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CHARITABLE CONTRIBUTIONS OF INDUSTRIAL/COMMERCIAL PROPERTY: MARKET TAX BENEFITS, PLUS BARGAIN SALES REVISITED

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In this day of double, triple or quadruple real estate price spirals, it may not be politically correct to refer to taxpayers having difficulties selling their property. Apart from the occasional need to find someone willing to just "take the property," there are a variety of circumstances where commercial buyers are available but the tax benefits of a contribution (or that curious amalgam called a bargain sale) may be more attractive than a cash sale. Let me review the following case history (from an actual deal).

Background

A major Fortune 500 corporation had decided to close down a large manufacturing facility in the midwest portion of the United States. The plant included a substantial amount of land. In fact, the parcel had been appraised at $22 million, and was carried on the company's books at approximately $2 million. The company's carrying costs for the property were around $200,000 per year. This corporation was profitable, with a marginal tax rate (including state income tax) of 40%.

Various options were considered. To recycle the property would involve major costs, as well as rezoning (always a political minefield), and perhaps a time frame that might extend for four years or even longer. Based on these various hurdles, the corporation defined four possible alternative courses of action it could pursue:

A. An all-cash (hopefully quick!) sale to a developer, which developer would in turn take on the burdens of redevelopment of the property.

B. Retaining the facility to locate an ideal user of the facility who would be able to use the real estate in its present condition (and with present zoning).

C. A joint venture undertaking between a developer and the Fortune 500 company for a future development that would have enough upside potential to justify the risk.

D. A charitable contribution to a particular organization.

Taxes, Taxes and More Taxes

Like all good commercial analyses, a comparison of the above four choices cannot be seriously commenced without reference to tax liabilities. Thus, for options A through D, the company went through a tax analysis of its net after-tax result.

A. All-cash Sale. Though the property was appraised at $22 million, an appraisal is one thing, and cash is another. The best readily available all-cash sale that had been offered was in the neighborhood of $8 million. The primary reason for this deflated price was the extensive cost and time it would require to renovate the property, and the difficulty of securing outside financing. The corporation was not willing to consider seller financing, which it considered too risky. Based on this rather unappetizing sale price, the after tax result would be:

After Tax Result
Sales proceeds $8 million
Tax basis $2 million
Capital gain $6 million
Tax on capital gain at 40% $2,400,000
Net after tax $5,600,000

B. Retention for Qualified User. Let's compare this to the rather unhappy tax result in option A. Due to the obsolescence of the building and the challenge of rezoning the property, the corporation felt it might take as much as four years to locate a prospect. The value of the property would likely decline by that time by 25%, to a level of only $16,500,000. The property could then be sold, but of course the $22 million figure would no longer be available. (Incidentally, this obviously assumes that the sale price would increase from the $8 million currently being offered from the all-cash buyer to the $16.5 million offered by the just-right end user.) Let's look at the after tax result:

After Tax Result
Sales proceeds $16.5 million
Tax basis (assumed unchanged) $2 million
Capital gain $14.5 million
Tax on capital gain at 40% $5.8 million
Net after tax from sale $10.7 million
Less carrying costs of $800,000 (4 years at $200,000 per year)
Tax savings at 40% $320,000
Net Carrying Costs $480,000
Total Net After Tax $10,220,000
Net present value at 10% $6,980,362

C. Joint Venture. The joint venture was perhaps the most risky. The corporation believed this approach to involve substantial uncertainty. The company felt that it was not in the real estate business, and should invest the proceeds from the disposition of this plant in the company's core business activities.

D. Charitable Contribution. Finally, let's look at the charitable contribution. This result looks very much like the all-cash sale. Bear in mind, though, that one critical element is that all-important moniker "fair market value." Here, the $22 million figure was used, since that was the appraised value, even though at the moment only an $8 million all-cash deal could be unearthed. Let's look at the after tax result.

After Tax Result
Fair market value $22 million
Tax deduction $22 million
Capital gain $0
Marginal tax rate (40%)
Net after tax $8.8 million

If we try to compare the net after tax, the bottom line is fairly simple. Based on the foregoing assumptions, the net after tax from the all-cash sale would be $5.6 million.

This was our alternative A. The all-cash sale on a long-term basis would be $10,220,000 (this was our alternative B), with a present value of $6,980,362. Alternative C was somewhat of a wildcard, the joint venture as to which no projections were advanced. With no numbers to crunch, we have no number to set forth as the choice for alternative C. But the charitable donation, alternative D, yielded a figure of $8.8 million. That was a far more attractive choice. As a result, the company conveyed the property to the charity that stepped forward with this approach, the National Development Council.

Bits and Pieces

It should not be lost on readers that there are usually other issues going on besides tax issues. One of the nontax advantages is public relations (even though tax professionals like to think they are at the center of the universe!). There were significant public relations values related to the National Development Council's background in economic development and small business financing, as well as its ability to recycle real estate of this difficult and unique nature.

Although it took nearly eight years, this particular property was rezoned to accommodate a mixed-use development, including a significant allocation to the local community for parkland. That makes not only the Fortune 500 company (but also the National Development Council) come out looking like winners.

Speaking of public relations, so as not to hide the ball any further, I may as well say who the Fortune 500 company was: R.J. Reynolds Tobacco Co. It certainly doesn't hurt R.J. Reynolds to get some good press now and then, especially after all of the anti-tobacco press, case law, ad campaigns, etc.

In this case, R.J. Reynolds got quite favorable press for donating 452 acres to a nonprofit organization. The site had been dormant for a number of years, and local press coverage indicated that the donation of the property would allow a comprehensive redevelopment providing much needed housing and civic improvement. The National Development Council, long-experienced in dealing with companies of the ilk of Kodak, General Motors, Berkshire Hathaway and other industrial corporations, would develop the site itself.

This kind of donation is nothing new, of course. Industrial companies have long sought charitable contributions of property as a way of generating immediate tax deductions and therefore cash flow, while being relieved of the responsibility of dealing with non-core business problems.

Bargain Sales Also Popular

Some donations are structured as bargain sales rather than outright deductions. A taxpayer who sells property to a charity for less than the property's fair market value can claim a deduction. The deduction is equal to the difference between the fair market value of the property and the amount realized from the sale. In order for a bargain sale to constitute a charitable contribution, the seller must make the sale with the requisite charitable intent, and the fair market value of the property on the date of the sale must exceed the selling price.

The donor must demonstrate that he purposely contributed property in excess of the value of any benefit he received. In general, the amount of a charitable contribution

made in property other than money is the fair market value of the property at the time of the contribution. State law controls the nature of property interest the taxpayer conveys.

For tax purposes, fair market value is the price that a willing buyer would pay a willing seller, both having reasonable knowledge of all the relevant facts and neither being under compulsion to buy or sell. The fair market value of the property should reflect the highest and best use to which the property could be put on the market on the date of valuation.

In the typical bargain sale, a taxpayer transfers property to a charitable organization for $100 per acre, but the fair market value of the property is $135 per acre. The price is greater than the basis, thereby causing gain recognition. On the taxpayer's return, he can claim a charitable contribution deduction equal to $35 per acre.

The IRS has stated in Private Letter Ruling 9235033 that in a bargain sale, the donor must have donative intent. The deduction will not be permitted unless the transfer was motivated by detached and disinterested generosity. If tax savings motivated the donation, the charitable contribution deduction will not be permitted.

As in any charitable contribution setting, it is important to avoid even the implication that something other than charitable intent and altruism motivated the transfer. The IRS, and to a lesser extent the Tax Court, will be alert to indications that the charitable contribution facilitates some retained right, or that there is an express quid pro quo for the contribution. Documentation of the contribution, including all correspondence, should reflect consideration of these pitfalls.

Basis Issues in Bargain Sales

Under the bargain-sale rules, if a deduction is allowable under Section 170 because a sale is made at a bargain price, the adjusted basis for determining gain from the sale will be that portion of the adjusted basis that bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.

In Hodgdon v. Commissioner, a taxpayer who made a bargain sale of property to a charity had to apply the special basis rule in recognizing gain, even though the limitation on charitable contributions resulted in no deduction ever being taken. The requirement (in the bargain-sale basis rule) of an "allowable" deduction was interpreted to mean a contribution available for deduction, even if it is ultimately not deducted because of future events not related to the nature of the charitable contribution.

The Hodgdons made a charitable contribution of a parcel of land worth $800,000 in May 1980, to San Bernardino, the city where they lived. Later that same year, they contributed real property with a fair market value of $3.9 million to Campus Crusaders for Christ, a qualified charity, which took the property subject to liabilities of $2.6 million. This was a bargain sale that resulted in gain to the taxpayers. In computing this gain, the basis of the contributed property under Section 1101(b) was its adjusted basis multiplied by the ratio of (1) the amount realized on the sale to (2) the property's fair market value.

The charitable deductions for the Hodgdons' contributions of capital gain property were, however, subject to limitation. Only $447,000 was deducted in the year of the

contributions, $21,000 in the following year, and nothing in the four remaining carryover years. The Hodgdons contended that the bargain-sale rules should not apply, because the sale did not result in an allowable charitable deduction.

"Allowable" Deductions

Under Section 1011(b), the bargain-sale basis rule applies if a "deduction is allowable under section 170" by reason of the sale. Since the total deduction for contributions of capital gain property ($468,000) was less than the first contribution ($800,000), the taxpayers claimed that nothing attributable to the later donation was ever deducted.

Regulations Section 1.1011-2(a)(2), however, provides that if a sale results in a contribution carryover, basis is apportioned whether or not the contribution is allowable as a deduction under Section 170 in a subsequent year. The Hodgdons agreed that the regulation supported application of the bargain-sale rule to their contribution, but argued that the regulation conflicted with the statute and was invalid.

The Tax Court rejected the taxpayers' contention that the second charitable contribution resulted in no allowable deduction. Nothing in Section 170 suggests that there is a first-in, first-out rule for donations. Also, Section 1011 did not imply that any distinction be made among charitable contributions based on the order in which they are made during a year. The court concluded that the taxpayers' deduction came from the pool created by both contributions.

The Tax Court found Regulations Section 1.1011-2(a)(2) to be reasonable and consistent with the statute when read in the context of the five-year carryover. Otherwise, a taxpayer might not report a bargain sale because the related contribution deduction could neither be taken currently nor used in either of the next two years. After the third carryover year, the Service could not know, absent an audit, if the taxpayer would have been entitled to a deduction for that third year. After the third year the Service would be barred by the three-year statute of limitations from assessing a deficiency for the contribution year.

Similarly, a taxpayer who initially reported and paid tax on a gain from a bargain sale would be precluded from claiming a refund if a resulting contribution carryover expired unused after the five-year carryover period. The court did not think Congress intended to jeopardize the rights of taxpayers or the Service with a rule that no deduction was "allowable" for Section 1011 purposes unless the contribution reduced taxable income in one of the five succeeding tax years.

The moral of the story in Hodgdon, of course, is that taxpayers should evaluate the effect of their charitable contribution deduction before making the contributions. In this case, the Hodgdons had made a substantial gift to the City of San Bernardino in May of 1980. Why they made the subsequent contribution to Campus Crusaders is not evident from the decision.

A Few More Issues

Charitable contributions of real estate raise special problems compared with other charitable contributions. Apart from the ever-present question of what the property contributed is truly worth (something that comes up with any kind of charitable contribution), there are distinct issues that arise more frequently with real estate contributions that with other types of property. Two of the most nagging questions that

may arise on a charitable contribution of real estate concern partial interests of property and questions of donative intent. As to the former issue, the rule is clear that no deduction is available for gifts of partial interests in property.

Consider the following facts, which raise both of these questions amidst the background of a not uncommon charitable contribution scheme. The question in this as in many other cases is whether sufficient "strings" on the property were retained by the donor.

An S corporation in the business of real estate development had a project consisting of a private residential community on 4300 acres. The corporation developed all but approximately 1300 acres into homesites, as well as numerous parks, trails, and a golf course. At any one time, the corporation holds between ten and sixty lots (ranging from one to three acres) for sale to customers in the ordinary course of its business. The corporation also holds a 5.6 acre tract that will not be subdivided and that consists of an historically significant farm (the "farm parcel").

The corporation planned to transfer the farm parcel to a tax-exempt organization that was created to acquire, restore and maintain the farm buildings. This tax-exempt organization would use the parcel to further its exempt purposes and provide information about the role of the farm in the area, and conduct related activities. The transfer to the farm is to be by quitclaim deed, with no special privileges or conditions retained by the donor organization.

However, the exempt organization gave the corporation $1500 to reimburse it for its costs in removing an underground gasoline storage tank from the parcel. The corporation is obligated to repay the $1500 in the event it does not donate the parcel to the exempt organization.

Following the conveyance of the property, the farm parcel would still remain subject to certain deed provisions applying to all property located in the residential community, including ownership and use covenants, and other restrictions and conditions. According to evidence presented by the corporation, the exempt organization's proposed use of the parcel will not increase (and may actually decrease) the value of the remaining undeveloped property.

Under these facts, the IRS ruled that the donor's entire interest in the property was being contributed. The donor would retain no privileges in the property, and the creation of the deed restrictions (and the grant of enforcement rights for those deed restrictions to the homeowners association) were not intended to avoid the partial interest rules of Section 170(f)(3)(A). The IRS concluded that there was donative intent present sufficient to satisfy the bargain sale rules.

Scenic and Conservation Easements
Additional problems arise where the type of property contributed is a scenic easement or conservation easement. Quite apart from valuation—which again is likely the most nagging question here—one question may be the motive of the taxpayer. In McConnell v. Commissioner, for example, the Tax Court disallowed a deduction for a contribution of property to a municipality on the ground that the transfer was motivated by an anticipated benefit "beyond the mere satisfaction flowing from the performance of a generous act." The court found that the McConnells' motives in transferring their interests in donated streets and sewers were (1) to avoid responsibility for future

maintenance of the streets and sewers, and (2) to enhance the value of their interest in the remaining property. In the Tax Court's view, this rendered Section 170 inapplicable.

Similarly, in Sutton v. Commissioner, the donor granted a perpetual easement that the court found was for the primary purpose of allowing him to develop his property. Thus, a charitable contribution deduction was denied. More recently, in McLennan v. United States, a scenic easement was donated in conjunction with a retained right to develop. The Claims Court held that the McLennans had transferred the easement with donative intent and with an exclusive conservation purpose. In the court's view, the McLennans were concerned about the pristine quality of the surrounding land, and were aware that the grant of the easement would reduce the total value of their property. The government's argument, on the other hand, was not very sophisticated: it contended that the McLennans were motivated by tax savings rather than by a desire to preserve and protect the land.

Planning a Charitable Contribution

In any charitable contribution setting, it is important to avoid even the implication that something other than charitable-mindedness and altruism motivated the transfer. The IRS, and to a lesser extent the Tax Court, will be alert to indications that the charitable contribution facilitates some retained right or, even more blatantly, that there is an express quid pro quo for the contribution. Careful documentation of the contribution, including any and all correspondence, should be mindful of these pitfalls.

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