. For the donor with a \$100,000 contribution base, \$10,000 in fifty-percent contributions, \$40,000 in thirty-percent contributions, and \$10,000 in twenty-percent contributions, there is a deductible contribution for the year of \$40,000 (\$10,000 in fifty-percent contributions plus \$30,000 in thirty-percent contributions). This donor is not allowed any twenty-percent contributions because his fifty-percent contributions (\$10,000) and "allowable" fifty-percent contributions (\$40,000) equal fifty percent of his contribution base.

The contribution of appreciated property that has been reduced in accordance with section 170(e)(1)(B) will be subject to either the fifty-percent or twenty-percent contribution limitations, depending upon the type of organization to which the property is given. On the other hand, capital gain property produces a charitable contribution equal to the full fair market value of the property and is limited to thirty percent of the donor's contribution base.¹¹² However, if the donor has only a small amount of capital appreciation involved in the property, he can elect under section 170(b)(1)(D)(iii) to have that appreciation reduced in accordance with section 170(e)(1)(B). If this election is made, all contributions to a public charity will be subject to the fifty-percent rather than the thirty-percent limitation. To determine if this is a feasible alternative, each donor will have to calculate the value to him of receiving a current, rather than a postponed, charitable deduction, while comparing that value with the cost of losing a charitable contribution equal to the section 170(e)(1) reduction. In making this determination, it should be borne in mind that contribution carryovers from prior years will have to be reduced as if section 170(e)(1) applied to them in the year of the contribution.

¹⁰⁸ INT. REV. CODE of 1954, § 871(a)(2).

¹⁰⁹ A detailed study of the interaction of the 20%, 30%, and 50% limitations together with the appropriate carryover provisions is beyond the scope of this Article. See generally Proposed Treas. Reg. § 1.170A-8, 36 Fed. Reg. 6096 (1971); Proposed Treas. Reg. § 1.170A-10, 36 Fed. Reg. 6100 (1971); Taggart, *supra* note 50, at 140-57.

¹¹⁰ INT. REV. CODE of 1954, § 170(b)(1)(A).

¹¹¹ *Id.* § 170(b)(1)(B).

¹¹² *Id.* § 170(b)(1)(D).

F. *Observations on Capital Gain Property*

With the increasing capital gains tax the donor who has appreciated property that would have produced capital gain if sold could, in certain circumstances, be in a better net worth position by contributing such property to a charity rather than selling it. Every donor should, therefore, take the time to calculate what method of disposing of the property would leave him in the greatest net worth position. Additionally, if the appreciation inherent in the property consists of both ordinary income and capital gain, a partial charitable contribution is still possible for the appreciation element. The appreciation in the contribution that is attributable to the capital gain element can be calculated from the following formula:¹¹³

$$\begin{array}{rcl} \text{Capital Gain} & & \text{Total Capital Gain} \\ \text{Portion} & = & \text{If Entire Property} \\ & & \text{Were Sold} \end{array} \times \frac{\text{Fair Market Value of} \\ \text{Contributed Portion}}{\text{Fair Market Value of} \\ \text{Entire Property}}$$

IV. INTERACTIONS

A. *The Appreciated Property Rules and the Gift of a Remainder Interest to a Charity*

1. *The Problem.* Prior to the enactment of section 170(f)(2)(A)¹¹⁴ the gift of an income interest to a noncharitable recipient with a remainder to a charity offered a small, but effective loophole in the tax laws. The trust fund was assumed to earn a three and one-half percent rate of return, and this same rate was also used to determine the present value of the income and remainder interests. Thus, it was possible for the trustee to invest the corpus in high-income, high-risk assets which would maximize income, but at the same time which would produce little relationship between the percentages used to calculate the value of the charitable remainder and the value actually received by the charity. It was this enhancement of the income interest at the expense of the remainder that Congress sought to eliminate.¹¹⁵

2. *Congressional Response.* Although the Treasury recommended no change in the treatment of charitable remainder interests in its proposals before the House Ways and Means Committee,¹¹⁶ the modifications as set forth by the House easily won Treasury approval.¹¹⁷ The Ways and Means Committee sought to assure that the charitable deduction received by the donor was in accord with the amount received by the charity by requiring that the remainder be in the form of a charitable remainder annuity trust (in which the income beneficiary is paid a fixed sum of dollars) or a charitable remainder unitrust (in which the income beneficiary is paid a certain percentage of the assets yearly). By coupling this with the requirement that a gift of a remainder not in trust must meet the trust rules, the House proposals would have required a donor's chari-

¹¹³ Proposed Treas. Reg. § 1.170A-4(c)(4), 36 Fed. Reg. 6092 (1971).

¹¹⁴ INT. REV. CODE of 1954, § 170(f)(2)(A).

¹¹⁵ H.R. REP. NO. 91-413 (Part 1), 91st Cong., 1st Sess. 58 (1969).

¹¹⁶ 1969 House Hearings 5372-79.

¹¹⁷ 1969 Senate Hearings 803-05.

table contribution deduction to more accurately reflect the relative fair market values of the income and remainder interests.¹¹⁸

The Senate Finance Committee generally agreed with the position of the House,¹¹⁹ although in some circumstances it appears to have accepted the argument that this lack of flexibility would cause an undue curtailment of charitable gifts.¹²⁰ The Finance Committee viewed the curtailment of a deduction for a pooled income fund arrangement and for the outright gift of real property, such as a residence with the retention of a life estate, as unduly restrictive.¹²¹ To remedy this deductions were proposed for these types of contributions.¹²²

The basic statutory pattern envisioned by the Finance Committee was accepted by the conference committee.¹²³ The pertinent statutory provision states:

In the case of property transferred in trust, no deduction shall be allowed . . . for the value of a contribution of a remainder interest unless the trust is a charitable remainder annuity trust or a charitable remainder unitrust . . . or a pooled income fund.¹²⁴

In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property, a deduction shall be allowed . . . only to the extent that the value of the interest contributed would be allowable as a deduction . . . if such interest had been transferred in trust.¹²⁵

(a) *Basic Operation.* In order for the contribution of a remainder to a charity¹²⁶ to receive a deduction in the year of the establishment of the trust,¹²⁷ the trust must be a charitable remainder annuity trust,¹²⁸ a charitable remainder unitrust,¹²⁹ or a pooled-income fund.¹³⁰ Through the use of any form of these vehicles for the contribution of a remainder to a charity¹³¹ the amount of the

¹¹⁸ H.R. REP. NO. 91-413 (Part 1), 91st Cong., 1st Sess. 56-57, 58-60 (1969).

¹¹⁹ S. REP. NO. 91-552, 91st Cong., 1st Sess. 87 (1969).

¹²⁰ 1969 *Senate Hearings* 50.

¹²¹ The problem with excluding both these arrangements, as viewed by the Finance Committee, is that a charitable deduction would not be allowed solely because it would not be possible to form them into an annuity or unitrust arrangement.

¹²² For valuation purposes the income interest for the pooled-income fund is to be valued at the highest value in the last three years or if the fund has not been in existence that long, then at 6%. S. REP. NO. 91-552, 91st Cong., 1st Sess. 88 (1969). For the outright remainder gift, depreciation (straight line) or depletion and a 6% discount factor are to be taken into account. INT. REV. CODE of 1954, § 170(f) (4).

¹²³ H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 295-96 (1969).

¹²⁴ INT. REV. CODE of 1954, § 170(f) (2) (A).

¹²⁵ *Id.* § 170(f) (3) (A).

¹²⁶ The Tax Reform Act has not answered the question of whether the gift of a remainder interest is "to" or "for the use of" a charity. Presumably it will be considered a "to" gift. Alice Tully, 48 T.C. 235 (1967). This is the position recently taken by the Treasury, except when the remainder is to be held in trust after the termination of all prior interests for the benefit of the charity. In this latter case the Treasury views the remainder as being "for the use of" the charity. Proposed Treas. Reg. § 1.170A-8(b), 36 Fed. Reg. 6097 (1971). This distinction is crucial because only gifts "to" a charity gain the benefit of the 50% deduction limit. INT. REV. CODE of 1954, § 170(b) (1) (A).

¹²⁷ INT. REV. CODE of 1954, § 170(f) (2) (A).

¹²⁸ *Id.* § 664(d) (1).

¹²⁹ *Id.* § 664(d) (2).

¹³⁰ *Id.* § 642(c) (5).

¹³¹ The Treasury has taken the position that an annuity trust or unitrust must be such in every respect; consequently, no combinations are allowed. Proposed Treas. Reg. § 1.664-1(a) (2), 36 Fed. Reg. 18668 (1971). The only apparent justification for this position is the mathematical difficulty in calculating the deduction if donors were to be allowed to combine methods.

charitable contribution¹³² will be the present value of the remainder in question.¹³³ If it is assumed that the donor, age fifty, transfers \$100,000 of property to a charitable remainder unitrust¹³⁴ under which the trust is to pay him five percent of the fair market value of the assets in the trust as determined at the beginning of the year with the payment to be made at the end of the taxable year and this transfer is made on January 1, 1970, then the present value of the remainder is \$37,816.¹³⁵ If the basis of the property contributed to the trust equals its fair market value on the date of funding the trust, then \$37,816 is the amount of the donor's charitable contribution (assuming that the percentage limitations are met and that the property is either real property or intangible personal property).¹³⁶

(b) "*Property Transferred in Trust.*" As a matter of statutory interpretation the word "property" in section 170(f)(2)(A) would refer to that property placed in trust in the initial funding. This is a reasonable interpretation, since if the word "property" referred to the remainder itself, the statute would have the strained grammatical reading that for a "(remainder) transferred in trust, no deduction" is allowed "for the value of the contribution of a remainder interest unless the trust is a charitable remainder" annuity or unitrust or a pooled-income fund.¹³⁷ Likewise, if the word "property" meant remainder, the statute would have to read that a deduction would be allowed for the contribution of "the" remainder. Under the preferred interpretation, on the other hand, the statute means that when property is transferred to a trust which provides for a remainder interest to be given to a charity, there is no charitable deduction for the amount of that remainder unless the provisions of this section are met.

(c) *Section 170 (e) "Contribution of Property."* After determining the chari-

¹³² *Id.* § 1.170A-6(b), 36 Fed. Reg. 6094 (1971).

¹³³ Treas. Reg. § 1.642(c)-6 (1971); Proposed Treas. Reg. § 1.664-2(c), 36 Fed. Reg. 18673 (1971); Proposed Treas. Reg. § 1.664-4, 36 Fed. Reg. 18671 (1971).

¹³⁴ In the instance of a charitable remainder unitrust § 664(d)(2) states that a fixed percentage of the assets (not less than 5%) is to be distributed annually. However, only the trust income need be distributed (if it is less than the fixed percentage) on the condition that any undistributed amounts are made up in later years. INT. REV. CODE of 1954, § 664(d)(3). Therefore, with \$100,000 in trust assets and a 5% valuation figure, \$5,000 needs to be distributed. However, if the trust income were only \$4,000, then this amount could be distributed if the \$1,000 deficit were made up in later years. On the other hand, the Treasury mistakenly interprets this provision as allowing the distribution of *only* the trust income or the trust income *plus* any deficits. Proposed Treas. Reg. § 1.664-3(a)(1)(i), 36 Fed. Reg. 18674 (1971).

¹³⁵ The \$37,816 value is calculated in accordance with Proposed Treas. Reg. § 1.664-4(b), 36 Fed. Reg. 18676 (1971), as follows: The adjusted payout rate is 4.717%, or 5% × .943396 (from Table F). To then obtain the interpolated factor, Table E(1) yields:

$$\begin{array}{r} 4.6\% \text{ for a male age } 50 = .38623 \\ 4.8\% \text{ for a male age } 50 = \underline{.37244} \\ .2\% \text{ Difference} \qquad \qquad \qquad .01379 \\ X \qquad \qquad \qquad = \underline{.117\%} \\ .01379 = \underline{.2\%} \\ X = .00807 \end{array}$$

The interpolated factor is .37816, or .38623 (4.6% for a male age 50) less .00807. Therefore, the present value of the remainder interest is: \$100,000 × .37816 = \$37,816.

¹³⁶ However, if this future interest had been tangible personal property, the charitable contribution would have been taken into account only after the rights of the donor and all those related to him in the property had expired. INT. REV. CODE of 1954, § 170(a)(3).

¹³⁷ *Id.* § 170(f)(2)(A).

table deduction allowable under section 170 (before the application of the percentage limitations) on the contribution of a remainder interest, the reduction provisions of section 170(e)(1) would seem to come into play upon a literal reading of the statutory language providing a reduction for "the amount of any charitable contribution of property otherwise taken into account under this section." Both the legislative history and the proposed regulations support the application of section 170(e) to this gift of a future interest funded with appreciated property.¹³⁸

The crucial question is determining the meaning of the term "property," as used in section 170(e)(1), in the context of a remainder interest. A literal reading of the phrase "amount of any charitable contribution of property"¹³⁹ might lead to the conclusion that the "property" referred to is the remainder interest itself. As pointed out by Professor Taggart,¹⁴⁰ such a reading of the statute is untenable because a remainder interest of section 306 stock containing ordinary income appreciation could escape a reduction, if the donor could "age" this remainder before its contribution. Likewise, a contribution of a remainder interest with capital gain appreciation might have to be reduced under section 170(e)(1)(B) unless the remainder was also so aged. Thus, although the statute is ambiguous in its operation, logic points to the reading of the word "property" in section 170(e)(1) to mean the total assets placed in the trust at its funding, from which eventually the remainder is to be drawn. This reading by implication has been accepted by the Treasury in its promulgation of the proposed regulations under section 170(e).¹⁴¹ As a consequence, this donation is viewed as a gift of less than the donor's entire interest in the appreciated property, so as to invoke the allocation of basis provisions between that portion of the property contributed and that portion not contributed.¹⁴²

With the charitable contribution of a remainder interest being viewed in this manner, the donor's adjusted basis at the time of the contribution (here the time that the deduction is allowed, which is the year of the funding of the trust) is allocated so that:

$$\text{Adjusted Basis of Contributed Portion} = \frac{\text{Fair Market Value of Contributed Portion}^{143}}{\text{Fair Market Value of Entire Property}} \times \text{Adjusted Basis of Entire Property}$$

Then the amount of appreciation taken into account for the purposes of section 170(e)(1) is the amount of gain which would have been recognized if the contributed portion had been sold by the donor at its fair market value at the

¹³⁸ Proposed Treas. Reg. § 1.170A-6(b)(2), 36 Fed. Reg. 6094 (1971). Presumably, the determination will first be made of the value of the charitable deduction which is "allowable." If this deduction is not "allowed" in the current year because the percentage limitations have been exceeded, then a carryover under § 170(d) should be in order. This is the only equitable result.

¹³⁹ INT. REV. CODE of 1954, § 170(e)(1).

¹⁴⁰ Taggart, *supra* note 50, at 114-16.

¹⁴¹ Proposed Treas. Reg. § 1.170A-6(b)(2), 36 Fed. Reg. 6094 (1971).

¹⁴² INT. REV. CODE of 1954, § 170(e)(2).

¹⁴³ For the purposes of this formula the fair market value of the remainder interest is taken to be its present value. See note 133 *supra*.

time of the contribution to the charity.¹⁴⁴ Thus, in the example previously mentioned if \$100,000 in property is used to fund a trust with a basis of \$45,000, then the portion of the adjusted basis allocated to the contributed remainder interest would be \$17,017.¹⁴⁵ This means that the amount of gain which would be taken into account under section 170(e)(1) would be the fair market value of the remainder interest (\$37,816) less the adjusted basis for the contributed portion (\$17,017), or \$20,799. If the amount of the appreciation is attributable to ordinary income property, the amount of the charitable deduction for the donor in the year of the trust's creation is \$17,017, or the amount of his basis in the contributed portion.¹⁴⁶ If, on the other hand, the appreciation is subject to reduction under section 170(e)(1)(B) the amount of an individual's charitable deduction is \$27,417.¹⁴⁷

B. *The Appreciated Property Rules and the Gift of an Income Interest to Charity*

1. *The Problem.* Prior to the Tax Reform Act a donor could contribute a \$10,000 income interest to charity with a remainder to a family member, for example, and be better off than if he had simply kept the income interest himself.¹⁴⁸ If the donor were in the seventy-percent top marginal tax bracket, an income interest of \$10,000 would net him \$3,000. However, by giving this \$10,000 income interest to a charity for five years, the donor would not be taxed on the income and would currently receive a charitable contribution of \$45,151.¹⁴⁹ Thus, in addition to obtaining this deduction immediately with the property finally going to someone of his own choosing, the donor is at least \$16,606 better off over a five-year period.¹⁵⁰

2. *Congressional Response.* The Treasury recommendations to curb this abuse were directed at not allowing a charitable deduction for an income interest unless the donor was taxable on the income from the trust.¹⁵¹ The House Ways

¹⁴⁴ Proposed Treas. Reg. § 1.170A-4(c)(1), 36 Fed. Reg. 6091 (1971).

¹⁴⁵ Since the present value of this remainder interest is \$37,816, the calculation would be:

$$\frac{\$37,816}{\$100,000} \times \$45,000 = \$17,017 \text{ adjusted basis of contributed portion of the property.}$$

¹⁴⁶ INT. REV. CODE of 1954, § 170(e)(1)(A).

¹⁴⁷ This is composed of the \$17,017 basis plus 50% of the \$20,799 appreciation, or approximately \$10,400, to yield \$27,417.

¹⁴⁸ 1969 House Hearings 5150.

¹⁴⁹ This is using the valuation table as set forth in Treas. Reg. § 20.2031-7(f) (1958). Under the new valuation tables, however, this interest would give only a \$42,124 value. Treas. Reg. § 20.2031-10(f) (1970). In comparing these figures it should be remembered that a donor could give the charity an income interest for two years or more and not be taxed on the income as it accrued. INT. REV. CODE of 1954, ch. 736, § 673(b), 68A Stat. 227. This latter provision was deleted by Congress in 1969. Tax. Reform Act of 1969, Pub. L. No. 91-172, § 201(c), 83 Stat. 560.

¹⁵⁰ The \$16,606 figure is obtained by subtracting from \$31,606 (the value of the charitable deduction at the 70% tax rate), the \$15,000 (\$3,000/year × 5 years) which the donor would have obtained if he retained the income interest. Of course, there should be added to this amount an interest factor, which would make the net to the donor even greater.

¹⁵¹ 1969 House Hearings 5150-51, 5374. This means that beginning in 1970 for the donor in the 70% tax bracket a gift of \$10,000 over a 5-year period would have a present value of \$42,124, as set forth in note 149 *supra*, and \$7,000 in income taxes yearly. In 5 years he will pay \$35,000 in ordinary income taxes to leave a minus net worth position of \$5,513 (\$29,487 value of the charitable deduction less \$35,000). The donor must calculate

and Means Committee followed the Treasury recommendations by proposing that the amount of the income interest be allowed as a charitable deduction only if the donor were taxable on the income or all the property was given to charity, and providing also for a "recapture" of a portion of the charitable deduction if the donor ceased to be taxable on the income.¹⁵³ In addition, the income interest had to be in the form of an annuity or unitrust to insure a reasonable correlation between the amount of the charitable deduction and the income actually going to the charity.¹⁵³

Although the Treasury recommended to the Senate Finance Committee that long-term income interests of at least twenty years be exempt from this rule,¹⁵⁴ both the Senate Finance Committee¹⁵⁵ and the conference committee¹⁵⁶ accepted the proposals of the House Ways and Means Committee. The pertinent provisions of the statute as enacted are:

No deduction shall be allowed under this section for the value of any interest in property (other than a remainder interest) transferred in trust unless the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest is a fixed percentage distributed yearly of the fair market value of the trust property (to be determined yearly) and the grantor is treated as the owner of such interest for purposes of applying Section 671.¹⁵⁷

This paragraph shall not apply in a case in which the value of all interests in property transferred in trust are deductible.¹⁵⁸

(a) *General Operation.* Section 170(f)(2)(B) provides generally that to be deductible, the income interest must be a guaranteed annuity or a specified percentage of the value of the assets in the trust, and the grantor must be taxable on the amount of this income. Assuming that the grantor were taxable on the income from the trust, the remaining requirements could be fulfilled by having the trust pay an annuity to the charity of, for example, \$5,000 per year.

when he could obtain a savings under this technique by use of the following formula:

$$Y = \frac{D - B}{AC}$$
 For the purposes of this formula, Y = percentage return needed for each

of the years that income is paid to the charity, D = net to donor after ordinary income taxes if he had retained the income interest, B = value of the charitable deduction less ordinary income taxes over the period in question, A = number of years income is to be paid to the charity, and C = value of the charitable deduction. Here the formula yields: $Y = \$20,513/\$147,435 = 14\%$. If the donor can earn more than a 14% NET return per year on the \$29,487 value of the charitable deduction, he will be in a better financial position by making the contribution. Thus, the gift of an income interest has been all but effectively eliminated for this donor.

¹⁵³ H.R. REP. NO. 91-413 (Part 1), 91st Cong., 1st Sess. 60-61 (1969); H.R. REP. NO. 91-413 (Part 2), 91st Cong., 1st Sess. 32 (1969).

¹⁵³ *Id.*

¹⁵⁴ The rationale for the Treasury proposal was that the donor had effectively given the property away in such a circumstance. 1969 *Senate Hearings* 797-99.

¹⁵⁵ S. REP. NO. 91-552, 91st Cong., 1st Sess. 91-93 (1969).

¹⁵⁶ H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 296 (1969).

¹⁵⁷ INT. REV. CODE of 1954, § 170(f)(2)(B). However, it should be noted that the Treasury takes the position that the income interest, whether in trust or not, for which a deduction is allowed under §§ 170(2)(B) or (f)(3) is "for the use of" the charity and not a gift "to" the charity, so that it will not qualify for the 50% limitation under § 170(b)(1)(A). Proposed Treas. Reg. § 1.170A-8(b), 36 Fed. Reg. 6096 (1971).

¹⁵⁸ INT. REV. CODE of 1954, § 170(f)(2)(D).

Alternatively, if the value of the trust assets were \$100,000, the grantor could satisfy these requirements by having the trust pay a specified percentage of these assets to the charity each year. If this percentage were seven percent, then in the current year \$7,000 would be paid to the charity. In this way the Treasury hopes to assure that at least a certain sum of money is going to the charity.

A literal reading of section 170(e)(1) would lead to the conclusion that there would have to be a reduction for the amount of appreciation inherent in the contribution of an income interest. However, the problem of determining what the word "property," as used in section 170(e), refers to in the context of an income interest has been partially alleviated by the recent Treasury pronouncement that income interests for which a deduction is allowed under section 170(f)(2)(B) do not come within the ambit of section 170(e).¹⁵⁹ The most direct result of this position is that the income interest governed by section 170(f)(2)(B) is not reduced for the appreciation of any property used to fund the trust. Indeed, this would seem the most equitable position to take, since the grantor (donor) will be taxable on the amount of the income anyway. Therefore, a further reduction by the amount of the appreciation in the property used to fund the trust (which will probably revert to the donor anyway) could put the donor in a worse position than if he had simply used his normal salary to make the charitable contribution.

If the income contribution consists of, for example, the interest element from a bond,¹⁶⁰ this would be a contribution of less than the donor's entire interest in such property. It seems clear that no charitable deduction would be allowed for this contribution because the interest element would not be in the form of a guaranteed annuity or unitrust interest.¹⁶¹ However, when the interest element is all that the donor owns, section 170(f)(3)(A) will not apply, since a donation of this interest element would be the donor's entire interest in the property. Section 170(f)(2)(B) would not apply because the donation will not be in trust. Because a deduction is not "allowed" for this interest under section 170(f)(2)(B), the contribution will be subject to the reduction rules of section 170(e).¹⁶² As a consequence, the next inquiry concerns the manner in which these reduction rules apply when correlated with section 170(f)(3)(A).

Here the term "property," as used in section 170(e), can mean only the income element itself, since this is the only "property" the donor has. Thus, when the donor has disposed of the bond and makes a charitable gift of the retained interest element, the reduction rules of section 170(e)(1)(A) would most

¹⁵⁹ Since the term "ordinary income property" does not include an income interest with respect to which a deduction is allowed under § 170(f)(2)(B), and since a comparable statement is not found with regard to "section 170(e) capital gain property," the inference is that the Treasury will not apply § 170(e)(1)(A), but that it would apply § 170(e)(1)(B) to the same transaction to which § 170(f)(2)(B) applies. Proposed Treas. Reg. §§ 1.170A-4(b)(1), (2), 36 Fed. Reg. 6091 (1971). It is submitted that this inequitable result is without logical foundation.

¹⁶⁰ These cases have usually involved the gift of an income interest to a noncharitable recipient. See, e.g., *Helvering v. Horst*, 311 U.S. 112 (1940).

¹⁶¹ In accordance with § 170(f)(3)(A) this contribution is tested under the trust rules of § 170(f)(2)(B). Here, although the "form" of the income element does not qualify, the donor would be taxed on the income, presumably under § 673(a), if this had been a transfer in trust, so that the second half of the § 170(f)(2)(B) requirements would be met.

¹⁶² See note 159 *supra*.

likely come into play. The theory would be that the sale of this interest would have produced ordinary income in much the same way as an assignment of wages.¹⁶³ Since the donor would have had no basis in these interest coupons, the value of the charitable contribution would be reduced to zero. This donor will also probably be taxed on the future accrual of income from the donated interest element.¹⁶⁴ However, at the same time, he will not be allowed a charitable deduction in those future years, since the deduction has to be taken in the year of contribution, regardless of the year in which income is recognized.¹⁶⁵ Thus, this donor gains no comfort from the Treasury's position of not applying section 170(e) when income is recognized in the same year as the contribution and because of the contribution,¹⁶⁶ since the income will be recognized only in later years.

If the taxpayer donates an income interest which he has received by gift, devise, or bequest to charity, again the term "property," as used in section 170(e), must refer to the income interest itself, since this is the only "property" the donor has. If this income interest is contributed to a public charity, the donor will receive a deduction for its full fair market value,¹⁶⁷ while a gift to a private foundation subject to section 170(e)(1)(B) would be reduced by fifty percent of the *entire value* of the income interest. The reason for this, of course, is that the donor would have had no basis in this property upon its sale.¹⁶⁸ On the other hand, if a prospective donor retained a life estate in property which he had originally purchased while selling the remainder for its present value, it would seem that section 1001(e) would not be applicable.¹⁶⁹ Therefore, any reductions necessitated by section 170(e)(1)(B) would apply only to the excess of the fair market value of the income interest less its adjusted basis.¹⁷⁰ However, in both these instances unless the donor's effective capital gains tax

¹⁶³ A good discussion of the cases in this area may be found in 2 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 18.02 (1967). It is possible that this could be viewed as a capital transaction. See note 167 *infra*.

¹⁶⁴ This was the Treasury's position on the gift of back-interest coupons which had been issued by the Japanese government on certain prewar bonds. Rev. Rul. 58-275, 1958-1 CUM. BULL. 22. See S.M. Friedman, 41 T.C. 428, *aff'd in part*, 346 F.2d 506 (6th Cir. 1965).

¹⁶⁵ INT. REV. CODE of 1954, § 461(a).

¹⁶⁶ Proposed Treas. Reg. § 1.170A-4(a)(3), 36 Fed. Reg. 6091 (1971).

¹⁶⁷ This assumes that the disposition of an income interest which is all the taxpayer owns (for example, a life estate) would be a capital transaction. See *Bell's Estate v. Comm'r*, 137 F.2d 454 (8th Cir. 1943).

¹⁶⁸ The rationale here is that § 170(e) relates the reduction rules to the hypothetical situation of the character and amount of gain if the contributed property had been sold. If the income interest acquired by gift, devise, or bequest had been sold, the gain would have been the total amount realized. INT. REV. CODE of 1954, § 1001(e).

¹⁶⁹ This would certainly be true if the donor had sold the remainder interest, since the Treasury would not be able to argue that the basis of the income interest was determined by reference to §§ 1014 or 1015. It should also be noted that unlike a gift of the use of property, § 170(f)(3) does not specifically state that the gift of an income interest is always less than the donor's entire interest in the property. There is thus no statutory prohibition against this procedure. See Taggart, *supra* note 50, at 91-92.

¹⁷⁰ Assume that the donor owns property with a fair market value of \$10,000 and a \$4,000 basis. The donor sells a remainder interest in this property to a third party when the present value of the remainder interest is 50%. If the donor then immediately contributes the income element to a charity, only \$3,000 (\$5,000 present value of the income interest less \$2,000 basis allocated to the income interest) would be subject to the § 170(e)(1)(B) reductions (if a variation of the step-transaction doctrine were not applicable to this situation).

was in excess of thirty percent, he would be better off to sell the property and retain the proceeds.¹⁷¹

(b) *Section 170(f)(2)(D)*. The combined effect of the proposed regulations and section 170(f)(2)(D) has left some interesting interpretative problems. Section 170(f)(2)(D) provides that the remainder and income provisions of section 170(f) do not apply if all interests in the property are transferred to a charity. Thus, if the income interest is given to charity X, and the remainder interest is given to charity Y, the donor does not have to be taxed on the income, the income does not have to be an annuity or percentage of the assets, and the remainder does not have to be in the form of a remainder annuity trust, a remainder unitrust, or a pooled-income fund. For the purposes of illustration, assume that property with a fair market value of \$100,000 and a basis of \$45,000 is contributed by a fifty-year-old donor to two different charities so that one receives an income interest and the other a remainder interest. The present value of the life income interest is \$67,997, and the present value of the remainder is \$32,003.¹⁷² Using these facts, there are at least three possible interpretations of the statute.

First, both of the contributions could be treated as a unit. In this situation the unitary charitable contribution would be \$100,000. The appreciation of \$55,000 would cause a reduction in the amount of the charitable contribution (if any) under section 170(e).¹⁷³ This first interpretation has the force of a literal reading of the statute because the exclusionary language of section 170(f)(2)(D) leaves only the provisions of section 170(e) to be applied to the gift. It is expected that the Internal Revenue Service would rely upon this interpretation, and this is only equitable because these same results would apply if the entire property had been given to one charity rather than having different types of interests split between two charities.

Secondly, the gifts could be considered unitary for the purposes of section 170(f)(2)(D), and yet separate for the purposes of applying the reduction provisions. Even though section 170(f)(2)(A) and (B) would still be inapplicable, the argument would be that the allocation of basis provision applies because the phrase "less than the taxpayer's entire interest in the property contributed"¹⁷⁴ refers to each contribution unit separately. In accordance with this interpretation the remainder portion would be allocated a fair market value of \$32,003 and an adjusted basis of \$14,401.¹⁷⁵ Here the reduction provisions of section 170(e), if applicable, would apply to the \$17,602 appreciation. With respect to the income interest, the provisions of section 170(f)(2)(B) do not apply, but presumably the provisions of section 170(e) would because a contribution of the income interest is not "allowed" under section 170(f)(2)-

¹⁷¹ See notes 77-78 *supra*.

¹⁷² Treas. Reg. § 20.2031-10(f), Table A(1) (1970).

¹⁷³ Presumably 67.997% of the reduction would be born by the income interest, and 32.003% would be born by the remainder interest.

¹⁷⁴ INT. REV. CODE of 1954, § 170(e)(2).

¹⁷⁵ The adjusted basis of the remainder would be calculated as follows:

$$\$45,000 \times \frac{\$32,003}{\$100,000} = \$14,401. \text{ Proposed Treas. Reg. § 1.170A-4(c)(1), 36 Fed. Reg. 6091 (1971).}$$

(B).¹⁷⁶ Thus, under this interpretation of the statute the reduction provisions would be applied in one of two ways. Under the first alternative the value of the income interest of \$67,997 would be subject to the reduction rules of section 170(e). This view takes the word "property," as used in section 170(e), in the context of an income interest to mean the income interest itself. Although this is a possible interpretation of the statute, it totally disregards the allocation of basis provision which was applied to the remainder interest, and, thus, is not a very reasonable interpretation. Under the second alternative the portion of the appreciation in the property used to fund the trust which is attributable to the income interest (here \$37,398)¹⁷⁷ would be subject to the reduction rules under section 170(e). This interpretation views the word "property," as used in section 170(e), in the context of an income interest to mean the assets underlying the income interest. This is the more logical reading of the statute.

Although the second possible interpretation involves the meshing of two components for certain provisions of the Code and their separation for others, this reasoning is not without precedent.¹⁷⁸ The prospective donor, except for one possible situation, would be well advised to "stay clear" of this argument. He could gain no advantage over the results in the first interpretation, and he could even have a greater reduction in the amount of his gift (under the more logical reading of the statute) when compared with the gift of the entire property to one charity. The possible exception would be when one of the gifts is thought not to require a reduction under section 170(e)(1)(B), but it later turns out to require such a reduction. In anticipating this result, the donor may not want to commingle the gifts, and thus jeopardize his gift, which was not subject to any reduction provisions.

The final possibility is that there are two completely separate contributions. Under this interpretation the income interest is totally separate and distinct from the remainder interest. This is an instance of the left hand not knowing what the right hand is doing. Here the remainder interest would be tested under the rules of section 170(f)(2)(A) without regard to the testing of the income interest under the rules of section 170(f)(2)(B). Unless the rules of each section were satisfied the interest in question would fail to qualify, which presumably is what happens in the hypothetical above. This last alternative is the least reasonable. If the property involved were something on the order of securities which were placed in separate trusts, then the argument that these items could be separated metaphysically would be on firmer ground. However, here the use of one piece of property from which two separate interests are created does not lend itself as well to metaphysical division. Being the least advantageous to the taxpayer in requiring that both the provisions of section 170(f)-(2)(A) and (B) be met, it is doubtful that any taxpayer would want to ad-

¹⁷⁶ See note 159 *supra*.

¹⁷⁷ This figure represents the total appreciation of \$55,000 less the \$17,602 appreciation attributable to the remainder interest. The same results could be obtained by subtracting from \$67,997 (the fair market value of the life estate) the basis allocated thereto under § 170(e)(2), or $\$30,599 \left(\frac{\$67,997}{\$100,000} \times \$45,000 \right)$.

¹⁷⁸ See, e.g., *American Potash & Chem. Corp. v. United States*, 399 F.2d 194 (Ct. Cl. 1968).

vance this interpretation to the Internal Revenue Service. Similarly it is not anticipated that the Service would accept such an argument. However, if it should, the force of the statement that the income and remainder provisions will not apply when "the value of all interests in property transferred in trust are deductible under section (a)"¹⁷⁹ should prove to be a lethal weapon in the conference or courtroom in preventing a reduction of the charitable contribution.

C. Interaction of the Bargain Sale and Appreciated Property Rules

1. *The Problem.* Prior to the Tax Reform Act a donor was able to "sell" appreciated property to a charity at a value equal to his basis therein, treat the amount realized as a return of capital, pay no income taxes on the appreciation, and have a charitable deduction for the full amount of the appreciation "given" to the charity.¹⁸⁰ Only in the situation in which the sales price exceeded his basis would the taxpayer realize a taxable gain.¹⁸¹ These advantages arose from viewing the transaction (both gift and sale) as a unit, rather than as a partial gift and a partial sale. If, on the other hand, this latter, more logical view of treating the transaction as a partial gift and a partial sale were adhered to, there would be a charitable deduction for the amount which was "contributed" to the charity, and a realization of income on the portion sold in the amount of the value received less the proportionate part of the adjusted basis allocated to the sold portion. Obviously, this allocation method would not have produced results as favorable to the donor.

For the individual donor the value of the bargain-sale technique is aptly shown in the following illustration. For all of these figures the fair market value of the property subject to the bargain sale is \$10,000, and its basis is \$4,000.

	Sale Price	Contribution	70% Value Deduction	Effective Tax Rate on Appreciation	Net to Donor ¹⁸²
1.	4,000	6,000	4,200	-0-	8,200
2.	6,000	4,000	2,800	1,400 (70%)	7,400
3.	6,000	4,000	2,800	500 (25%)	8,300
4.	10,000	-0-	-0-	4,200 (70%)	5,800
5.	10,000	-0-	-0-	1,500 (25%)	8,500
6.	10,000	-0-	-0-	1,860 (31%)	8,140
7.	2,000	8,000	5,600	-0-	7,600
8.	-0-	10,000	7,000	-0-	7,000

A formula which can be derived from the table to inform the donor when a bargain sale would be more advantageous than selling the property and retaining the proceeds is when his top marginal tax rate plus the tax rate on the ap-

¹⁷⁹ INT. REV. CODE of 1954, § 170(f) (2) (D).

¹⁸⁰ Rev. Rul. 69-102, 1969-1 CUM. BULL. 32; see William Waller, 39 T.C. 665 (1963).

¹⁸¹ See Elizabeth H. Potter, 38 T.C. 951 (1962); Treas. Reg. § 1.1001-1(e) (1) (1960).

¹⁸² This column represents any amount realized by the donor on the sale plus the amount of any savings available to him for the charitable contribution. In the instance of a sale of the entire interest, it is the fair market value received less the appropriate tax. When a contribution of the entire interest is made, it represents the tax savings to the donor. Thus, a simplistic way to view the "net to donor" column is that this represents the effect of various dispositions of property with a \$10,000 fair market value upon the donor's net worth.

preciation exceed 100 percent.¹⁸³ Thus, if the top marginal tax rate were seventy percent, and the tax rate on the appreciation twenty-five percent, the total figure of ninety-five percent would dictate the selling of the asset and retention of the proceeds, rather than using the bargain sale provisions. This result is verified by items (1), (2), (3), (5), and (7) in the above illustration. However, if the taxpayer's top marginal tax rate were seventy percent, any tax on the appreciation in excess of thirty percent would point to the use of the bargain sale. This is borne out by items (1), (2), (3), (4), and (6) of the illustration.

Such advantages to the donor were predestined for curtailment.¹⁸⁴ The response of Congress to this problem was the enactment of the new section 1011(b). As will be subsequently developed, the problems created by this new section, arising from the ambiguity of its language, are partially remedied by the Treasury's new proposed regulations. However, not all of the benefits of the bargain sale have been eliminated, so that the prospective donor should still make the appropriate computation to determine that course of action which will yield him the most benefits.

2. *Congressional Response.* Congress sought to curb the abuses inherent in the bargain sale by providing in section 1011(b) that the portion of the property sold to the charity gives rise to income.¹⁸⁵ Basically, the donor is considered to have "sold" a percentage of his property to the charity and to have "donated" the remainder. For the percentage of the property sold his amount realized is the value which he receives, and his basis therein is the allocable portion of

¹⁸³ See Berall & Enright, *Tax Reform and the Donative Sale*, 47 TAXES 585, 587 (1960). The rationale here would be that when the combined tax rate exceeds 100%, the percentage amount in excess of 100% adds dollars to the donor in the "net to donor" column. For example, with a top marginal rate of 70% the total percentage is 140%. The net amount to the donor under a sale is \$5,800, while the net under a bargain sale is \$8,200, or an increase of \$2,400. This increase represents 40% times the appreciation of \$6,000, or a resultant \$2,400.

Another way to visualize this result is that a top tax rate of 70% will be used to determine the value of the charitable deduction to the donor. In order to put the tax on the appreciation in the same perspective, start with 100% and deduct the tax percentage on the appreciation. Thus, a tax on the appreciation of 25% would give a 75% benefit to the donor as opposed to a 70% benefit in the form of a charitable deduction. Likewise, a tax rate of 70% on the appreciation would give a benefit to the donor of 30% of the appreciation, as opposed to a 70% benefit for a charitable contribution. In this latter instance the charitable contribution in the bargain sale technique gives a net benefit to the donor of 40% of the appreciation in question.

¹⁸⁴ These advantages were widespread because as the formula in note 183 *supra* points out, it would be to the donor's advantage to use the bargain sale technique for ordinary-income property if his tax bracket exceeded 50%. Under the 1969 surtax rates single taxpayers entered the 50% limit at only \$20,000 taxable income, and married taxpayers filing a joint return at \$40,000, while under the 1970 tax rates single taxpayers entered the 50% limit at \$22,000, and married taxpayers filing a joint return at \$44,000. Moore, *Estate Planning Under the Tax Reform Act of 1969: The Uses of Charity*, 56 VA. L. REV. 565, 566 (1970).

¹⁸⁵ Although the Treasury had not made any recommendations in this area, the choice of this method of dealing with the problem was envisioned by the House Ways and Means Committee and gained approval in the conference committee. See 1969 House Hearings 5146-57, 5372-79; H.R. REP. NO. 91-413 (Part 1), 91st Cong., 1st Sess. 54 (1969); H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 294 (1969). Thus, the argument of Senator Gore that this provision was a modest step toward tax fairness carried the day. S. REP. NO. 91-552, 91st Cong., 1st Sess. 82, 336 (1969).

the entire adjusted basis in the property determined according to the following formula:

$$\begin{array}{rcc} \text{Adjusted Basis} & & \text{Adjusted Basis} \\ \text{of Sold Portion} & = & \text{of Entire Property} \\ & \frac{\text{Amount Realized}}{\text{Fair Market Value}} & \times \\ & \text{of Entire Property} & \end{array}$$

The donor's gain is then the amount realized less the adjusted basis of the sold portion, with the character of this gain determined by the character of the property involved in the transaction. The pertinent provision reads: "If a deduction is allowable under Section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property."¹⁸⁶ This wording is not a model of clarity. An important question left open by the statute is the relationship of the section 170(e) reduction provision to section 1011(b), and whether one must look first to section 170 or section 1011(b) when a bargain sale has occurred in order to determine the effect of this transaction.

(a) "*Is Allowable.*" The interpretation given the phrase "is allowable" governs the choice of section 170 or section 1011(b) as the starting point. If this phrase is interpreted to mean that a determination is initially made to set forth the "allowable" charitable contribution before there can even be a bargain sale, then obviously the provisions of section 170 are looked to first. This is the interpretation adopted by the Treasury,¹⁸⁷ and it is the most rational reading of the language "[i]f a deduction is allowable."¹⁸⁸

The alternative interpretation of this language is that there is first the allocation into the "sale" portion and the "gift" portion of the transaction under normal tax fundamentals.¹⁸⁹ The gift portion of the property is then looked to in order to determine if any reduction should be made under section 170(e). Thus, it would be possible under this interpretation to have both the inclusion of some ordinary income and a charitable deduction in offsetting, equal amounts, when the interpretation espoused by the Treasury would not lead to such a result.

There would be no difference in result between the use of the Treasury interpretation or the alternative interpretation of the statute. However, if the donor had a combination of fifty-percent and twenty-percent charitable contributions, he could incur a greater tax liability with no corresponding charitable deduction benefit. Assume that the donor has a \$100,000 contribution base, \$30,000 in contributions to fifty-percent charities and \$20,000 in contributions to twenty-percent charities. He then makes a bargain sale to a twenty-percent charity of property with a \$10,000 fair market value for its \$4,000 basis. If the appreciation in this property were ordinary income, the Treasury view would produce no charitable contribution, and, thus, the bargain sale provisions

¹⁸⁶ INT. REV. CODE of 1954, § 1011(b).

¹⁸⁷ Proposed Treas. Reg. § 1.1011(b)-2(a)(1), 36 Fed. Reg. 6109-10 (1971).

¹⁸⁸ INT. REV. CODE of 1954, § 1011(b).

¹⁸⁹ See Taggart, *supra* note 50, at 130-31.

would never be triggered. The result would be a sale of the property for its \$4,000 basis with no gain or loss being recognized.¹⁹⁰ On the other hand, the alternative view would first require an allocation under the bargain sale rules. The \$2,400 of gain produced thereby would be taken into account as ordinary income producing an additional \$1,680 in taxes for the donor in the seventy-percent tax bracket.¹⁹¹ However, there would be no corresponding charitable contribution benefit because the limitations on twenty-percent contributions have already been exceeded, and there is no carryover.¹⁹²

Thus, on balance, the Treasury reading of the statute remains the most logical and equitable. There is no taxation of "imaginary" gains in the instance of a contribution of appreciated ordinary income property for which there would be no corresponding tax benefit. The Treasury's statutory reading also successfully navigates the thorny issue of determining what the word "property," as used in section 170(e)(1), refers to in the context of a bargain sale. By looking first to section 170 when property with a \$10,000 fair market value is sold to the charity for its \$4,000 basis, the "contribution of property otherwise taken into account"¹⁹³ is the \$6,000 appreciation.

(b) *Deduction Allowable by Reason of a "Sale."* Before the provisions of section 1011(b) become applicable, it is necessary that the charitable deduction under section 170 be allowable by reason of a "sale." The significant fact for donors is that the statute does not use the common phrase "sale or exchange." A possible rationale for this deletion is that it was simply an oversight on the part of the legislative drafters.¹⁹⁴ Such an interpretation seems doubtful, however, since the committee reports make no reference to an exchange, and section 1011(b) is entitled: "Bargain Sale to a Charitable Organization."

Although the Treasury has taken the position that section 1011(b) applies to both a "sale or exchange,"¹⁹⁵ it is reasonable to assume that Congress did not anticipate that the nonrecognition exchange provisions of the Code would be used by donors. Assuming no cash or mortgages were involved, the donor would simply own different property with no benefit from the charitable contribution.¹⁹⁶ The situation apparently envisioned by the Treasury involves, for

¹⁹⁰ According to the Treasury view, it is first determined that there is a \$6,000 charitable contribution. Since this contribution consists entirely of ordinary income appreciation, the contribution is reduced to zero under § 170(e). Therefore, the donor receives only a \$4,000 benefit from this transaction (the amount realized), and § 1011(b) never comes into play.

¹⁹¹ The alternative view would allocate \$1,600 to the basis of the "sold" portion ($\$4,000 \times 40\%$), leaving a \$2,400 gain. This gain would yield \$1,680 in taxes at the 70% tax rate. Next, \$2,400 would be allocated to the basis of the contributed portion ($\$4,000 \times 60\%$), leaving \$3,600 ordinary income appreciation. After the § 170(e) reductions there would be a \$2,400 charitable contribution, which, if deductible, would yield a \$1,680 benefit at the 70% tax rate.

¹⁹² The charitable contribution to a 20% charity is limited to the lesser of 20% of the donor's contribution base or the excess of 50% of the contribution base over the allowable contributions to 50% charities. (Therefore, all 30% contributions will go to reduce the contribution limitations of 20% donations, even though these 30% contributions may not be deductible in the current tax year.) If these limitations are exceeded, then there is no provision for the carryover of the excess 20% donations. INT. REV. CODE of 1954, §§ 170(b)(1)(B), 170(d).

¹⁹³ *Id.* § 170(e)(1).

¹⁹⁴ Such oversights have been made in the past. *E.g., id.* § 341(f)(1).

¹⁹⁵ Proposed Treas. Reg. § 1.1011(b)-2(a)(1), 36 Fed. Reg. 6109-10 (1971).

¹⁹⁶ This, of course, assumes that the properties involved in the exchange have the same fair market values.

example, the donor's transfer of property with a fair market value of \$10,000 and a basis of \$4,000 to a charity in a section 1031 exchange for property of a like kind having a fair market value of \$4,000. Here it would seem that the charitable contribution is \$6,000, so that the bargain sale rules are triggered. However, any such nonrecognition exchanges seem unlikely, since the charity's holding of business or investment property will give rise to unrelated business-income problems.¹⁹⁷ Therefore, it is submitted that the Treasury's addition of "exchange" to the statutory language to cover this situation is unwarranted.

On the other hand, if under these same facts the exchange consists of materially different types of property, there would be a recognition transaction.¹⁹⁸ The Treasury is justified in applying the bargain sale rules in this situation to prevent the inequities which were rampant before the Tax Reform Act which allowed cash or its equivalent to be received for the amount of the donor's basis with the full amount of the appreciation in the property being taken as a charitable deduction. Any other result would allow a donor to circumvent the bargain sale rules. However, in this latter type of exchange the ordinary meaning of the word "sale" as a transfer of property for money or its equivalent¹⁹⁹ would easily encompass the receipt of an annuity,²⁰⁰ and there is no reason why it would not also apply to an exchange of dissimilar properties. It is submitted that a court making this interpretation would be adhering to, rather than thwarting, the obvious purpose of the statute,²⁰¹ so that the Treasury's addition of the word "exchange" to cover this situation is likewise unwarranted.

3. *Mortgaged Property Used in a Bargain Sale.* In its proposed regulations²⁰² the Treasury extends the *Crane* doctrine²⁰³ to cause a realization of income to the donor when property used in a bargain sale is subject to an indebtedness. This rule applies whether the charity assumes the debt or not, and by their terms, the proposed regulations apply only when there is a charitable contribution under section 170 by reason of a sale or exchange. In the instance of a donor who merely contributes the property and receives nothing in return there is no recognition, since this is not a sale or exchange.²⁰⁴ For the recipient

¹⁹⁷ INT. REV. CODE of 1954, §§ 511-13.

¹⁹⁸ Treas. Reg. § 1.1001-1(a) (1957).

¹⁹⁹ Commissioner v. Brown, 380 U.S. 563 (1965).

²⁰⁰ This is specifically provided for in Proposed Treas. Reg. § 1.1011(b)-2(a)(4), 36 Fed. Reg. 6110 (1971). Prior to the Tax Reform Act, however, if the actuarial value of the annuity received by the donor were greater than his tax basis in the property, gain would be recognized to that extent. Otherwise, the difference between the fair market value of the property and the actuarial value of the annuity would constitute a charitable contribution. Rev. Rul. 62-136, 1962-2 CUM. BULL. 12.

²⁰¹ *Helvering v. Hammel*, 311 U.S. 504, 510-11 (1941); cf. *Commissioner v. Gillette Motor Transp. Co.*, 364 U.S. 130, 134 (1960); *Commissioner v. P.G. Lake*, 356 U.S. 260, 265 (1958).

²⁰² Proposed Treas. Reg. § 1.1011(b)-2(a)(3), 36 Fed. Reg. 6110 (1971).

²⁰³ *Crane v. Commissioner*, 331 U.S. 1 (1947).

²⁰⁴ If this were not the case, the donor's contribution of property with a fair market value of \$10,000, a basis of \$4,000, and a \$2,000 mortgage would result in a bargain sale computed in the following manner: the adjusted basis for determining gain under section 1011(b) would be \$800 ($\$4,000 \times \$2,000/\$10,000$), which gives a \$1,200 gain to be recognized ($\$2,000 - \800). However, if this situation were considered a bargain sale, then the same result would have to follow for property which was: (a) purchased with \$2,000 cash and \$2,000 mortgage, (b) purchased with \$4,000 mortgage which is now \$2,000 equity and \$2,000 mortgage, and (c) purchased with \$4,000 mortgage which still remains as such. There is no logical foundation for such a result. It is one easily avoided by

of like-kind property under section 1031, there will be no charitable contribution as long as the fair market value of the property received equals the fair market value of the property given up, and, therefore, no recognition of income from the mortgage because section 1011(b) is never activated.²⁰⁵ Likewise, when full fair market value is received in a non-like-kind exchange, there is no charitable contribution so that section 1011(b) never comes into play to cause a recognition.²⁰⁶

In the normal bargain sale situation "the amount of the indebtedness shall be treated as an amount realized."²⁰⁷ If this phrase is interpreted to mean that the indebtedness is treated as an amount realized *in excess* of the cash received by the donor, the donor who purchased the property with a pre-existing mortgage thereon is penalized. The mortgage would be a part of his basis, and upon the sale of the property for the amount of his basis, there is no equitable reason for requiring him to recognize more income.²⁰⁸ On the other hand, if this phrase is given the more reasonable interpretation that the amount of the indebtedness is an amount realized *if it were not otherwise so treated*, then no inequity results. The donor would have to take the indebtedness into account only when he had placed a mortgage on the property subsequent to its acquisition. In such a situation it is proper for the donor to recognize additional income on a transaction that smacks of a cash wring-out.²⁰⁹

mortgaging property other than the one anticipated to be contributed, and it is submitted that these inequities militate against such an interpretation. If, however, the donor is relieved of liability for the indebtedness, he could be subject to taxation under, for example, § 108.

²⁰⁵ Depending upon the particular facts, the donor may recognize income on the transaction, but it will not be because of the bargain sale provisions. INT. REV. CODE of 1954, § 1031(d); Treas. Reg. § 1.1031(d)-2 (1956).

²⁰⁶ Gain would be recognized in such a transaction under the *Crane* doctrine, note 205 *supra*, and accompanying text, or Treas. Reg. § 1.1001-1(a) (1957).

²⁰⁷ Proposed Treas. Reg. § 1.1011(b)-2(a)(3), 36 Fed. Reg. 6110 (1971).

²⁰⁸ If the mortgage were part of the purchase price so that the donor's basis (\$4,000) consisted of \$2,000 mortgage and \$2,000 cash, a bargain sale of the property at a basis of \$4,000 would cause the mortgage to be "realized." If the language of the proposed regulations means that under these facts a sale of the property at its basis requires an additional \$2,000 to be recognized on account of the mortgage, then this donor is unjustly penalized. Compare the following figures: (a) if the property is sold for its \$4,000 basis (which includes a \$2,000 mortgage) and the mortgage is considered "realized," the gain is \$2,400 or \$4,000 amount realized less \$1,600 basis; or (b) if under these facts the \$2,000 mortgage is considered realized in addition to the cash received, the gain is \$3,600, or \$6,000 amount realized less \$2,400 basis. This extra \$1,200 gain in the second example is caused by the donor being considered to have recognized the \$2,000 mortgage twice!

²⁰⁹ This reading would properly take the mortgage into account as an amount realized only once, when the mortgage is a portion of the basis of the property in question. When the mortgage has been added later, this is correctly considered an additional amount realized, for otherwise, the donor would obtain an undue advantage using this technique. Consider the following figures: (a) Capital gain property is involved with a basis of \$4,000 and a fair market value of \$10,000. The mortgage of \$2,000 is not a part of the basis. Thus, if the mortgage is not included in the amount realized, the gain is \$2,400 (\$4,000 amount realized less \$1,600 basis) on which there is a \$600 tax, assuming a 25% tax rate. The charitable contribution thus becomes \$6,000. In these circumstances the net to the donor is \$9,600 (\$2,000 from the mortgage, plus \$4,000 cash plus \$4,200 value of the charitable contribution at the 70% tax rate less \$600 capital gains tax). This would be even more advantageous to the donor than selling the property and retaining the proceeds with the 25% tax rate being applicable to the appreciation. (b) Assume the same facts except that the \$2,000 mortgage is considered as an amount realized in addition to the cash received. Here the gain is \$3,600 (\$6,000 amount realized less \$2,400 basis) on which the capital gains tax is \$900. The gift is \$4,000. This means that the net to the donor is \$7,900 (\$2,000 mortgage plus \$4,000 cash plus \$2,800 value of the gift at 70% tax rate less \$900 capital gains tax).

4. *The Percentage Limitations.*²¹⁰ The bargain sale rules require that a determination first be made whether a charitable contribution is "allowable" under section 170,²¹¹ and the Treasury has taken the position that the percentage limitation rules should be applied in making this determination.²¹² If it is assumed that a donor with a \$100,000 contribution base who has made \$50,000 in cash donations makes a bargain sale to a fifty-percent charity of capital gain property with a fair market value of \$10,000 for its \$4,000 basis, there would be no charitable deduction in the year of sale. With no charitable deduction being "allowable" because the percentage limitations had been exceeded, section 1011(b) would not be triggered, and there would be no income recognition. Here the \$6,000 charitable contribution could be carried forward under section 170(d), and if it is assumed that this donor could take advantage of such a carryover in later years, he would be able to successfully circumvent the bargain sale rules.

To close this loophole the proposed regulations further provide that in such a circumstance the bargain sale rules are applied in the year of the sale, regardless of whether the charitable contribution carryovers result in deductions in the succeeding years.²¹³ Thus, the Treasury has taken a very literal interpretation of the word "allowable." In the fact situation posed, a charitable contribution was "allowable" in the sense that absent the percentage limitations such a deduction could be taken. The percentage limitation only prevented this "allowable" deduction from being taken; therefore, a deduction was merely not "allowed." The Treasury position is undoubtedly more in harmony with the congressional purpose underlying section 1011(b), while at the same time giving the donor some much needed guidance.

5. *Continued Use of the Bargain Sale.* The technique of the bargain sale has been laid to rest for the donor with ordinary income property, since there is no charitable deduction available under section 170(e)(1)(A). With capital gain property the donor will receive less money through the bargain sale technique than via a sale of the property and a retention of the proceeds. However, the donor can come out ahead with the bargain sale as compared with simply contributing the property to a charity.²¹⁴ Finally, when the reduction rules of section 170(e)(1)(B) apply to the appreciated property used in the bargain sale, the donor will still retain the greatest net amount from a sale and retention of the proceeds; however in certain circumstances in which the basis of the property exceeds fifty percent of the fair market value of the property the bargain sale can still be more advantageous than the outright contribution.²¹⁵

²¹⁰ See generally Taggart, *supra* note 50, at 135-39.

²¹¹ INT. REV. CODE OF 1954, § 1011(b).

²¹² Proposed Treas. Reg. § 1.1011-2(a)(1), 36 Fed. Reg. 6110 (1971).

²¹³ *Id.* § 1.1011(b)-2(a)(2).

²¹⁴ For the donor in the 70% tax bracket with property having a fair market value of \$10,000, a basis of \$4,000, the variable results are as follows: (a) a contribution of the property to a public charity would be worth \$7,000; (b) a sale of the property with retention of the proceeds would be worth \$7,900, assuming a capital gains tax of 35%; and (c) a bargain sale to a public charity at basis would be worth \$7,360 (\$4,000 cash realized plus \$4,200 value of the \$6,000 contribution less \$840 capital gains tax).

²¹⁵ For the taxpayer in the 70% top marginal tax bracket, if the basis of the property is 60% of its fair market value, then even with the maximum capital gains rate of 35% the

V. CONCLUSION

In 1969 Congress attempted to curb some of the more flagrant abuses inherent in gifts of appreciated property to charities. This certainly has been a result of the Tax Reform Act of 1969. However, at the same time it is unfortunate that Congress overacted in its zeal to solve a current problem. This reaction has left a host of unanswered questions and doubts, even after the Treasury's first efforts to solve some of the statutory ambiguities in its proposed regulations. Hopefully though, tax equity will find its way through the complexities left for posterity.

bargain sale is the preferable contribution technique. For example, if the property has a fair market value of \$10,000 and a basis of \$6,000, the net amount to the donor is \$7,400 or \$6,000 cash received plus \$2,240 value of the contribution (which sum is \$4,000 — $(\$4,000 \times 40\%)$ (50%) = $\$3,200 \times 70\%$ or \$2,240) less \$840 capital gains tax, on the bargain sale as opposed to a net value of \$7,000 on the contribution of the property to a charity. Therefore, the tax planner should make the appropriate computation for his more wealthy clients, since the bargain sale may still be of some benefit to them.