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Bargain Sale as Charitable Gift

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What is it?

A bargain sale is just what the phrase implies. It is a sale of property to charity at a bargain price; that is, for less than the property's fair market value. A bargain sale is also referred to as a donative sale because it is treated for tax purposes as in part a gift and in part a sale. When you sell property to charity at a bargain price, you are deemed to have participated in two separate transactions for tax purposes: (1) a sale, and (2) a charitable contribution. With regard to the sale portion, you are subject to income tax on your pro rata share of the property's appreciation. However, with regard to the charitable contribution portion, you are entitled to a charitable contribution deduction. The amount of the charitable deduction is the difference between the fair market value of the property and the sale price (subject to limitations). For tax purposes, each transaction is treated separately on your tax return.

Example(s): Ronald decides to sell some stock to his favorite charity. On the date of sale, the stock's fair market value is \$10,000. Ronald sells the stock for \$4,000, which is equal to Ronald's basis in the stock. Ronald has held the stock for more than 12 months. The result is that Ronald has made both a sale and a charitable contribution. His gift to charity is \$6,000 (\$10,000 - \$4,000). So, Ronald can claim a charitable deduction of \$6,000 (subject to certain limitations). But he is also subject to income tax on his share of the stock's appreciation. Ronald is deemed to have given the charity 60 percent of his stock, and thus 60 percent of his \$4,000 basis in the stock (\$2,400) is allocated to the stock that Ronald is deemed to have donated. The remaining basis, \$1,600, is allocated to the \$4,000 worth of stock that Ronald is deemed to have sold to charity. Thus, Ronald must report a long-term capital gain of \$2,400 on his tax return. Assuming a capital gains tax rate of 15 percent (and assuming that Ronald has no offsetting losses, deductions or credits), Ronald will owe \$360 in income tax.

Bargain sale rules also apply when you donate property to charity that is subject to debt, like a mortgage. Such property is commonly referred to as encumbered property.

When can it be used?

You want to make a gift to charity but want to recover all or part of your investment in an asset

When you make a bargain sale to charity, you can recoup some, if not all, of your original investment in the asset, depending on the sale price. For tax purposes, the donation to charity is deemed to be the difference between the current fair market value of the asset and the sale price.

Strengths

Provides income tax deduction

In a bargain sale transaction, a charitable gift always results. Thus, if you itemize deductions, you receive a charitable deduction for the value of the gift to charity. The value of the gift is the difference between the fair market value of the property and the sale price.

Example(s): Suppose you own real estate worth \$100,000 that you purchased 10 years ago and which has a adjusted basis of \$30,000. If you sell the property to charity for \$30,000 in a bargain sale, the amount of the gift to charity is \$70,000. Your allowable deduction is limited to either 30 percent or 50 percent of your contribution base (your contribution base is generally equal to your adjusted gross income), depending on the type of charity and the property you sell (lower limitation percentages may apply in the case of bargain sales of capital gain property). Any amount that cannot be deducted in the given year can be carried over and deducted in the following year, for up to 5 years, assuming you still itemize deductions in those years.

Allows you to recover all or part of your original investment in an asset

When you make a bargain sale to charity, you get the satisfaction of knowing you can recoup all or a portion of your original investment in an asset, depending on the sale price you set.

Example(s): Ten years ago, Jen purchased \$10,000 worth of stock. It is now worth \$25,000. If Jen sells the stock to her favorite charity for \$10,000 in a bargain sale, she will recover all of her original purchase price (although she will still be subject to income tax on her share of the stock's appreciation).

Minimizes out-of-pocket cost of a charitable contribution

From a tax perspective, it is almost always better to make a bargain sale to charity than to sell the asset yourself and donate the sale proceeds to charity.

Example(s): Suppose you own a stamp collection with a fair market value of \$10,000 that you purchased five years ago for \$4,000. If you make a bargain sale to charity and sell the asset for \$4,000, you get a charitable contribution deduction of \$6,000 (subject to limitations). Yet you will also be subject to income tax on your pro rata share of the asset's appreciation, in this case \$2,400 (\$4,000 sale price less your bargain sale adjusted basis of \$1,600, which you calculate as $\$4,000/\$10,000 \times \$4,000$ total adjusted basis). Assuming a capital gains tax rate of 15 percent (and also assuming that you have no offsetting losses, deductions or credits), you will owe \$360 in income tax as a result of the bargain sale. By contrast, if you sold the asset outright and later made a cash donation to charity of \$6,000, you would still receive a charitable contribution deduction of \$6,000 (subject to limitations), but you would also be subject to income tax on your \$6,000 gain. Assuming a capital gains tax rate of 15 percent (and assuming that you have no offsetting losses, deductions or credits), you would owe \$900 in income tax as a result of the \$6,000 gain. So the bargain sale could save you \$540 in taxes in this example.

Provides you with positive social, religious, and/or psychological benefits for donating to your favorite charity

Yes, the tax benefits can be nice. In addition, donating to charity can be a real morale booster.

Reduces potential federal estate tax liability

When you leave directions in your will for a bargain sale to charity, the executor of your estate is entitled to deduct the value of the gift to charity from your gross estate for federal estate tax purposes.

Example(s): In his will, Fred directs his estate to sell his stock to charity for \$10,000, his purchase price ten years ago. The stock is now worth \$50,000. When Fred dies and the bargain sale is completed, the executor of Fred's estate can deduct the full value of the gift to charity, \$40,000, from the gross estate.

Tradeoffs

Requires irrevocable commitment

Before you sell your appreciated property to charity, you had better be sure this is what you want to do, because when you complete the transaction, it's a done deal.

Assets donated to charity are assets lost to your family

When you donate a portion of your estate to charity, these assets are forever removed from your inheritable estate.

Requires you to pay income tax on your share of the bargain sale asset's appreciation

When you make a bargain sale to charity, the transaction is treated in part as a sale and in part as a charitable contribution. With regard to the portion treated as a sale, you will be subject to income tax on your pro rata share

of the asset's appreciation.

How to do it

Pick a charity you wish to donate to and verify that it is a qualified charity

Just because you like the local church choir doesn't mean the IRS will. The IRS allows you to deduct contributions only to qualified charities. Generally, qualified charities are those operated exclusively for religious or educational purposes, medical or hospital care, government units, and certain types of private foundations. Every year, the IRS publishes a list of all qualified organizations in IRS Publication 78, commonly known as the Blue Book. Check to make sure your charity is listed in this publication.

Tip: After you pick a charity, it is a good idea to contact the charity to make sure it is willing to accept your gift. The charity just may not be interested in receiving your lunch box collection from the 1950s.

Pick an asset to sell to charity and name your price

If you want to recover your initial investment in an asset and at the same time receive a nice charitable contribution deduction, it is best to sell an asset that has appreciated substantially in value from the time you purchased it. This is commonly referred to as a low basis asset.

Tip: Make sure to obtain an independent qualified appraisal for your asset.

Caution: If you pick securities for your bargain sale, it is a good idea to sell them directly to the charity rather than transfer them to a broker with instructions to sell "for the account of" the charity. The reason is that the IRS might believe the broker is acting as your agent, in which case the full amount of the gain on the securities will be taxed to you, rather than just the sale portion of the transaction.

Document your intent to make a gift

It is a good idea to document your intent to make a gift to charity, specifically the difference between the fair market value of the property and the sale proceeds. Otherwise, the IRS may disallow a charitable deduction. One way to do this is to write a letter to the charity prior to the transaction expressing your intent to make a gift and naming the property and its value.

Report any gain on your tax return

The IRS requires you to report your pro rata gain resulting from the asset's appreciation on your income tax return in the year of the bargain sale.

Tax considerations

Income Tax

Provides income tax deduction

A bargain sale is treated as consisting of both a sale and a charitable gift for tax purposes. For the charitable gift, the IRS allows you to take a charitable deduction for the value of the gift, assuming you itemize deductions.

Your allowable deduction for the given year is limited to either 30 percent or 50 percent of your contribution base (your contribution base is generally equal to your adjusted gross income), depending on the type of property donated to charity and the classification of your charity as a public charity or a private foundation (lower percentage limitations apply to gifts of capital gain property). If you are unable to take the full deduction allowed you in the given year, you may carry over and deduct the difference for up to five succeeding years, again assuming you still itemize deductions in those years.

Tip: Generally, a public charity is a publicly supported domestic organization, and a private foundation does not have the same base of broad public support. IRS Publication 78, published every year, provides a list of qualified charities and notes whether they are public charities or private foundations.

Gift Tax

No gift tax consequences

If the recipient of your bargain sale is a qualified charity, you are exempt from the gift tax rules.

Estate Tax

Reduces size of gross estate

If you leave instructions in your will for your executor to make a bargain sale to charity, your estate can deduct the value of the gift to charity from your gross estate. The smaller your gross estate, the less chance you have of owing estate tax.

Example(s): In his will, Arthur leaves instructions for a bargain sale of stock to his favorite charity. If the value of the gift is \$30,000, the executor of the estate can deduct \$30,000 from the gross estate.

Questions & Answers

What happens if the property you donate to charity is subject to debt?

If you donate property to charity that is subject to debt such as a mortgage, the IRS treats the transaction as a bargain sale. This is true even though you may not receive any cash proceeds in the transaction. The IRS considers the amount of any debt relief to be the purchase price in the deemed bargain sale.

Example(s): Donald donates a piece of real estate to charity. On the day of transfer, the property is worth \$25,000. His basis in the property at the time of the donation is \$15,000, and he has held the property for more than 12 months. Donald receives no cash in the transaction; however, the property was encumbered by a \$10,000 mortgage on the date of the transfer. The result is that the transaction is treated as a bargain sale. As such, the IRS considers Donald's windfall to be \$10,000, the amount of the outstanding debt. His allowable charitable deduction is \$15,000 (the fair market value of the property minus the sale proceeds). In determining gain on the transaction, the tax code requires Donald to allocate gain between the gift and sale portions of the transaction. So, \$9,000 is allocated to the gift part of the transaction (15/25ths of \$15,000) and \$6,000 (10/25ths of \$15,000) to the sale part. This \$6,000 is then offset against the sale proceeds of \$10,000 to determine the gain on the sale portion of the transaction. The result is a long-term capital gain of \$4,000 on the transaction, which Donald must report on his income tax return. Thus, Donald must pay taxes even though he did not receive any cash proceeds in the transaction.

What is the result on the sale of a partial interest in property?

The sale of a partial interest in property does not constitute a bargain sale. Rather, the sale of a partial interest in property falls under the category of split-interest gifts, so-called because the gift is split between a charitable beneficiary and a noncharitable beneficiary. There are four types of partial-interest gifts:

- An undivided portion of your entire interest in a piece of property
- A remainder interest in a personal residence or farm
- A remainder interest in real property granted only for conservation purposes
- An interest transferred in trust

In the trust situation, the tax code includes strict rules that must be followed to receive favorable tax benefits. Trusts that meet the tax code guidelines include charitable remainder annuity trusts (CRATs), charitable remainder unitrusts (CRUTs), pooled income funds, and charitable lead trusts. In any event, the IRS does not consider the sale of a partial interest in property to be a bargain sale.

What is the result when a corporation sells its own stock to charity?

Under IRS rules, when a corporation sells its own stock to charity and receives no money or property in return, the corporation recognizes no gain or loss on the sale. Thus, the bargain sale rules do not apply. The corporation is simply entitled to a charitable deduction equal to the difference between the stock's fair market value and the sale price to charity.

Is it better to make a bargain sale to charity or to sell the property at fair market value and then make an outright cash gift to charity?

From a tax perspective, it is usually better to make a bargain sale to charity because you do not pay income tax on the gain on the portion of the property considered a charitable donation.

Example(s): Suppose you own stock that you have held for more than 12 months with a fair market value of \$10,000 and an original purchase price of \$4,000. If you make a bargain sale to charity for \$4,000, the IRS considers your gain on the sale to be \$2,400. ($\$4,000$ sale price less your bargain sale adjusted basis of $\$1,600$, which you calculate as $\$4,000/\$10,000 \times \$4,000$ total adjusted basis). With a 15 percent capital gain tax rate, you will owe \$360 in taxes. (assuming that you have no offsetting losses, deduction or credits). By contrast, if you sell the stock for \$10,000, and then donate \$6,000 to charity, you will be subject to income tax on your \$6,000 profit. Thus, you will owe \$900 (assuming that you have no offsetting losses, deduction or credits). A bargain sale saves you \$540 in taxes.

Are there any circumstances when your charitable deduction for a bargain sale will be reduced?

The tax code includes rules that sometimes operate to reduce the amount of your charitable deduction. In certain circumstances, when long-term capital gain property is donated to charity, the amount of the charitable deduction must be reduced by any unrealized gain on that property. Likewise, when ordinary income property is donated to charity, the amount of the deduction must sometimes be reduced by the amount of unrealized ordinary income or short-term capital gain.

Example(s): Suppose you bought stock for \$4,000 and then donated it to charity four months later, when the stock was worth \$6,000. The value of your contribution to charity is \$6,000. However, under the reduction rules, the amount of your contribution is reduced by any short-term gain, in this case, \$2,000. Thus, your allowable charitable deduction is \$4,000.

These reduction rules operate differently in the context of a bargain sale. In a bargain sale transaction, the reduction rules are applied by calculating the amount of gain (either short-term or long-term) that would have been realized if you sold just the donated portion of the property at fair market value at the time of the bargain sale. Specifically, the gain used for computing the reduction amount is the difference between: (a) the fair market value of the portion of property donated to charity, and (b) the adjusted basis of the portion contributed to charity. This equals the adjusted basis of the entire property multiplied by the fair market value of the portion of property donated to charity, and divided by the fair market value of the entire property. Adjusted basis means the original cost of an asset, plus or minus any adjustments made to this cost.

Example(s): Thelma purchased stock three months ago for \$4,000. It is now worth \$10,000. She sells the stock to her church for \$2,000 in a bargain sale. The amount of Thelma's contribution to charity is \$8,000 ($\$10,000 - \$2,000$). Yet, under the reduction rules, this \$8,000 amount will be reduced by \$4,800. This reduction figure is calculated by subtracting \$3,200, which is the adjusted basis of the part of the stock contributed to charity ($\$4,000$ original cost \times $\$8,000$ amount of contribution/ $\$10,000$ value of entire stock), from the \$8,000 contribution to charity. The result is that Thelma's \$8,000 contribution to charity is reduced by \$4,800. Her allowed charitable deduction is \$3,200.



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