The Back Forty
Primer Series

Primer #1: Bargain Sales of Fee Simple Interests in Property

With this issue,[1] The Back Forty *introduces a "primer" series on issues and transactions of interest to the land trust community. The first installment deals with the bargain sale and is a basic discussion of the principal elements of that transaction. Our hope is that our subscribers may not only find these primers helpful in amplifying their own knowledge, but that they photocopy them to use as handouts to landowners and their advisors. We welcome your comments.*

In the charitable context, a "bargain sale" is simply a sale of property to a qualified tax-exempt charitable organization at a price less than its established fair market value. Over the last twenty years or so, it is very likely that more land has been acquired for conservation purposes by means of the bargain sale than through all other charitable incentives combined.

To illustrate the operation of a straightforward bargain sale, suppose Zane Sturdley, owner of an undeveloped 1,200-acre tract of Arkansas bottomland hardwoods, recently appraised at $900,000, determines to sell that property to the Magnolia Springs Land Trust for $600,000 (two-thirds of its fair market value). Zane acquired the property through inheritance from his father, and his basis is $150,000.

Zane's sale to the land trust for $600,000 comprises both (1) a taxable sale and (2) a charitable contribution. Although the tax results of those two transactions may be separately described, their interaction is important in determining the overall consequences to Zane.

The "sale" portion. In order to determine the gain on Zane's sale, Internal Revenue Code section 1011(b) requires that his basis in the property be allocated between the sale and gift portions according to their relative values. Expressed algebraically, with *X* representing basis allocated to the sale, the apportionment is as follows:

$$\frac{X}{\text{total basis}} = \frac{\text{amount realized on sale}}{\text{fair market value of property}}$$

[1] Originally dated February 1991; updated in February 2008 and April 2015

So as to Zane's sale,

$$\frac{X}{\$150{,}000} = \frac{\$600{,}000}{\$900{,}000}$$

$X = \$100{,}000$

Thus, the sale produces a long-term capital gain of $500,000 ($600,000 (amount realized) less $100,000 (allocable basis)).

The "gift" portion. The charitable contribution – the "bargain" portion of the transaction – is measured by the appraised value of the property less the amount paid to Zane by the land trust. Here, Magnolia Spring has received a $300,000 contribution, consisting of appreciated real property. Under the percentage limitations of Code 170(b)(1)(C)(i), that contribution may be deducted currently in an amount not exceeding 30% of Zane's adjusted gross income. Remember, however, that adjusted gross income has been very substantially inflated by the sale itself. For example, if Zane's adjusted gross income before considering the bargain sale were $100,000, the sale would increase adjusted gross to $600,000 (by the $500,000 gain), and Zane would be permitted a current deduction of $180,000 (30% of $600,000). The remaining $120,000 of the charitable contribution would be carried over and used as a contribution of appreciated property in the succeeding year, subject to the same 30% limit. Excess charitable contributions carry forward for as long as five years beyond the year of the gift or until sooner exhausted.

Mortgaged properties. Where the target property serves to secure a debt (via a mortgage or deed of trust, for example), and the acquiring land trust either assumes the obligation or takes the property subject to that obligation, the amount of the liability secured by the property is treated as additional consideration received. To illustrate with reference to Zane Sturdley's situation, suppose Magnolia Springs pays Zane only $400,000 cash, but takes the property subject to a preexisting $200,000 mortgage. The results would be exactly the same as described above; i.e., Zane has received consideration totaling $600,000 ($400,000 cash and relief of the mortgage liability), has a $500,000 capital gain, and has made a $300,000 contribution.

The appraisal issue. Prospective donors or their advisors often express apprehension that the bargain sale may subject a taxpayer to severe IRS audit scrutiny. In fact, the bargain sale is no more likely to do so than any sizeable charitable transactions. Tax returns are selected for audit based in part on various "profiles," among them the relativity of charitable contributions to income. Since bargain sales, particularly involving real estate, tend to be sizeable transactions, an audit is not unlikely. But the examining agent's concern will almost invariably be with the validity of the appraisal, not a challenge to the concept of a bargain sale. It is not the bargain sale per se that is apt to invite an audit, but an appraisal that appears deficient in its assumptions or methodology or excessive in its property valuation.

The relative bargain. Although the land trust has no responsibility to quantify the donation (and, indeed, should neither participate in the appraisal process nor attest to the asserted value), it may well be asked to express its gratitude, or to acknowledge that the transaction constitutes a bargain purchase. Such an acknowledgement may be difficult to render where the "gift" appears small relative to the amount of the sale price. As a rule of thumb, we suggest the there be no acknowledgement of a donation at all where the asserted contribution is less than 10% of the property's fair market value, and that where the asserted contribution is between 10 and 20% of fair market value, the land trust carefully consider requests for expressions of gratitude based on the facts of the particular case – including, perhaps, the reputation of the appraiser and the land trust's own knowledge of property values in the area.

Alternative minimum tax considerations. Although an exhaustive analysis of the possible alternative minimum tax implications of a bargain sale are beyond the scope of this primer, the land trust and its counsel should be aware that a sizeable bargain sale with a substantial gift component may drive the taxpayer into the alternative minimum regime. Where that happens, the anticipated tax benefit may be severely diminished, since the appreciation element in the donation constitutes an item of tax preference.

Returning to our Zane Sturdley illustration, we saw that, for regular tax purposes, Zane's bargain sale produced a present charitable contribution deduction of $180,000. Of that amount, $150,000 represents appreciation in the presently deductible gift portion ($50,000 of Zane's total basis is, in effect, allocated to the gift portion, thus $250,000 of that portion represents capital appreciation. Since he currently uses $180,000 of the charitable deduction, five-sixths of that amount is similarly characterized as capital appreciation).

The message as to the possible applicability of the alternative minimum tax is quite simple: before illustrating a prospective donor's tax benefits under the "regular" tax system, be sure to ascertain that the taxpayer is (1) not presently in an alternative minimum situation, and (2) will not be falling into that regime via the proposed bargain sale.

William T. Hutton, February 1991