

A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains

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I. INTRODUCTION

Abel purchases 100 shares of Microsoft for \$10 per share, a total of \$1,000. When the price reaches \$100 per share, he donates the stock to the Museum of Fine Arts and claims a deduction for the market value, \$10,000. His \$9,000 gain is never taxed. On the other hand, if *Betty*, an artist, contributes her own painting to the museum, which similarly is worth \$10,000 and cost her \$1,000 to create, her gain is taxed indirectly. Her deduction is limited to basis,¹ which is generally equivalent to taxing the gain.²

When, however, a sale would result in a long-term capital gain, the deduction is limited to basis only if the donee is a private foundation³ or the property is tangible personal property and its use by the donee is unrelated to the donee's exempt function.⁴ While this provision seems intended to achieve indirect taxation of gain, it is not always equivalent to gain recognition followed by a fair market value deduc-

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¹ IRC § 170(e)(1)(A) (limiting charitable deduction to basis when gain would be taxed at ordinary income rates if the painting were sold).

² This approach, however, effectively, allows some deductions that otherwise may be denied by the limit on the charitable deduction. For example, assume an artist has adjusted gross income of \$100,000 and wishes to donate a painting with a zero basis and a fair market value of \$120,000. Under current law, the donation does not affect taxable income. On the other hand, if the contribution resulted in a realized gain of \$120,000 and the offsetting charitable deduction remained limited under § 170(b)(1)(A) to 50% of AGI or \$110,000, taxable income would increase by \$10,000.

³ IRC § 170(e)(1)(B)(ii). A fair market value deduction is allowed for traded stock. IRC § 170(e)(5). This preserves the incentive for private foundations without raising valuation concerns.

⁴ IRC § 170(e)(1)(B)(i).

tion.⁵ Since long-term capital gains are taxed at a lower rate, the taxpayer often would be better off if she sold the property, paid tax at the lower rate, and utilized the charitable deduction from a donation of the proceeds to offset higher-taxed ordinary income.⁶ This two-step maneuver would be unnecessary if the transfer resulted in constructive realization of gain and a fair market value deduction.⁷

This Article explores whether such taxation of built-in long-term capital gains should occur whenever appreciated property is contributed to charity.⁸ To set the stage for discussion of this issue, Section II briefly considers the argument for the charitable deduction itself. The point of this exercise is not to challenge the charitable deduction. Rather, it is to make it possible to determine whether the rationale for the charitable deduction indicates that the treatment of appreciated property should not be modified. I suggest that some combination of the following claims may support the charitable deduction:

(1) It is, at least arguably, appropriate in order to properly measure the tax base.⁹

⁵ As amended in 1969, IRC § 170(e) reduced the deduction in the case of capital gains property by 50% of the gain that would have been recognized as long-term capital gain if the property contributed had been sold at its fair market value. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201, 83 Stat. 487, 549. Since at that time, 50% of capital gain was excluded from income, the effect generally was the same as if the gain were realized and a fair market value deduction allowed.

⁶ This would not be true if the charitable deduction had to be used against capital gains nor for charitable giving in excess of the charitable deduction limit. Consider a taxpayer who has utilized the charitable deduction up to the limit and has sufficient other deductions to eliminate taxable income. This Article ignores the possible application of the minimum tax. Under current law, a gift of appreciated property has no effect on taxable income. This would not be the case, however, if the gain were realized since the charitable deduction would increase by only 50% of the gain.

⁷ Limiting the deduction to basis may be wise, however, at least whenever valuation is likely to be difficult. See text following note 93.

⁸ This generally is the result under the tax systems of a number of other countries, for example, Canada, Australia, Japan, and France. See Hugh J. Ault, *Comparative Income Taxation: A Structural Analysis* 239-41 (1997). Moreover, the issue has been debated for some time in the United States. In 1938 the House of Representatives recognized the "fallacy of a deduction for unrealized appreciation" and attempted unsuccessfully to pass a provision that limited the deduction for such property to the lesser of its adjusted basis or its fair market value. See Michael J. Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals*, 59 Va. L. Rev. 830, 847 n.49 (1973); Peter J. Wiedenbeck, *Charitable Contributions: A Policy Perspective*, 50 Mo. L. Rev. 85, 119 n.102 (1985). For purposes of the minimum tax, the 1986 Act limited the deduction to basis. Tax Reform Act of 1986, Pub. L. No. 99-514, § 701, 100 Stat. 2085, 2321. Congress eliminated this rule beginning in 1993. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13171, 107 Stat. 312, 454.

⁹ William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 344-46 (1972) [hereinafter *Personal Deductions*].

(2) It is the most sensible way to increase funding for the charitable sector.¹⁰

(3) It is essential in order to maintain the current level of support for existing institutions, which grew in response to the deduction and generally are supported by the public.

I believe that the first two of these arguments are not persuasive and that in the end support for maintaining the deduction, which I do not challenge here, may rest on the third.

This Article examines in Sections III and IV whether these arguments also support the absence of gain recognition upon the transfer of capital gains property to a public charity. I conclude that they do not. Since any gain not recognized upon a transfer to charity rarely would be recognized in the future, it would seem that, if income measurement is the concern, a transfer should be considered a realization event.¹¹

It sometimes is argued that property now contributed to charity otherwise would not be sold until after the death of the donor.¹² Since built-in gain on property held to death is not taxed,¹³ consistency arguably requires nonrecognition on a transfer to charity. I reject this argument on equity grounds in Section III, even though I assume that basis step-up will continue.

Section IV examines the treatment of appreciated property as an incentive. It suggests that constructive realization of gain:

(1) should not have a significant impact on the timing of transfers, particularly if the limit on the charitable deduction were eliminated,

(2) would beneficially encourage gifts in cash rather than in kind, and

(3) would have an uncertain effect on the total amount of giving.

¹⁰ See Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 *Tenn. L. Rev.* 687 (1999) (discussing the effect of tax policy on charities).

¹¹ Since the property is transferred as a gift, the charity's basis would be the same as the donor's. IRC § 1015. Since the charity is generally tax-exempt, its basis for property is ordinarily not relevant. Basis is relevant on a gift of stock in an S corporation since the sale of stock is subject to the tax on unrelated business income (UBIT). IRC § 512(e)(1). Unrealized gain eventually could be taxed on a donation by an S corporation as well. Since shareholder basis is reduced by the value of the contributed property, not its basis, the built-in gain affects the amount of gain reported on a sale of the stock. See Joint Comm. on Tax'n, 107th Cong., *Description of an Amendment in the Nature of a Substitute to H.R. 7, The "Community Solutions Act of 2001,"* at 19 (Comm. Print 2001) (proposing change to this rule). One alternative to constructive realization of gain on a transfer to charity would be to tax the charity when it sells. That possibility is not pursued here.

¹² See Wiedenbeck, note 8, at 122 n.117 (citing Comm'n on Private Philanthropy and Public Needs, *Giving in America: Toward a Stronger Voluntary Sector* 145-46 (1975) [hereinafter *Filer Commission Report*]).

¹³ IRC § 1014(a)(1) (allowing basis to "step up" to fair market value).

Section V states the conclusion.¹⁴ In short, I conclude that the current treatment of appreciated property is inequitable and need not have a significant impact on the timing of contributions. Therefore, it can be justified only on the ground that it is an uniquely efficient incentive for additional contributions. Since the evidence for that conclusion is weak, I favor constructive realization of gains on all transfers to charity, with the possible exception of property uniquely important to the charitable mission, such as works of art or environmentally-sensitive land. I do not object to other measures to maintain the overall incentive for charitable giving. In particular, I propose the elimination of the limit on charitable deductions for transfers to public charities.

II. THE CHARITABLE DEDUCTION

Most observers justify the charitable deduction as an incentive, a means to encourage taxpayers to increase their contributions to charity.¹⁵ The tax system is not the only way to accomplish this goal. The government could enhance contributions to charity by a matching grant. Much like many employers do, it could offer to "match" individual contributions by contributing some percentage of the donation to the charity chosen by the donor. In fact, 30 years ago, some advocated replacing the charitable deduction with a direct government match.¹⁶ Such a program could match an equal percentage of all contributions, which would allow all individuals to direct an amount of federal funds in proportion to their own out-of-pocket contributions. Alternatively, the match could vary by donee or by the individual's "effort" as measured by the percentage of income contributed.¹⁷

A tax deduction or credit could achieve equivalent results. The "match" would occur if donors responded by adding the tax savings associated with the contribution to the out-of-pocket amount they were willing to transfer to charity. Similarly, a matching grant achieves the intended result only when the match does not cause contributors to reduce their out-of-pocket donation. The extent to which

¹⁴ Readers who are familiar with this subject may wish to focus on Sections III and IV.A.

¹⁵ See, e.g., Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 Va. L. Rev. 1393, 1396 (1988) (discussing whether the deduction can be justified on equity or efficiency grounds).

¹⁶ E.g., Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 Tax L. Rev. 377, 396-413 (1972).

¹⁷ Paul R. McDaniel, *Study of Federal Matching Grants for Charitable Contributions*, in 4 *The Commission on Private Philanthropy and Public Needs, Research Papers* 2417, 2417-19, 2426 (1977).

a donor maintains her out-of-pocket cost determines the equity and efficiency of the incentive.

We all know that one's demand for movies, for example, may depend on the price. Consider an individual who now attends one movie a week at a cost of \$10. If her demand for movies is inelastic and the price of a movie declines to \$5, she still may go to only one movie and reduce total movie spending. Or she may go to three movies every two weeks, seeing more movies at less cost than before (an average of \$7.50 per week). Alternatively, she may go to two movies a week, keeping her out-of-pocket cost constant. Finally, since movies are so cheap, she might see three movies a week, increasing her cost for movies, despite the price decline.

Since the charitable incentive reduces the price of buying charitable services, the effect is similar to a decline in movie prices. Assume *Barbara*, an individual in a 40% bracket,¹⁸ would contribute \$100 to charity in the absence of a deduction. She would be out of pocket \$100. Due to the deduction, *Barbara* can now purchase \$100 of charitable services for only \$60. Like the response to the reduction in the cost of movies, there is a question how people like *Barbara* will respond to a decline in the price of charitable giving. Will a deduction cause her to "purchase" more charity as opposed to other goods and services? The range of possibilities can be put into four categories.

First, the deduction has no impact on the amount of the gift. In this case, the charity still will get \$100. The \$40 revenue loss from a \$100 deduction goes entirely to *Barbara* without any gain to charity. If this is the result, the charitable deduction obviously has failed as an incentive and would have to be defended, if at all, on other grounds.

Second, *Barbara* increases her donation but by less than the tax savings. The donor's out-of-pocket cost again declines, but not as much. A transfer between \$100 and \$166.67 would have this characteristic. For example, if the donation increases to \$150, there is a revenue loss of \$60, which exceeds the \$50 increase in charitable giving. There is a \$10 benefit to *Barbara*, whose out-of-pocket cost declines to \$90 (\$150 contribution less \$60 tax savings).

Third, *Barbara* increases her donation by the exact amount of the tax savings, so that out-of-pocket cost and "private" consumption are unchanged. This occurs if *Barbara* increases her gift to \$166.67. In that case, the donor again has given up \$100 of private consumption, which is the amount available after tax from pretax earnings of \$166.67.

Fourth, *Barbara* increases her donation by more than the tax savings, that is to an amount greater than \$166.67. *Barbara's* out-of-

¹⁸ For purpose of simplification, all examples in this Article assume a flat rate of 40%.

pocket cost increases so that she has less money available to spend on noncharitable pursuits. As with the fourth alternative with respect to movies, charitable giving is so cheap that the donor spends even more of her own money on charity than she would have at the higher price. For example, if *Barbara* gives \$200 to charity, she will have forgone \$120 of private consumption and have saved \$80 in tax. Since the gift increases from \$100 to \$200, the charity has an additional \$100, at a revenue loss of only \$80. *Barbara* reduces her private consumption by \$20.

Some have argued that the charitable deduction is tax efficient in the sense that the fourth alternative describes the impact of the deduction.¹⁹ The price reduction for charitable services increases demand so much that the increase in giving exceeds the revenue loss from the deduction. Earlier research supported this claim,²⁰ but, while results vary a great deal, the preponderance of opinion today seems to be that the revenue loss exceeds the additional giving, possibly by a very substantial amount.²¹ Unlike the earlier research, more recent studies attempt to trace the behavior of the same individuals over time and to separate transitional effects, as donors anticipate a change in their tax situation, from the permanent impact of a tax change.

Thus, if Congress eliminated the deduction it plausibly could increase the level of support to the charitable sector without additional cost, merely by appropriating the money, derived from repealing the deduction, for direct government programs. This could include gov-

¹⁹ E.g., Charles T. Clotfelter, *The Impact of Tax Reform on Charitable Giving: A 1989 Perspective*, in *Do Taxes Matter? The Impact of the Tax Reform Act of 1986*, at 203, 206-13 (Joel Slemrod ed., 1990) [hereinafter *Impact*]; Charles T. Clotfelter & C. Eugene Steuerle, *Charitable Contributions*, in *How Taxes Affect Economic Behavior* 403, 422-31, 436 (Henry J. Aaron & Joseph A. Pechman eds., 1981) (supporting the proposition that, with respect to higher income taxpayers, donations will increase by an amount exceeding revenue loss); Martin Feldstein, *The Income Tax and Charitable Contributions: Part I—Aggregate and Distributional Effects*, 28 *Nat'l Tax J.* 81, 82 (1975).

²⁰ See Clotfelter & Steuerle, note 19, at 407-36 (summarizing earlier research).

²¹ See, e.g., Gerald E. Auten, Charles T. Clotfelter & Richard L. Schmalbeck, *Taxes and Philanthropy Among the Wealthy*, in *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* 392, 415-17 (Joel Slemrod ed., 2000); Kevin Stanton Barrett, Anya M. Guirk & Richard Steinberg, *Further Evidence on the Dynamic Impact of Taxes on Charitable Giving*, 50 *Nat'l Tax J.* 321, 328-29, 332 (1997); Joseph J. Cordes, *The Cost of Giving: How Do Changes in Tax Deductions Affect Charitable Contributions*, in *Emerging Issues in Philanthropy Seminar Series 2* (Urban Inst. Center on Nonprofits and Philanthropy & the Harvard Univ. Hauser Center for Nonprofit Organizations, 2001), available at http://www.urban.org/UploadedPDF/philanthropy_2.pdf (last visited Jan. 7, 2003); Pamela Greene & Robert McClelland, *Taxes and Charitable Giving*, 54 *Nat'l Tax J.* 433 (2001); William C. Randolph, *Dynamic Income, Progressive Taxes and the Timing of Charitable Contributions*, 103 *J. Pol. Econ.* 709, 721-26 (1995). But see Laura Tiehen, *Tax Policy and Charitable Contributions of Money*, 54 *Nat'l Tax J.* 707, 711-16 (2001) (suggesting that increased giving may be approximately equal to the revenue loss, but noting that she was unable to separate transitory from permanent effects).

ernment grants or contractual payments to charitable organizations that act as intermediaries. A great deal of this, of course, occurs.²² Nevertheless, a matching grant program, directly or through means of a tax deduction or credit, may have certain advantages.²³

First, there is no assurance that elimination of the charitable deduction would lead to increased government support for the philanthropic sector.

Second, the deduction allows individuals to direct federal funds, as opposed to leaving the choice up to the majority of the Congress, whose support might be accompanied by an increase in government supervision. An increase in giving less than the tax savings could be acceptable if one believes that the advantages of pluralism and less red tape are such that, say, an additional \$50 (as in the second example above) directed to charity by *Barbara* is superior to the potential transfer of \$60 directly by Congress.

Third, it may be more efficient to give tax, or other relief, to contributors than it would be for the government to make direct transfers to charity. Thus, some assert that individuals will respond to government grants, which increase the resources of charities, by reducing their own contributions.²⁴ Therefore, the assets available to charity would not increase by the cost of the government program. In addition, while not everyone agrees, some suggest that direct government grants would have a larger impact on out-of-pocket transfers than would the tax savings associated with a deduction.²⁵ Thus, assume *Barbara* would donate \$60 to charity if there were neither a tax deduction nor direct government support. Assume further, that she responds to the charitable deduction by increasing her contribution to \$90, reducing her out-of-pocket cost to \$54. As indicated, some observers suggest that if the charitable deduction were repealed and the government increased its support by the revenue gain, in the form of direct grants, *Barbara* not only would not return to her pre-deduction gift of \$60, but, since she would consider the additional government

²² See James Andreoni & A. Abigail Payne, *Government Grants to Private Charities: Do They Crowd Out Giving or Fundraising?* 1-2 (Inst. of Gov't & Pub. Affairs, Univ. of Ill., Working Paper No. 94/09, 2001) (analyzing data on tax returns of 474 social services organizations and 245 arts organizations between 1982 and 1996; the average government grant to social services organizations was \$2.7 million while the average government grant to art organizations was \$1.2 million).

²³ William C. Randolph, *Charitable Deductions*, in *The Encyclopedia of Taxation and Tax Policy* 52, 54 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle eds., 1999); Cordes, note 21, at 3.

²⁴ E.g., Cordes, note 21, at 3.

²⁵ Brody, note 10, at 759; Cordes, note 21, at 3. But see Barrett et al., note 21, at 328-29, 332 (suggesting that using the price elasticities they find for the charitable deduction, direct government expenditures are probably more efficient).

support to make her contribution less essential, she likely would reduce her gift to below \$54.

Finally, some assert that when individuals are encouraged to donate to charity, it causes them to lend support in other ways, for example, by volunteering services.²⁶

These arguments would not necessarily support the use of the tax system as opposed to a matching grant or, if the tax approach is used, a deduction in lieu of a credit. In the case of a credit, the tax savings, and thus, the presumed government "match," could be the same percentage of the contribution for all taxpayers. If the credit were refundable, the match would be identical for all individuals, as in the case of a matching grant.

The tax savings associated with a deduction, on the other hand, depends upon the marginal tax rate of the donor. The "match" would be two-thirds of the out-of-pocket cost of the contribution for someone subject to a 40% rate,²⁷ but only about 18% for a taxpayer in the 15% bracket.²⁸ The match is, of course, nothing at all for those not subject to income taxation. Thus, a deduction favors higher-bracket taxpayers. Moreover, in its current form, the deduction is limited to itemizers²⁹ and may be particularly favorable to those who are able to contribute appreciated property.

Nevertheless, a deduction sometimes is said to be both more efficient and more equitable than a credit.³⁰ This is based on the assumption that the price elasticity of giving is highest for the rich. In other words, for each dollar of revenue loss, the wealthy will give more to charity than the less wealthy. Therefore, by concentrating the tax benefits on the wealthy, a deduction most efficiently maximizes the ratio of increased giving to revenue loss.³¹ Moreover, if the wealthy increase their giving by more than the tax savings, an assumption which, as noted above, at one time was accepted as valid,³² the result is that the wealthy have less to spend on themselves. On the other hand, if the tax benefit were in the form of a credit, the wealthy would give

²⁶ Cordes, note 21, at 3.

²⁷ The out-of-pocket cost for a \$100 contribution is \$60 and the government "match" of \$40 is two-thirds of \$60.

²⁸ The out-of-pocket cost for a \$100 contribution is \$85 and the government "match" of \$15 is 17.6% of \$85.

²⁹ IRC § 63(b), (d).

³⁰ Gerard M. Brannon, *Tax Expenditures and Income Distribution: A Theoretical Analysis of the Upside-Down Subsidy Argument*, in *The Economics of Taxation* 87, 92-95 (Henry J. Aaron & Michael J. Boskin eds., 1980); see also Martin Feldstein, *A Contribution to the Theory of Tax Expenditures: The Case of Charitable Giving*, in *The Economics of Taxation*, supra at 120-21.

³¹ Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* 66 (1985) [hereinafter *Tax Policy*] (citing studies to this effect); Clotfelter & Steuerle, note 19, at 416, 427.

³² See text accompanying note 19.

less, retaining a greater amount for direct personal consumption, while the less well-off would give more, retaining less for direct consumption. These arguments suggest that aiming federal support at those who are more likely to increase their own out-of-pocket costs, or at least reduce them by a smaller amount, can be both efficient and equitable.

This analysis, however, ignores the personal consumption that may arise from directing charitable gifts and the reality that the well-off favor different charities than those favored by the population in general.³³ Thus, it treats all charitable giving as a unit without regard to the actual donees or the individuals that select them. Moreover, as noted above, recent research suggests that the elasticity of giving for the wealthy is not as great as once thought.³⁴ Since the tax savings from the deduction likely exceeds the increase in giving, leaving more for private consumption, it seems important to be more certain than we apparently are that elasticity increases as income rises.³⁵

These objections would be irrelevant if a deduction could be defended, as some do, on the ground that an appropriate tax base is income reduced by charitable contributions. William Andrews so supported the charitable deduction, asserting that "taxable consumption should embrace only private, preclusive, household consumption."³⁶ Many observers have challenged this view, in my opinion persuasively.³⁷ Nevertheless, to the extent that the charitable deduction can be said not to reduce taxable income below the amount spent on private consumption, its limitations as an incentive may seem less disturbing.

In sum, the argument for a deduction as the best means of increasing support for charity may not be overwhelming. The case for a credit may be stronger. In the end, therefore, a deduction may have to be defended on the basis that it has led to a particular pattern of federal support, fostering the growth of certain institutions. A credit would direct funds to different organizations and, in particular, would

³³ Auten et al., note 21, at 405-06; John G. Simon, *Charity and Dynasty Under the Federal Income Tax System*, in the *Economics of Nonprofit Institutions* 246, 248 (Susan Rose-Ackerman ed., 1986).

³⁴ See text accompanying note 21.

³⁵ Clotfelter, *Tax Policy*, note 31, at 71; Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 *Case W. Res. L. Rev.* 663, 685 (1988) (suggesting evidence showing that elasticity increases as income rises is not conclusive).

³⁶ Andrews, *Personal Deductions*, note 9, at 371. As discussed below, see text accompanying notes 54-55, Andrews did not support the current treatment of appreciated property. Andrews, *Personal Deductions*, note 9, at 372.

³⁷ Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 *Hastings L. J.* 343, 375-77 (1989); Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 *Stan. L. Rev.* 831, 844-58 (1979); see also Gergen, note 15, at 1414.

likely increase support for religious organizations.³⁸ Therefore, it may not make sense to support a credit, which would be disruptive and controversial, unless one also asserts that this shift in priorities is desirable. In any event, I assume for the purpose of this Article that the charitable deduction will remain as is. The question is whether that means there should be no change in the treatment of appreciated property as well.

The fair market value deduction for appreciated property similarly might be defended on the ground that it is an efficient incentive for charitable giving. In particular, it might be argued that the current treatment is important to the growth and maintenance of certain institutions, such as museums and universities, which are heavily dependent on property gifts, and that there is no evidence of public disapproval of this result. Nevertheless, even if one uncritically accepts these assertions in support of the charitable deduction, I believe that we should be more skeptical about the treatment of appreciated property. In my view, stronger proof than now available is required to justify current law. My reasons are set forth in the next two Sections.

III. EQUITY OF THE FAIR MARKET VALUE DEDUCTION

A. *In General*

Supporters of current law would emphasize the incentive provided by the fair market value deduction and would argue that, as long as there is a basis step-up at death,³⁹ the treatment of appreciated property is indistinguishable from the treatment of cash gifts and has no additional revenue cost.⁴⁰ Consider *Charlotte*, who now makes her charitable donations with appreciated property, but has enough cash or full-basis property to meet her desired level of both consumption and charitable contributions. If constructive realization applied to a transfer to charity, she conceivably could maintain her current level of donations with cash, while holding all appreciated property until death to avoid recognition of gain. Since *Charlotte* would not expect to pay tax on sale, even zero-basis property could be considered to be equivalent to cash.⁴¹ In other words, a gift of property, like a gift of cash, would cost a donor in the 40% bracket 60% of the amount received by charity and the revenue loss would be identical.

³⁸ See generally Simon, note 33, at 251-59; Jeff Strnad, *The Charitable Contribution Deduction: A Politico-Economic Analysis*, in *Economics of Nonprofit Institutions*, note 33, at 265.

³⁹ IRC § 1014.

⁴⁰ See Lawrence B. Lindsey, *Gifts of Appreciated Property; More to Consider*, 34 *Tax Notes* 70 (Jan. 5, 1987).

⁴¹ See *id.* at 67.

Nevertheless, I believe that it is appropriate to insist on stronger proof of the efficiency of the current treatment of appreciated property for three reasons. First, even if the supporters' argument is correct, the transfer of appreciated property to charity allows donors to achieve diversification without gain recognition, which is both unfair and inconsistent with the goal of other Code provisions.

Second, particularly if contributed property otherwise would be sold, the treatment of appreciated property further tilts the benefits of the charitable deduction towards the wealthy who are most able to take advantage of it.

Finally, the treatment of appreciated property cannot be defended as a means of measuring the amount available for private consumption.

The equity and income measurement aspects of this argument are considered next. I defer discussion of the incentive impact to Section IV.

B. Diversification and Gain Recognition

The treatment of property transfers to charity unfairly allows taxpayers to diversify tax-free without waiting until death. Even though *Charlotte* has sufficient cash for both "private" consumption and the desired level of giving, she has an incentive to donate appreciated property in lieu of cash. The donation of low-basis property to charity enables *Charlotte* to dispose of undiversified holdings without tax ever being collected on the gain, while retaining cash, which she can use for new investments.⁴² This result is inconsistent with § 1259, which requires gain to be recognized when a taxpayer eliminates substantially all the risk of loss and opportunity for a gain on an investment that previously appreciated in value.

This provision suggests that acceptance of realization as the taxable event derives its force from the proposition that it is appropriate to tax when there is a shift in risk.⁴³ While the realization requirement usually is said to be administratively necessary because of the difficult problems of valuation and liquidity that would arise if taxpayers were required to account for any change in value that occurred during the taxable year, in many cases there is little connection between realiza-

⁴² This extra advantage, which makes gifts more attractive, may increase charitable giving at no additional revenue loss. C. Eugene Steuerle & Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 *Am. J. Tax Pol'y* 399, 417 (1995). But see text accompanying notes 101-07.

⁴³ Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 *Tax Notes* 967, 970 (Nov. 24, 1997).

tion and either liquidity or valuation.⁴⁴ With marketable securities neither is a problem, whether or not a sale takes place. On the other hand, when there is an exchange of property, both liquidity and valuation may be a concern; yet on many exchanges gain or loss must be recognized. Taxable events more consistently seem to track a significant change in the nature of the taxpayer's holdings.

When the growing use of forward contracts, equity swaps, and other financial products made it easier to eliminate risk without recognition of gain, Congress changed the law.⁴⁵ As Treasury put it, "It is inappropriate for taxpayers to be able to dispose of the economic risks and rewards of owning appreciated property without realizing income for tax purposes."⁴⁶ But, this is exactly what *Charlotte* can do. By transferring property in lieu of cash to charity, she disposes of an appreciated asset and can replace it with a new investment without paying tax.

One might argue that this opportunity is no different than that available to *Charlotte*'s heirs after her death. Holding property until death to obtain a basis step-up has a price, however, the inability to diversify one's holdings.⁴⁷ Charitable contributions, without gain recognition, can substantially accelerate the point at which untaxed diversification is achievable. In my view, basis step-up at death is unjustified and should be eliminated. It certainly should not be used as an excuse for permitting the additional inequity of lifetime diversification without tax. In short, there is a cost associated with the benefit of the basis step-up and *Charlotte* should not get the benefit without paying that price.

Of course, *Charlotte* has to be willing to transfer part of her assets to charity in order to achieve tax-free diversification. If her marginal rate is 40%, a transfer of property worth \$100 reduces the value of her holdings by \$60. This is also true, however, of a cash transfer to charity. The question is whether an additional benefit for contributions of

⁴⁴ Michael J. Graetz & Deborah H. Schenk, *Federal Income Taxation, Principles and Policies* 144-45 (rev. 4th ed. 2002) (discussing liquidity and valuation concerns).

⁴⁵ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001(a), 111 Stat. 788, 903-06.

⁴⁶ Treasury Dep't, General Explanations of the Administration's Revenue Proposals (1997), 97 TNT 26-5, Feb. 7, 1997, available in LEXIS, TNT File.

⁴⁷ Diversification without tax may be available to those who are willing to participate in so-called swap funds, Gary B. Wilcox & Byron L. Shoji, *Investment Company Limitations for Corporations and Partnerships* (2002), available at WESTLAW, 479 PLI/Tax 325; see David Cay Johnston, A Tax Break for the Rich Who Can Keep a Secret, *N.Y. Times*, Sept. 10, 2002, at C1, or who have the wealth to engage in other complex arrangements with high transaction costs; William M. Paul, *Constructive Sales Under New Section 1259*, 76 *Tax Notes* 1467 (Sept. 15, 1997). Of course, in my view, these opportunities to diversify without tax should be cut off as well.

property is a necessary and efficient incentive for charitable giving. This is discussed in Section IV.

It is noteworthy, moreover, that by a partial transfer to charity, *Charlotte* could obtain an equivalent amount of tax-free diversification while giving much less away. For example, *Charlotte* could transfer the \$100 of appreciated property to a charitable remainder trust with a life interest for herself, and after her death for her grandchildren, equal to as much as 90% of the value of the property transferred.⁴⁸ Since the trust is tax-exempt,⁴⁹ it could sell the property without tax consequences. The income beneficiaries would be taxable on the capital gain only if distributions from the trust exceeded ordinary income for the current and all prior years.⁵⁰

Given the \$4 tax savings from the transfer of a \$10 interest to charity and the value of the noncharitable interest in the trust (\$90), *Charlotte* effectively may obtain tax-free diversification while giving up only 6% of the value of the property to charity. This behavior might make sense even for a donor who has no charitable impulse. Since there is very little benefit to charity, the inequity of allowing diversification without gain recognition is particularly strong in the case of a partial transfer and seems unwarranted even if the treatment of outright gifts is unchanged.

C. Excessive Benefits to the Wealthy

As noted above, some have suggested that since donors like *Charlotte* would merely switch to cash gifts, and hold the undiversified property until death, a gift of property does not imply the additional advantage of avoiding the tax on the gain. But even such a donor gets the additional advantage of diversification. Moreover, it seems likely that some current property donors would recognize gain if constructive realization applied to charitable transfers. First, holding property until death could leave *Charlotte* with a less diversified portfolio than she is able to achieve now without tax. She may well find this result unsatisfactory and, therefore, would sell property or give property to charity in order to be able to achieve further diversification.⁵¹

Others may not have sufficient cash or high-basis property to cover their current level of giving. They may be even more likely to continue to make contributions in kind or to sell property to obtain cash

⁴⁸ IRC § 664(d)(1)(D).

⁴⁹ IRC § 664(c).

⁵⁰ IRC § 664(b).

⁵¹ Lindsey points out that the value of appreciated property given to charity in a year may well be less than 1% of the amount of untaxed accrued gains in that year. Lindsey, note 40, at 69. He thus suggests that retention to death would be much more common.

to donate. If these realizations would occur, current law results in a revenue loss and provides a greater benefit to those who contribute appreciated property. With both a deduction and an exclusion from income, a gift of appreciated property costs as little as 40 cents on the dollar.⁵² This substantially expands the favoritism for the wealthy beyond what results from the choice of a deduction in lieu of a credit.

The idea of pluralism suggests that we are better off when all individuals help select the beneficiaries of government funds rather than leaving it to the political process. It is inconsistent with this idea to leave so much of the choice to the rich and to allow them to make the selection at so little pain to themselves.

D. *Equity and Income Measurement*

As noted above, some support the charitable deduction as necessary to limit the tax base to "private, preclusive, household consumption."⁵³ A fair market value deduction without taking account of unrealized gain cannot be so defended.⁵⁴ To the extent the contribution consists of untaxed appreciation, the deduction eliminates the tax on other income, which the donor retains for personal use.

In my original example in which *Abel* is allowed a \$10,000 deduction for the fair market value upon contributing Microsoft stock that cost him \$1,000, the deduction allows him to avoid tax on \$9,000 of other income, retained for personal use and not donated to charity. If the goal of the charitable deduction is to measure income available for private consumption, only a deduction of \$1,000 is required in order to recognize that *Abel* may have paid tax on the \$1,000 he used to purchase the Microsoft shares.

As Andrews recognized, however, the income measurement rationale also would put into question the treatment of charitable contributions made from realized capital gains, inherited property, and tax-exempt income, such as interest on state and local bonds.⁵⁵ For example, consider *Abel's* son *Alan*, who inherits the Microsoft stock with a basis and value of \$10,000. If *Alan* donates this stock to charity, he,

⁵² The apparent justification for constructive realization of ordinary income and short-term gains, IRC § 170(e)(1)(A), is that a fair market value deduction would be overly generous. In particular, at a 70% marginal rate, the top rate in 1969, a deduction for fair market value enabled the donor to gain more from a donation than from a sale. This result can occur only if the marginal rate is above 50%. Nevertheless, the combination of the exclusion of ordinary income and the charitable deduction may be thought to reduce the real cost of the charitable transfer to an unacceptably low level. I argue in the text that the same conclusion should be reached as to capital gain property.

⁵³ Andrews, Personal Deductions, note 9, at 371.

⁵⁴ *Id.* at 372.

⁵⁵ *Id.* at 372-74.

like *Abel*, is giving away an amount that has never been taxed. Therefore, a fair market value deduction would eliminate tax on other income not given to charity. If the treatment of *Alan* is not considered inappropriate, it may seem more difficult to challenge the treatment of *Abel* on the ground that it is not consistent with income measurement.

Nevertheless, the treatment of appreciated property is, in this context, unlike other tax preferences. Thus, one could explain current law as establishing an ordering rule that treats charitable contributions as made first from fully-taxed income. *Alan*, of course, must have some taxable income; otherwise, he would get no benefit from the charitable deduction. Treasury at one time proposed apportioning charitable deductions between taxable and tax-exempt income.⁵⁶ While this makes sense, allocating charitable deductions first to fully taxed income could be deemed consistent with the hoped-for incentive effect. Perhaps for similar reasons, it may not be considered troublesome that deductions do not offset capital gains until ordinary income is reduced to zero.

Possibly, one could justify the current treatment of appreciated property on this basis. Thus, even though *Abel* actually contributes Microsoft stock, his donation could be deemed to come out of fully taxed income, to the extent thereof. A gift of appreciated property is distinguishable, however, in that it is the gift itself that is the source of the tax preference. It is only by contributing property that the donor can both avoid tax on the gain and change the property she owns.

Thus, suppose the law were changed as this Article suggests, so that *Abel* would be subject to a tax on a donation of his Microsoft stock. It would be useless to require on a gift of property that *Abel* use his charitable deduction to offset this capital gain. *Abel* would merely sell the Microsoft stock and contribute cash to charity, which would enable him to use the deduction to offset ordinary income. Similarly, with a minimum of planning, taxpayers can avoid any effort to trace charitable contributions to tax-exempt receipts.

On the other hand, if appreciated property transfers were taxable, avoidance of tax on the gain would require a real change in position. *Abel* would have to contribute cash and continue to hold the Microsoft stock. In that circumstance, tracing the charitable contribution to its actual source, for example, to justify limiting the deduction to previously taxed income or basis, is both feasible and appropriate. Unlike the examples in the previous paragraph, failure to trace represents an affirmative decision to allow the tax preference.

⁵⁶ House Comm. on Ways and Means and Senate Comm. on Finance, 91st Cong., Tax Reform Studies and Proposals, U.S. Treasury Department (Comm. Print 1969).

I recognize that this line of reasoning may conflate the income measurement argument with the argument that it is inappropriate to allow diversification without gain recognition. I think it explains, however, why the income measurement justification for the charitable deduction raises questions as to the treatment of appreciated property even though the result as to gifts of capital gains or tax-exempt receipts remains unchanged.

In sum, I believe that the current treatment of gifts of appreciated property is seriously inequitable. Nevertheless, supporters might assert that constructive realization on charitable transfers would have a devastating effect on contributions. In other words, the increase in contributions justifies the unfairness in the treatment of appreciated property. The next Section examines this claim.

IV. INCENTIVE EFFECTS OF GAIN FORGIVENESS

Treating the transfer of appreciated property as a realization event might have three separate potentially harmful effects. First, donors might delay transfers until after death. Second, contributions more often would be made in cash rather than in kind. Third, donors would reduce their contributions. I explore these potential impacts of a change in law in some detail below, but let me begin by summarizing my conclusions.

As to timing, even with constructive realization, it would still make sense for most to give during life in order to take advantage of the income tax deduction, which is ordinarily more valuable than avoiding the tax on gain. Moreover, if the deduction for charitable contributions were unlimited, those who now make nondeductible contributions at least would continue to be indifferent between lifetime and testamentary transfers and could have a new preference for lifetime giving. Finally, constructive realization would reduce, and in many cases eliminate, the incentive that now exists to defer lifetime giving in order to increase personal consumption.

As to the form of the gift, with the possible exception of property uniquely important to the mission of the donee, encouraging gifts to be made in kind is not sensible. In kind gifts may be difficult to value and, in addition, impair the welfare of the recipient, which has to deal with property it may not want and that may be costly to sell.

Thus, I would argue that current law can be justified only by establishing that forgiveness of gain is the most efficient feasible way to increase charitable giving (in terms of the ratio of additional gifts to lost revenue). Moreover, I believe it is essential to establish that an efficiency advantage, if it exists, is large enough to justify the loss of equity. In my view, this case has not been made.

A. *Timing of the Transfer*

This Section discusses the impact of existing law on the timing of the gift. I assume for this purpose that the donor has identified a holding of appreciated property that she intends to give to charity. I conclude that, since the income tax deduction would be lost if property were held to death, lifetime gifts generally would still minimize the tax burden, even if the gain were subject to tax. I recognize that if constructive realization were adopted, those who make contributions in excess of deductible limits would have an incentive to defer giving until death.⁵⁷ Such deferral would provide the advantage of a step-up in basis without cost since these donors are unable to claim an income tax deduction. Eliminating the limit on charitable deductions, which constructive realization makes feasible, at least would restore neutrality between life and death transfers and could create an advantage for lifetime giving. While there may be arguments that would support a limit in some form, it would make sense, on balance, to accept an unlimited deduction in order to achieve constructive realization.

Moreover, it usually is not noted that if a donor wishes to invest in property that she expects to appreciate, she often would gain by deferring the contribution to later in life. This results in tax-free appreciation. Constructive realization of gain would reduce, if not eliminate, this potential advantage of deferring lifetime giving. Thus, if the goal is to encourage a gift as early as possible, current law could be counterproductive.

1. *Potential Deferral Until Death—Deductible Gifts*

Under current law, a donor achieves three potential benefits from a charitable gift of appreciated property during her lifetime—income tax deduction, elimination of capital gains tax, and estate tax exclusion. In contrast a testamentary gift achieves only the latter two. If a lifetime gift resulted in realization of gain, however, the donor would forgo one of these three benefits, as a capital gains tax would have to be paid. It could be avoided only if property was held until death. By doing so, the donor would have to forgo either the income tax deduction (if the will left property to charity)⁵⁸ or the estate tax exclusion (if

⁵⁷ As discussed below, it appears that in some circumstances, constructive realization would have little or no effect on tax liability and could even reduce the tax burden in the case of a currently nondeductible gift. Of course, to the extent the latter would be true, the donor, in the absence of constructive realization, would have the option to sell the property and give cash to the charity. It is possible, however, that a sale of a painting, for example, to a charity, where the charity uses cash that had been contributed by the seller immediately prior to the sale, might be treated as a gift in kind.

⁵⁸ I assume that a charitable transfer at death would get the benefit of the basis step-up.

all property passed to the heirs who then made a deductible charitable gift). Given this choice, it generally would be cheaper to pay the capital gains tax.

A charitable deduction offsets ordinary income, to the extent thereof, before offsetting capital gains. Hence, as long as a capital gains preference exists, the deduction for a gift of appreciated property almost always would save more tax than the cost of gain recognition.⁵⁹ Therefore, for deductible contributions, a lifetime charitable gift would still reduce taxes more than a testamentary transfer would even if the latter allows gain to escape tax.

If it were possible to count on the donation being made by the heir, both the deduction and avoidance of capital gain could be achieved.⁶⁰ An estate tax would have to be paid, however, which is, again, likely to be more costly than the tax on the gain.

A donor who is not subject to the estate tax would prefer a "testamentary" gift only if she is willing to trust her heirs to make a contribution not required under her will. Further, if carryover basis accompanied repeal of the estate tax there would be no advantage in delaying a gift until death.

Of course, taxpayers do not always maximize tax savings. In particular, there seems to be less lifetime giving and more bequests than tax minimization would imply.⁶¹ Therefore, if the benefit of lifetime giving declines, this conceivably could impact the amount of such gifts even if they were still tax-preferred.⁶² Nevertheless, tax minimizers would have no reason to defer gifts until the step-up is available.

The examples in Table 1 prove this conclusion by illustrating the amount available to an heir after all taxes have been paid, where the donor has \$100 of wages and \$100 of zero-basis property, which is given to charity. Of course, this is the case where the impact of the constructive realization would be most severe. The examples compare the outcome when the gift is made just before death, at death, or im-

⁵⁹ If there is insufficient ordinary income so that the charitable deduction offsets capital gain, the donor still would benefit from a lifetime gift because, except in the case of zero-basis property, the deduction would be larger than the amount of gain recognized. In the latter case, the donor would be neutral, as the additional lifetime advantage from the deduction would exactly offset the disadvantage of gain recognition.

⁶⁰ This situation is *Case c* in Table 1, following text at note 63.

⁶¹ Auten et al., note 21, at 414. Cf. Gabriel Rudney & Shirley Rudney, *Generosity of the Wealthy: Facts and Speculations*, 56 *Tax Notes* 107 (July 6, 1992) (suggesting factors other than tax minimization influence lifetime giving).

⁶² Those who are uncertain that they can afford a given level of charitable giving may be most affected by an extra tax burden that would reduce their private holdings.

mediately after death.⁶³ The estate tax rate is assumed to be 50%, the income tax rate 40%, and the capital gain rate 20%.

TABLE 1

	Wage	Donor's Income Tax	Donor's Capital Gain	Estate Tax	Heir's Income Tax	Net
a. Lifetime gift- current law	\$100	\$ 0	\$ 0	\$50	\$ 0	\$50
a*. Lifetime gift- constructive realization	100	0	20	40	0	40
b. At death	100	40	0	30	0	30
c. After death	100	40	0	80	(40)	20

Case a Lifetime gift under current law: Since the charitable deduction eliminates the income tax on the \$100 of wages, \$50 is left after payment of the estate tax.

*Case a** Lifetime gift and constructive realization: The capital gains tax of \$20 on the gift would reduce the donor's holdings out of her wages to \$80. The heir would receive \$40 after payment of the estate tax. The retention is reduced by \$10 from current law (the extra capital gains tax of \$20 reduced by the estate tax savings).

Case b Gift at death: If the property is held to death and then given to charity, the donor would pay \$40 tax on wages and estate tax of \$30. The gross estate would be \$160, but there would be a deduction for the gift to charity, resulting in an estate tax of 50% of \$60. The retention is \$20 less than from a lifetime gift under current law (the extra income tax of \$40 on the wages reduced by the estate tax savings). *Case a** is more advantageous than *Case b* because the income tax savings from the deduction is more than the capital gains tax.

⁶³ All events are assumed to occur simultaneously so there is no intervening investment income. The results would not be affected by a time interval if all investments produced the same rate of return (obviously true if investments were in the same property), and if all gains were in the form of unrealized appreciation so there was no income tax. If there were taxable income from the property to be donated, the opportunity to avoid tax by contributing to charity would increase the preference for a lifetime gift.

Case c Gift after death: After tax, the donor would have \$60 left from wages. The estate tax on this amount plus the \$100 in property, which also passed to the heir, would be \$80 ($\$160 \times 50\%$). After paying the estate tax, the heir would be \$20 short, aside from the value of the property. If, however, the heir makes a charitable gift of the \$100 property, she would save \$40 in income tax, netting her \$20. Assuming the heir is in the same bracket, the income tax result is the same as in *Cases a* and *a**. The \$40 tax the decedent pays on the wages is later recovered when the charitable deduction is claimed. The retention is \$30 less than with a lifetime gift under current law because of the additional estate tax. The additional estate tax also makes *Case c* less advantageous than *Case a**, even though the capital gains tax is eliminated under *Case c*.

The differences between the results of *Cases a*, *b*, and *c* establish the superiority, under current law, of lifetime giving. As shown by comparing *Case a* to *Case a**, constructive realization would make a lifetime gift less advantageous, but *Case a** is still superior to *Cases b* and *c*. In other words, it still would be preferable to make a lifetime gift, even though the unrealized gain would become subject to tax.

2. *Nondeductible Contributions-Unlimited Deduction*

The examples in the previous Section depend on the income tax deduction for charitable giving to establish that, even with constructive realization, contributing to charity during life would maximize tax savings. The examples do not consider the possibility of a donor whose contributions exceed the limit on charitable deductions.⁶⁴ In fact, a not insignificant number of donors may make nondeductible contributions.⁶⁵

Under current law, such a donor would be indifferent between lifetime gifts and testamentary transfers. In both cases, there would be no deduction, no tax on the unrealized gain, and the amount of the transfer would not be subject to either gift or estate taxes. If construc-

⁶⁴ On gifts to "public" charities, the limit is 30% of AGI in the case of gifts of appreciated property, IRC § 170(b)(1)(C)(I), (F), and 50% of AGI in the case of gifts of cash, IRC § 170(b)(1)(A), (F), and gifts of capital gains property where the taxpayer elects to limit her deduction to basis, IRC § 170(b)(1)(C)(iii), (F).

⁶⁵ Auten et al., note 21, at 403-04 (suggesting that more than one-quarter of all gifts by taxpayers with more than \$2.5 million of gross income are not deducted in the current year. No information is given as to the amount eventually deducted under the five-year carryover).

tive realization applied and there was no change in the limit on charitable deductions, testamentary gifts often would be preferred because this would allow the donor to avoid capital gains tax without payment of any additional income or estate tax. An unlimited charitable deduction would eliminate this bias and could even lead to a preference for lifetime giving. I conclude that, on balance, removing the limit on the charitable deduction would be acceptable if this were essential in order for constructive realization to be adopted.⁶⁶

a. Impact on Donor

If the limits were retained, since any additional deduction would be limited to 50% of the additional gross income, it would seem that the increase in tax from realization of the gain would be greater than the additional savings from the increase in the charitable deduction. The impact of constructive realization, however, could be much smaller than may be imagined. First, the additional charitable deduction could offset ordinary income. In that case, while taxable income would increase by 50% of the realized gain, actual tax liability might increase at a lower rate. Second, if current deductible contributions were in property, subject to a limit of 30% of AGI, taxable income would increase by less than 50% of the gain.

Assume *Dora* has AGI of \$100,000 and makes a \$50,000 cash contribution to charity. If *Dora* has \$10,000 of other itemized deductions, her taxable income would be \$40,000, which at a 40% rate would make her tax liability \$16,000. Suppose *Dora* makes an additional contribution of \$40,000 of zero-basis property. Under current law, this has no impact on taxable income.

If her constructive gain were taxable, *Dora's* AGI would increase to \$140,000. The charitable deduction would be \$70,000 (\$20,000 more⁶⁷) and, together with the other itemized deductions of \$10,000, would reduce her taxable income to \$60,000. Taxable income would increase by \$20,000 or one-half the constructive gain. Since the \$80,000 of deductions offset ordinary income first, however, *Dora* would have only \$20,000 of ordinary income (\$20,000 less than under current law) and \$40,000 of capital gain. If capital gains were taxed at 20%, or one-half the rate on ordinary income, tax liability would continue to be \$16,000.⁶⁸

⁶⁶ The discussion is limited to the treatment of contributions to so-called public charities. The possibility that a lower limit on contributions to private foundations may be justified is put to the side.

⁶⁷ The charitable deduction would be \$70,000 or 50% of AGI.

⁶⁸ Capital gain (\$40,000 x 20% = \$8,000) + ordinary income (\$20,000 x 40% = \$8,000) = \$16,000.

Alternatively, assume *Dora* currently makes a contribution of zero-basis property. Under current law, the charitable deduction is limited to 30% of AGI, or \$30,000, since her AGI is \$100,000.⁶⁹ With \$10,000 of other deductions, taxable income would be \$60,000. At a 40% rate, the tax would be \$24,000. Suppose, in addition to the \$30,000 deductible contribution, *Dora* makes a further contribution of \$70,000 zero-basis property. Under current law, this has no effect on her tax liability.

If the unrealized gain on both the deductible contribution (\$30,000) and the nondeductible contribution (\$70,000) were taken into income, gross income would increase by \$100,000 to \$200,000. Since all gains would be realized, the charitable deduction would be 50% of AGI or \$100,000. Since the deduction increased by \$70,000, taxable income would increase by only \$30,000 (to \$90,000).⁷⁰ Since this would be less than the capital gain of \$100,000, the entire income would be taxed at capital gain rates. If the rate were 20%, tax liability would be only \$18,000, or less than under current law. In these circumstances, constructive realization has a positive impact for *Dora*, which suggests that under current law she would have been better off selling the property and contributing cash.⁷¹

Such a limited impact from realization would not always occur. Returning to the original example, suppose *Dora* wishes to contribute \$1 million of zero-basis property, in addition to \$50,000 in cash. In that case, constructive realization would cause taxable income to increase by \$500,000 or one-half the built-in gain. Even though the entire income of \$540,000 would be taxable at capital gain rates, *Dora's* tax liability obviously would be substantially higher.

The picture would be significantly different if the charitable deduction were unlimited. In that case, in the example in the previous paragraph, not only would taxable income be unchanged at \$40,000 but, since it would all be capital gain, tax liability would decline.⁷² Further, to the extent that the property donated has a basis, taxable income also would decline.⁷³ In these circumstances, there would be no reason to delay contributions until death, and there may well be a preference for lifetime gifts that does not exist under current law.

⁶⁹ IRC § 170(b)(1)(C)(i).

⁷⁰ $\$200,000 - \$100,000 - \$10,000 = \$90,000$.

⁷¹ *Dora* could elect to apply §§ 170(e), (b)(1)(C)(iii), but this is not helpful since it would limit the deduction to basis. IRC § 170(e)(1)(A).

⁷² If the deduction were unlimited, it might be reasonable to reconsider the practice of applying the deduction first against ordinary income. Allocation of a portion of the deduction to capital gains would be more appropriate.

⁷³ As discussed in Subsection IV.A.1, if the current charitable deduction consists of appreciated property, gain realization would increase tax liability but by less than the tax savings from the deduction.

Therefore, it makes sense to consider whether it would be acceptable to remove the limit on the charitable deductions if all gains were recognized on a transfer to charity.

*b. Can an Unlimited Deduction Be Justified?*⁷⁴

A limit on the charitable deduction has existed since a 15% limit was instituted as part of the Revenue Act of 1917.⁷⁵ Such a limit is inappropriate if the deduction is intended to measure the proper tax base. If, however, the charitable deduction is a federal matching program, designed to increase the amount received by charities chosen by individual donors, a limit may be logical. In light of the preference given to wealthier donors, the limit would restrict the amount of federal funds that could be directed by any one donor. As Eugene Steuerle and Martin Sullivan have pointed out, however, this concern might suggest a dollar limit rather than a limit based on a percentage of income.⁷⁶

A percentage limit may be defended on the ground that individuals should not be allowed to avoid paying tax totally. On the other hand, deductions up to 50% of AGI could be combined with other deductions to reduce taxable income to zero, and some individuals might have substantial amounts of taxable income even if the charitable deduction were allowed to exceed 50% of AGI. If total tax avoidance were the concern, it might make more sense to disallow charitable contributions in excess of some percentage of AGI for purposes of the minimum tax only.⁷⁷ A percentage limit on the charitable deduction for regular tax purposes is more difficult to justify.

While these arguments suggest that a limit of some sort may have merit, they are not overwhelming. Therefore, it seems reasonable to forgo a limit if a change in the treatment of appreciated property could be achieved only by allowing an unlimited deduction. In fact, there is reason to believe that the treatment of appreciated property strongly influenced the retention of a limit on the charitable deduction. Prior to 1969, there was an unlimited charitable deduction if in the taxable year plus eight of the ten preceding years charitable con-

⁷⁴ For a more detailed discussion of this issue, see Steuerle & Sullivan, note 42, at 408-22.

⁷⁵ Revenue Act of 1917, ch. 63, § 63, § 1201(2), 40 Stat. 300, 330; see John K. McNulty, *Public Policy and Private Charity: A Tax Policy Perspective*, 3 Va. Tax Rev. 229, 229 & n.1 (1984). For a general overview of the development of the limitation on charitable deductions by individuals, see 1 Jacob Mertens, Jr., *The Law of Federal Income Taxation*, Code Commentary, § 170(b):1-4, 1041-52 (Martin M. Weinstein & James J. Doheny eds., 1989).

⁷⁶ Steuerle & Sullivan, note 42, at 413-15.

⁷⁷ See *id.* at 414.

tributions plus income taxes exceeded 90% of taxable income.⁷⁸ The unlimited deduction is said to have been enacted to enable a particular nun, who had taken a vow of ~~poverty~~^{poverty} and given all her income to charity, to avoid tax.⁷⁹

The repeal of this provision probably was motivated by the use of the unlimited deduction by donors of appreciated property who, despite contributing an amount of property equal to the required percentage of AGI, unlike the nun, retained an amount fully equal to their AGI for their own use. These individuals, thus, took advantage of the unlimited deduction to avoid tax completely even though their entire income was not given to charity. Congress was troubled by those who "pile[d] one advantage on top of another"⁸⁰ to eliminate all tax liability. The unlimited deduction was accordingly repealed.⁸¹

Further, until 1969, the limitation on the charitable deduction was the same for a gift of property as it was for a cash donation. When Congress decided to increase the regular charitable deduction for gifts to public charities to 50% of AGI in 1969,⁸² it did so solely for gifts of cash (or property gifts on which gain was recognized). Perhaps because of what Congress felt was an abuse of the unlimited deduction by those who donated property, it was unwilling to increase the limit for gifts of appreciated property.⁸³

This concern, however, does not suggest that an unlimited deduction would be inappropriate if transfers of property did not allow gain to escape tax. Thus, the unlimited charitable deduction for estates and trusts may be acceptable because the deduction is limited to amounts included in gross income.⁸⁴ It seems clear that trading an

⁷⁸ IRC § 170(b)(1)(c) (before repeal in 1969) (calculated without taking into account the charitable deduction, personal exemptions, and loss carrybacks).

⁷⁹ 115 Cong. Rec. 22,562-63 (1969) (statement of Rep. Mills).

⁸⁰ H.R. Rep. No. 91-413, at I-1, reprinted in 1969-3 C.B. 200, 200. The Committee report, however, does not explicitly indicate that Congress had gifts of appreciated property in mind when it spoke of multiple advantages.

⁸¹ See *id.* at I-52 to I-53, reprinted in 1969-3 C.B. 200, 234; Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b), 83 Stat. 487, 550-52.

⁸² Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b)(1)(A), 83 Stat. 487, 550-51.

⁸³ It has been argued that since the advantage is the nonrecognition of gain, a special limit, if any, should apply to the amount of appreciation, not the full fair market value of the transfer. Steuerle & Sullivan, note 42, at 417. A transfer of \$100,000 of appreciated property, however, would enable a donor to diversify investments of \$100,000. It is true that the donor with the lower basis avoids more tax by the donation, but a higher-basis donor is probably more likely to sell, even if contributions lead to realization of gain. The low-basis donor may just hold to death. Thus, the revenue loss from the current treatment may be greater for the higher-basis donor.

⁸⁴ IRC § 642(c); Reg. § 1.642(c)-3(b). For a similar reason, it is sensible to be lenient on attempted assignments of income from services. See Rev. Rul. 67-137, 1967-1 C.B. 63 (allowing employee to designate recipient of employer contributions without including the amount in gross income). But see *Schuster v. Commissioner*, 800 F.2d 672 (7th Cir. 1986)

unlimited deduction for constructive realization would substantially improve the equity of the tax system.

3. *Deferral of Lifetime Gifts*

Current law could lead to deferral of lifetime giving because it gives a donor the opportunity to achieve untaxed appreciation on property that she expects to sell during her lifetime. Consider *Ellen* who is in the 40% bracket. She owns property, such as growth stock, which is now worth \$100 and is expected to provide a return in the form of unrealized appreciation, as opposed to currently taxable earnings. A current transfer to charity would produce a tax savings of \$40. If *Ellen* were interested in maintaining some interest in the transferred property, she could invest the \$40 tax savings. If the property doubles in value, *Ellen* would have property worth \$80, subject to a potential capital gains tax of \$8 if the property was sold, leaving her with \$72 to consume.

She may make a similar investment, with a better tax result as to any future appreciation (total forgiveness, not just deferral), by merely postponing the transfer to charity.⁸⁵ Thus, if *Ellen* continues to hold the property until it doubles in value to \$200, the donation provides \$80 of tax savings. Unlike the case of the current gift, the full \$80 can be spent without paying capital gains tax. Perhaps, it can be said in both cases that the initial investment in the property is \$140 (\$100 for the charity, \$40 for the donor). As noted, in the first case, this occurs directly. *Ellen* contributes \$100 worth of property to charity and purchases an additional \$40 for herself. In the case of the deferred gift, the charity has the expectation of receiving property now worth \$100 and *Ellen's* \$40 "investment" arises because the tax savings from the contribution depends upon the value of the property. In the latter case, *Ellen's* "gain" is not subject to tax.

In fact, it would be similarly advantageous to defer a gift of cash if the donor is contemplating an investment in property that she expects to produce income primarily in the form of appreciation. For example, consider *Fran*, who makes a cash gift of \$100. At the same time, she invests the \$40 tax savings from the contribution in property, which, as expected, doubles in value over time but produces little or

(taxing nun who, pursuant to a vow of poverty, transmitted her entire salary from a government health service to her order).

⁸⁵ The annual limit on deductible giving and the possibility of an untimely death may inhibit a strategy that would concentrate gifts later in life. Nevertheless, the example suggests that donors who pledge a specific amount and spread the gift over time, without compensating the charity for delay, not only benefit by getting credit from the donee for a gift that is larger in present value terms than the one actually made, but also get a tax advantage.

no income. *Fran* has property worth \$80, subject to a potential tax on \$40 of capital gain.

On the other hand, assume *Fran* defers the gift and invests the \$100 in this property. Upon contributing the property to charity when it doubles in value to \$200, she will enjoy \$80 of tax savings that she can spend without a potential capital gains tax.

This result should be troubling because there is an incentive to give currently even if the contribution is to become part of an endowment or otherwise be set aside for the future. This is so because a transfer to charity avoids any future tax on investment income and, thereby, allows income to accumulate on a before-tax basis, rather than at the donor's after-tax rate of return.

Consider, for example *Gary*, who earns \$100 in wages. If \$100 is given to a charity, which earns 10% tax-free, after three years the charity accumulates \$133.10. If there is no current transfer and *Gary* is in the 40% bracket, he retains \$60 after paying the tax on wages. If this is invested to earn 10% before tax (or 6% after tax), after three years *Gary* has \$71.46. Given the tax savings, this would enable him to transfer \$119.10 to charity.⁸⁶ This amounts to \$100 accumulated at a 6% return.⁸⁷

If, however, expected gain is in the form of unrealized appreciation, tax can be avoided even if the transfer to charity is delayed. Thus, it would seem that if built-in gain were taxable on a transfer to charity, this opportunity to benefit by delaying the gift would end. Only appreciation that occurred while the charity owned the property would be tax-free. Surprisingly, however, constructive realization would not change the calculus in the case of zero-basis property.

Suppose, as in the above example, *Ellen* makes an immediate gift when the zero-basis property is worth \$100. If her gain were taxable, the capital gains tax of \$20 on the \$100 gain would reduce the amount available to invest to \$20 (\$40 tax savings from the deduction less \$20 capital gains tax). If this investment doubled, she would have property worth \$40, subject to a potential capital gains tax on sale. On the other hand, if the gift were deferred until the property doubled to

⁸⁶ At a 40% rate, a contribution of \$119.10 results in a tax savings of \$47.64 which, when added to \$71.46, equals \$119.10.

⁸⁷ This point is not always understood. Thus, it sometimes is suggested that, since tax need not be paid on investment income when it is contributed to charity, a charitable donee could receive the full pretax investment income even if the donor retains the property. In the above example, the \$6 earned on the \$60 investment could be donated to charity annually, thereby eliminating the tax otherwise due on the investment income. This analysis misses the impact of the deduction on the amount available for investment. If there were a current transfer to charity, the amount available to invest is \$100, not \$60, and the investment income is \$10, not \$6. Six dollars is in fact an after-tax return from the investment of \$100, not a pretax return.

\$200, this would result in an \$80 tax savings from a deduction and a \$40 tax on the \$200 of constructive gain. Therefore, *Ellen* would retain \$40, not subject to a future capital gains tax.

This perhaps surprising conclusion could be said to occur because deferral (of the tax on unrealized appreciation) is equivalent to tax exemption for the investment income (on what would have been the after-tax amount available to invest).⁸⁸ Thus, in some sense, in the case of a deferred gift, even though the donor holds the property, only the future appreciation on the portion of the investment attributable to basis is "effectively" subject to tax. If the basis is zero, the entire return is, effectively, tax-exempt even if the donor holds the property and built-in gains are nominally taxable.

As the following example shows, however, constructive realization can restore the incentive for current giving when the property has sufficient basis. For example, suppose *Helen* owns property worth \$100, which has a basis of \$40. Assume she wishes to contribute the property to charity and invest the tax savings in similar property. If the property is given to charity immediately, *Helen* would save \$40 in taxes from the \$100 deduction. Since the tax on the constructive gain would be \$12 (20% of \$60), there would be \$28 left to invest. If the value doubles to \$56, there would be a potential tax liability of \$5.60 on sale (20% x \$28 of gain), leaving \$50.40.

If the donation were delayed until the property was worth \$200, *Helen* would have \$48 (\$80 tax savings from the deduction less the \$32 tax on the \$160 of constructive gain). In this situation, *Helen* would benefit from making a current gift. Even after paying the tax on the capital gain, she would have \$50.40, more than \$48. At the assumed tax rates, the donor would be better off with an immediate donation as long as the basis of the property exceeded 25% of value.⁸⁹

⁸⁸ William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1126 (1974); Daniel I. Halperin, Interest in Disguise: Taxing the "Time Value of Money," 95 Yale L.J. 506, 519 (1986).

⁸⁹ In the example in the text, the total "investment" can be said to be \$128 in either case. With the current gift, *Helen* has \$28 to invest (taxable) and the charity has \$100 (tax-free). If the gift is deferred, *Helen's* investment of \$100, with a basis of \$40, can be "restated" as a taxable investment of \$40 (her basis) and a tax-free investment of \$48 (the amount that would have been available from the \$60 of appreciation after a capital gains tax is paid). In addition, there is the tax-free "investment" of \$40 from the benefit of the deduction. A taxable portion of \$28, as with the current gift, is obviously preferable. Since total "investment" would not vary with the timing of the gift (in either case, it would be the sum of the value of the property and the benefit from the income tax deduction less the capital gains tax), the taxpayer would prefer a deferred gift if basis (the portion of the investment that can be said to be taxable) was less than the "fully taxed" investment she would make with the tax savings from an immediate gift. At the assumed rate bracket, the tax savings would equal 40% of the investment less 20% of the gain. Thus, if the appreciation is 75% of the investment, the tax on the gain if the property is contributed would be 15% of the investment, leaving 25% (40% - 15%) of the value of the donated property to invest. In this

In sum, under current law, a donor interested in making a gift and, at the same time, investing in property that is expected to produce income mostly in the form of unrealized appreciation, may have an incentive to delay the gift until later in life. Constructive realization, on the other hand, would encourage gifts to be made currently in order to take advantage of the tax-free build-up, which could be achieved only if the charity held the property. The advantage of delay would at least be smaller and, if basis were large enough, could be eliminated.

B. Form of the Gift

This Section focuses on the potential impact of the treatment of appreciated property on the form of the gift. Assume for this purpose, that the taxpayer has settled upon the amount and timing of the charitable gift. Under current law, gifts of property generally are favored over donations of cash. The gift of some tangible personal property, however, is discouraged. Constructive realization would discourage all property gifts. This is a positive result except possibly as to property, such as art, uniquely important to the charitable mission.

The encouragement of property transfers is obvious in the case of an individual who has to dispose of some property because she has insufficient cash to finance both the charitable gift and the desired level of consumption. Currently, to avoid recognition of unrealized gain, she will spend the cash and give the property to charity. If gains were realized, she would be indifferent between giving cash and property.

Further, as noted above, with respect to *Charlotte*, even taxpayers who have sufficient cash for both consumption and the desired level of giving have an incentive to donate property in order to achieve diver-

case, this amount is equivalent to the basis of the contributed property and the results would be identical. This is shown algebraically as follows:

Where b = basis, a = appreciation, c = capital gains tax (.2), t = ordinary income tax (.4), and g = investment growth (greater than 1), the savings from donating *now* are: $g[(b + a)t - ca] - c(g - 1)[(b + a)t - ca]$.

This reduces to:

$$a(gt - gc - cgt + ccg + ct - cc) + b(gt - cgt + ct).$$

The savings from donating *later* are:

$$gt(b + a) - c[ga + (g - 1)b].$$

This reduces to:

$$a(gt - gc) + b(gt - gc + c).$$

So suppose that savings now = savings later, or algebraically that:

$$a(gt - gc - cgt + ccg + ct - cc) + b(gt - cgt + ct) = a(gt - gc) + b(gt - gc + c).$$

This reduces to:

$$ac(g - 1)(c - t) = bc(g - 1)(t - 1), \text{ which is the same as } a(c - t) = b(t - 1) \text{ which, where } t = .4 \text{ and } c = .2 \text{ means that } a^* - .2 = b^* - .6 \text{ or, } a = 3b.$$

(or appreciation equals 3x basis, which means that appreciation equals 75% of value).

sification.⁹⁰ If constructive realization were the rule, one could expect individuals like *Charlotte* to switch to cash gifts and to try to avoid the transfer of property.

Current law already discourages gifts of tangible personal property if the "use by the donee is unrelated to the purpose or function constituting the basis for its exemption."⁹¹ The deduction is limited to basis, which seems generally appropriate. Gifts in kind impair the welfare of the recipient, which has to deal with property it may not want and which may be costly to sell.

Moreover, favoring cash gifts would reduce the potential for abusive valuation. In fact, the concern for excessive valuation of charitable transfers led to the limitation on gifts of tangible personal property.⁹² Since the deduction is limited to basis, it would not often make sense for a donor to become subject to this provision. She would be better off selling the property, paying tax at the capital gains rate, and then delivering the proceeds to charity, which would enable her to use the charitable deduction to reduce ordinary income.⁹³ Such a sale would avoid the valuation problem.

The foregoing discussion suggests that, even if the general approach to the contribution of appreciated property remains unchanged, it is appropriate to continue the current treatment of tangible personal property and even to expand it to other types of property that are both unrelated to the function of the charity and particularly difficult to value. This could include real estate and certain intangible property. It also suggests that when gain is to be recognized with respect to property that is not important to the charitable mission, it makes sense to retain the current approach of limiting the deduction to basis, rather than considering the transfer to charity as resulting in constructive realization of capital gain and allowing a market value deduction against ordinary income.

I turn now to the issue of whether, if transfers to charity generally result in realization of gain, an exception should be made for property uniquely suited to the charitable mission. The current law exception for tangible property related to the function of the organization⁹⁴ re-

⁹⁰ See text accompanying notes 42-50.

⁹¹ IRC § 170(e)(1)(B)(I).

⁹² H.R. Rep. No. 91-413, at I-55, reprinted in 1969-3 C.B. 200, 235-36; S. Rep. No. 91-552, at 82, reprinted in 1969-3 C.B. 423, 476. Excessive valuations may be a particular problem with respect to some inventory. For example, if a manufacturer is not operating at capacity, a gift to charity would not replace a sale as more items could be produced for that purpose. If so, the items given to charity could not be sold, or at least could not be sold at the normal price. Basing the fair market value of the donation on the selling price of other items seems clearly excessive.

⁹³ See text accompanying note 6.

⁹⁴ IRC § 170(e)(1)(B)(I).

flects a balancing of the concern for overvaluation with the desire to promote donation over sale with respect to property that can enhance the charitable mission. As the prior Section suggests, if the individual has determined to make a certain transfer to charity, constructive realization should not cause the gift to be delayed,⁹⁵ but it could cause the form of the gift to change.

This would be a concern if it can be shown that constructive realization would lead, for example, to the private sale of valuable art as opposed to a contribution to a museum. If Congress wishes to promote gifts of works of art or environmentally sensitive land, it might make sense to excuse from realization property that is particularly important to retain in the nonprofit sector. On the other hand, it may be that the nonprofit sector generally would benefit if there were a preference for cash transfers that donees could use as they wished, as opposed to being saddled with art work that they may not particularly value. Thus, more information is needed to determine whether an exception to a general realization requirement is desirable and, if so, the appropriate scope of such an exception.

C. Increasing Charitable Donations

The next question is whether the treatment of appreciated property can be said to produce significantly more contributions per dollar of revenue loss than alternative means of encouraging donations. Thus, we need to determine the additional revenue loss, if any, that results from the failure to recognize gain, as well as the amount of additional contributions produced. As noted below, this information is not now available.⁹⁶

To consider this question it may be useful to divide potential contributors of appreciated property into two groups and to consider the range of potential behavior within each group. The first group consists of those who have enough free cash or high-basis property to satisfy their current level of giving but transfer property instead, and use the cash for diversified investments. The second group consists of those who do not have sufficient cash or high-basis property to cover their current level of giving. Some of the second group will hold substantial appreciated property until death and others will not. This Section builds on the earlier discussion of the effects of the charitable deduction as an incentive for cash contributions⁹⁷ and makes it more explicit as to property gifts for donors in particular circumstances.

⁹⁵ See text accompanying note 63.

⁹⁶ See text accompanying notes 107-10.

⁹⁷ See Section II.

*Charlotte*⁹⁸ is an example of the first group. Suppose she earns \$1,000 of current income, consumes \$360, and contributes \$400 to charity. Current income is sufficient for these purposes because the tax liability, after the \$400 donation, would be reduced to \$240.⁹⁹ *Charlotte*, however, contributes \$400 of undiversified low-basis property and invests \$400 of current income in a more diversified mix of assets.

In order to compare the revenue loss to the impact on giving, we would have to determine the effect that realization of gains would have on both the disposition of property and charitable contributions. At one extreme, realization of gains might lead to reduced contributions without yielding any revenue from such realization. Thus, if this property would not be sold in any circumstances prior to *Charlotte's* death, there is no additional revenue loss associated with the property gift. A gift of such property, like a gift of cash, has a revenue loss of 40% of the amount received by charity.

Further, the extra advantage, available under current law, of tax-free diversification, which makes gifts more attractive, may increase charitable giving.¹⁰⁰ Thus, if the property gift resulted in constructive realization, giving might decline even if no capital gains were incurred. For example, *Charlotte* may choose to continue to hold the undiversified property and reduce charitable giving by \$100, to \$300. After paying the additional tax of \$40, she would be able to increase her investments by \$60, which may compensate for the lack of diversification.

At the other extreme, *Charlotte* may value diversification sufficiently that she would be willing to sell property in order to achieve it, even if tax would need to be paid.¹⁰¹ If this would occur in the presence of constructive realization, current law results in a revenue loss. If *Charlotte* is a target giver who would maintain her charitable giving at the same level, this revenue loss is not associated with any increase in giving.

For the portion of the second group that will not hold substantial appreciated property at death, the total revenue loss is known. It is the combined impact of the income tax deduction and the capital gains exclusion. The issue is the extent to which the tax savings results in an increase in charitable contributions as opposed to additional private consumption. In particular, for the purpose of this inquiry, it is necessary to separate the impact of the capital gains exclusion.

⁹⁸ See text accompanying note 41.

⁹⁹ $\$1,000$ (income) - $\$400$ (contribution) = $\$600$ (taxable income) \times 40% = $\$240$.

¹⁰⁰ Steuerle & Sullivan, note 42, at 417.

¹⁰¹ See Section III.B.

Consider *Iris*, an individual in the 40% bracket, who earns wages of \$166.67 and also owns zero-basis property worth \$100. Assume that in the absence of any deduction or other special treatment, *Iris* would contribute \$100 (an amount equal to her after-tax wages) to charity and spend the net proceeds from the property. After paying a 20% capital gains tax on sale, her consumption would be \$80. If a deduction is allowed for property contributed to charity, *Iris* would donate property instead, thus eliminating both the capital gains tax and a portion of the tax on wages.

At one extreme, if the contribution remains fixed at \$100, *Iris* would have \$140 available for consumption, or \$60 more than before.¹⁰² Put another way, she would be able to "purchase" \$100 of charitable services at a cost of only \$40, or 40% of the amount received by charity, as opposed to 60% in the case of a cash gift. The revenue loss of \$60, including the extra \$20 attributable to the special treatment of appreciated property, has not increased charitable giving.

On the other hand, *Iris* could increase the amount of her gift, perhaps by the amount of her tax savings, thereby keeping prior consumption constant. Suppose she had \$250 of zero-basis property and \$250 in wages. If she sells the property, after paying both the capital gains tax (\$50) and the tax on wages (\$100), *Iris* would retain \$350. A transfer of the property, worth \$250, to charity would eliminate both taxes, leaving *Iris* with \$250 in cash, or \$100 less. The out-of-pocket cost is still 40% of the amount of the gift, but the charitable gift has increased from \$100 to \$250. The increase in contributions equals the tax savings of \$150, including the additional tax savings attributable to the nonrecognition of the built-in gain. We could assume, but do not actually know, that \$50 of the increased gift is due to the elimination of the capital gains tax of \$50. If the gift exceeds \$250, the revenue loss would be less than the increase in giving.

Donors in this second group who retain substantial amounts of appreciated property at death present the same quandary as the first group in the sense that it is necessary to estimate the impact of constructive realization on both property transfers and charitable contributions. Since, by definition, they do not have enough cash or high-basis property to maintain their current level of giving,¹⁰³ there is a revenue loss associated with the current level of donations unless these donors are both willing and able to borrow to provide funds for contributions.

¹⁰² She would have her pretax wages (\$166.67) less \$26.67, the tax due on \$66.67 (\$166.67 of wages less \$100 charitable deduction).

¹⁰³ As discussed in the previous Section, they would not have an incentive merely to delay giving in order to achieve the basis step-up. See text accompanying note 63.

Consider *Kate*, an individual in a 40% bracket, who has at least \$1 million of undiversified zero-basis property but, despite \$1 million of ordinary taxable income, has no "free" cash in excess of her "living" expenses of \$600,000. Assume, under current law, that *Kate* is willing to give the property to charity. This will save \$400,000 in taxes, which provides funds that *Kate* can invest in a diversified manner. *Kate* then would have \$400,000 of diversified investments, in lieu of \$1 million in a concentrated holding, and the charity would have \$1 million.

The issue is how much *Kate* would contribute if the gift of property were a realization event. At one extreme *Kate* could continue to donate \$1 million, while reducing her holdings to \$200,000, reflecting the \$200,000 tax on the capital gain.¹⁰⁴ In this scenario, under current law the fisc loses \$200,000 in capital gains revenue without any increase in giving.

If *Kate* wished to keep her remaining assets constant at \$400,000, the size of the charitable gift would depend upon the degree of diversification desired. If she wished to fully replace her existing assets, the contribution would be reduced to \$666,667.¹⁰⁵ *Kate* could sell the property for \$1 million, giving her a total of \$2 million. She would owe capital gains tax of \$200,000 and ordinary income tax of \$133,333 (the charitable contribution would reduce taxable ordinary income to \$333,333).¹⁰⁶ A total of \$1,666,667 then would be available. After the gift of \$666,667, she would retain \$1 million, or \$600,000 for consumption and \$400,000 for investment. The charity gets \$333,333 less. This is exactly equivalent to the increase in revenue, of which \$200,000 is derived from the realization of gain and the remainder from the reduction in the gift. Under this assumption, *Kate* would give \$333,333 more under current law than she would under constructive realization (from \$666,667 to \$1 million), with a revenue loss of like amount.

On the other hand, if, with realization of gain, the gift would be more than \$666,667, the absence of constructive realization increases giving by less than the revenue loss. Current law would be most effi-

¹⁰⁴ Thus, the after-tax proceeds from the sale of the property would be \$800,000. With the tax savings of \$400,000, a contribution of \$1 million would cost \$600,000, permitting the donor to retain \$200,000 after the donation.

¹⁰⁵ Alternatively, if *Kate* were willing to hold on to a portion of the property, she could give \$750,000 of property to charity, retaining \$250,000 for herself. Under this assumption, the capital gains tax would be \$150,000 (20% x \$750,000) and the tax on ordinary income would be \$100,000 (40% x \$250,000). After taxes of \$250,000, *Kate* would retain \$750,000 out of the ordinary income of \$1 million, giving her \$600,000 for consumption and \$150,000 for additional investments. Under this assumption, *Kate* would give \$250,000 more under current law than she would under constructive realization (from \$750,000 to \$1 million) with a revenue loss of like amount.

¹⁰⁶ Put another way, since the charitable contribution is reduced to \$666,667, the tax savings is reduced from \$400,000 to \$266,667.

cient if the gift would be less than \$666,667 where constructive realization was the norm. If that were the situation, the absence of constructive realization increases the gift by more than the revenue loss. This could occur if *Kate* believes that the reduction in her personal wealth, from \$1 million to \$400,000, which is acceptable if the charity gets \$1 million, would not be desirable if the charitable gift were reduced to \$666,667 and Uncle Sam got the rest.

Of course, these examples just outline a range of behavior in order to suggest that we cannot be certain that the current treatment of appreciated property provides an efficient incentive for charitable giving. It is, as they say, an empirical question and, as I understand the literature, we know very little about what actually occurs.

There are apparently no studies indicating whether or not appreciated property now given to charity would be sold or donated if gains were realized on charitable contributions. Moreover, there is little specific data concerning the price elasticity of giving appreciated property. Analysts generally appear to have computed the net cost of giving, in a particular income class, by taking a blended average of the cost of cash gifts and the cost of property gifts, based on data indicating the portion of giving in each form by taxpayers in that class.¹⁰⁷ The cost of property gifts is determined by making assumptions as to both the ratio of basis to value and the time at which the property otherwise would be sold. The latter determines the present value of the capital gains tax that is avoided by the donation. In some circumstances, it apparently is assumed that the property otherwise would be sold immediately.¹⁰⁸

As an example, assume basis equals 40% of value. In these circumstances, for taxpayers in the 40% bracket, a cash gift would be assumed to cost 60 cents on the dollar and a property gift 48 cents, assuming an immediate sale and a capital gains rate of 20%. Assuming, for purposes of simplicity, that people in this class make one-half their gifts in property and one-half their gifts in cash, the net cost of giving would be assumed to be 54 cents on the dollar for all donations. The elasticity of charitable contributions would be measured by the impact of a change in the cost computed in the same manner. It is not clear that this would capture the expected behavior of a taxpayer planning a property gift, much less a potential contributor with a lower or higher basis or one who has a different expectation as to when, if ever, the property otherwise would be sold.¹⁰⁹

¹⁰⁷ E.g., Clotfelter, *Impact*, note 19, at 209; Cherie J. O'Neil, Richard S. Steinberg & G. Rodney Thompson, *Reassessing the Tax Favored Status of the Charitable Deduction for Gifts of Appreciated Assets*, 49 *Nat'l Tax J.* 215, 217 (1996).

¹⁰⁸ Clotfelter, *Impact*, note 19, at 209; O'Neil et al., note 107, at 217.

¹⁰⁹ Lindsey, note 40, at 67-68.

There is, as far as I know, only one specific study that tries to isolate the elasticity with respect to property gifts.¹¹⁰ Although this study finds that donors in income classes below \$200,000 do not respond to the incentive for property gifts, it apparently finds a fairly high elasticity for gifts of appreciated property for those at the highest income level.¹¹¹ While this might suggest that the treatment of appreciated property could be efficient in some circumstances, the study sets forth a number of caveats regarding the reliability of its findings. For one thing, since no data as to basis was available, calculations were made assuming basis was uniformly either 25%, 50%, or 75% of value. Moreover, the study was based on only one year's data and did not observe donors over time.

Given the absence of clear evidence as to both the revenue loss and the impact on giving, the question becomes how we should proceed in uncertainty. In other words, where the burden of proof should lie. My view is set forth in the conclusion.

V. CONCLUSIONS

Support for the current treatment of appreciated property depends, at least in part, on the claim that since contributors of such property would react to potential gain recognition by contributing cash and holding all appreciated property to death, there is little revenue loss from excusing the gain from tax. On this theory, constructive realization would not gain much revenue, while it could cause contributions to be both deferred and reduced. If this were so, the current treatment of appreciated property could be said to be a particularly efficient incentive for charitable giving.

The revenue loss may not be trivial, however, and I have shown that the impact on contributions could be significantly less than may be claimed. First, a shift to cash contributions would be beneficial in that charities would have less expenses associated with the disposal of unwanted assets and there would be less revenue lost to excessive valuation. In addition, contributions would not necessarily be deferred. I showed that for those who deduct their contributions, tax would continue to be minimized by lifetime giving even if gains were recognized. Further, any incentive to defer currently nondeductible transfers until after death could be offset by repealing the limit on the deduction. This could even create a new incentive for lifetime giving. Finally, constructive realization would defer or eliminate a current potential advantage from the delay of lifetime gifts.

¹¹⁰ O'Neil et al., note 107, at 215.

¹¹¹ Id. at 229.

Moreover, the treatment of appreciated property is clearly not equitable. It favors the wealthy and the charities they support. For those who otherwise would sell, it further reduces the cost of giving, thereby requiring relatively little out-of-pocket cost compared to the size of the contribution. Moreover, even if the donor otherwise would not sell and is thus not avoiding a capital gains tax, the donation of low-basis property to charity enables her unfairly to substitute cash or new diversified investments for the donated property without paying tax on accrued gains. While the donor could accomplish this by holding property to death, this ordinarily has a cost, the inability to diversify one's holdings during life. I believe it is troubling to further increase what I view as the unjustified advantage of the basis step-up at death by allowing lifetime diversification without tax.

Thus, I would argue that current law can be justified only by establishing that forgiveness of gain is clearly the most efficient way to increase charitable giving (in terms of the ratio of additional gifts to lost revenue). Moreover, I believe it is essential to establish that an efficiency advantage, if it exists, is large enough to justify the loss of equity. In my view, this case has yet to be made. There is no proof that the increase in giving is uniquely large in relation to the lost revenue and that other more equitable means of maintaining similar support for charity are unavailable. Given the inequity of the current treatment, the burden of proof as to the value of the treatment of appreciated property as an incentive should be on supporters of current law.

In short, if the current preference for gifts of appreciated property is not uniquely efficient, constructive realization is clearly preferable. In light of this conclusion, the evidence as to efficiency is not sufficiently strong.

While the same uncertainty may exist as to the impact of the charitable deduction on cash gifts, this is less troublesome, in part, since the deduction also can be defended as necessary to measure income available for personal consumption. A fair market value deduction for appreciated property cannot be defended on this basis. Moreover, while the charitable deduction itself favors the wealthy, the treatment of appreciated property significantly aggravates this bias.

Therefore, in the absence of more solid information than currently exists as to the revenue loss and the impact on contributions, I favor treating contributions of appreciated property to charity as a constructive realization except, perhaps, for unique property important to the mission of the donee.¹¹² As suggested above, as to property that is not

¹¹² As noted above, even if there were no other changes, the ability to avoid realization of capital gain on a transfer of a partial interest to charity should be eliminated. See text accompanying notes 48-50.

important to the donee's mission, it is best to limit the deduction to basis.¹¹³ This would force a sale in order to achieve the advantage of the capital gain rates, which would have the effect of eliminating valuation issues.¹¹⁴ Perhaps, there could be an exception that would allow for gain recognition and a fair market value deduction, when valuation is not a concern, as in the case of traded securities. This would be appropriate if it could be shown that it would be helpful to allow a direct transfer to charity.

Although recognition of gain would likely have an impact on contributions, other steps could be taken that would increase support for the charitable sector. For example, I have suggested that the limit on the charitable deduction for contributions to public charities be repealed. In fact, limiting the deduction to basis in order to indirectly recognize gain, as suggested in the preceding paragraph, effectively would allow an unlimited deduction¹¹⁵ although as noted, it does not give the donor the opportunity to utilize the charitable deduction to reduce the amount of ordinary income.

It is true, of course, that the treatment of appreciated property has encouraged the growth of particular institutions that have come to depend upon such gifts. While property gifts comprise only about 15% of total giving, more than one-third of the contributions by those earning \$1 million or more are made in this form.¹¹⁶ Individuals donating property make a high proportion of their gifts to cultural and educational institutions. Thus, by itself, adoption of constructive realization could have a significant impact on contributions to such institutions as museums and universities, perhaps even if other steps are taken to assure that total support of the charitable sector remains constant.¹¹⁷

¹¹³ As noted above, this approach should be followed for difficult-to-value property whether or not constructive realization generally applies. See text accompanying notes 91-92.

¹¹⁴ To make this rule effective, a sale to a charity using funds contributed by the seller should be considered a gift in kind. If this approach applied to closely held stock, it would eliminate the opportunity, now apparently available, to give stock to charity and claim a deduction for fair market value even though it was obvious that the stock would be redeemed by the corporation. Rev. Rul. 78-197, 1978-1 C.B. 83. Under the ruling, only if the donee is legally bound to surrender the shares for redemption does the Service treat the proceeds as income to the donor. See *Palmer v. Commissioner*, 62 T.C. 684 (1974).

¹¹⁵ See notes 2 and 6.

¹¹⁶ See Auten et al., note 21, at 403.

¹¹⁷ Museums would be less affected, however, if a fair market value deduction continued for unique property. One can get some feel for the potential decline in support for these institutions from the impact of effective adoption of constructive realization under the alternative minimum tax. *Id.* at 408. We should recognize, however, that total giving in the affected years was skewed by those who accelerated gifts in anticipation of the change in law, *id.*, and then deferred giving in the expectation, which proved correct, that the constructive realization effect would be repealed, *id.*

Elimination of the limit on the charitable deduction, however, should be helpful to the same institutions.

In any event, while this argument may suggest a significant transition period, it cannot be used to deny all change.¹¹⁸ To take pluralism seriously requires a more equitable distribution of the ability to direct federal funds. This requires that unrealized gains be taxable when property is contributed to charity.

¹¹⁸ A transition period also could mitigate the problem that some people might not have knowledge of their basis.