Article of the Month
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Auctions: Donor Deductibility and Charity Documentation

Many charities hold fundraising auctions. While auctions can be a great way to raise money, there are several notable issues that arise.

Auction Types

There are two types of auctions: silent and open. A silent auction is one in which a card or bid sheet is placed next to each item that can be purchased. This card or sheet notes the minimum bid for the item and the fair market value of the item. Bidders then write their number and the amount they are willing to bid on the card or sheet. At the end of the auction, the highest bidder is the winning bidder and pays for the item.

In contrast, an open auction is one in which bidding is conducted under the supervision of an auctioneer. The auction items are typically published in a brochure with a detailed description, minimum bid and fair market value. The auctioneer begins the bidding at the minimum bid and bidders bid by raising their hand or a placard to indicate their desire to bid at the price called out by the auctioneer. The winning bidder is the highest bidder and pays for the item after the bidding has closed for that item.

Donor Deductibility

Charity auctions often are dependent on donations from those in the community. Several types of items may be offered at auction, but donors typically give one of two types of items to charity auctions: services or a tangible item. Some of the goods and services may be given by businesses, while others are given by individuals. In either case, the most common misconception is that donors believe they can deduct the full fair market value of the items they donate to be auctioned.

Is It a Gift?

To be deductible, the donor's donation must be a gift. First, the donor must have given the item as a "contribution or gift to or for the use of" the auctioning charity. Second, the gift must be a voluntary transfer. Third, the donation must be made "without compensation or in excess of benefits received." Fourth, any goods or services received by the donor in return reduce the donation. Goods and services include cash, property, services, benefits and privileges.

Gifts from Businesses

A gift of a business's services is typically not deductible because the IRS deems the services "lost income." Income is ordinary and gifts of ordinary income are not deductible. Sec. 170(e). Examples of services given by businesses include ad space, television air time and legal services.

Tangible gifts by corporations are permitted charitable deductions under Sec. 170. However, the deduction is limited to 10% of the corporation's taxable income in the year of the gift. The 10% must be calculated by excluding charitable deductions, net operating loss carrybacks and net capital loss carrybacks. Sec. 170(b)(2). If the gift exceeds 10% of the corporation's taxable income, it may be carried forward for up to five years. Sec. 170(d)(2)(A).

Many businesses make gifts of excess inventory. A corporation may deduct a gift of inventory at its cost basis, rather than at the fair market value of the item. However, if the use of the property by the charity is for the care of the ill, the needy or infants, a different rule may apply. Sec. 170(e)(3)(A). In this case, the gift will be the lesser of twice the basis or basis plus one-half of the appreciation. This more favorable rule also applies to gifts of scientific equipment and other qualified research equipment. Sec. 170(e)(4)(B).

Gifts from Individuals

As with businesses donating services, gifts of services by individuals typically do not qualify for a deduction. However, tangible gifts usually qualify for a deduction unless they are a partial interest gift. For example, a donor may donate a week of use at his or her vacation home. Such a gift is not deductible because it is a partial interest gift under Sec. 2522.

Use caution with a gift of an auction item that has appreciated in value since the donor purchased it. The item will be considered tangible personal property given for an unrelated use. For gifts of tangible personal property for an unrelated use, the donor only may claim his or her cost basis in the item, rather than the fair market value.

Donations of appreciated real property are deductible at fair market value up to 30% of an individual's adjusted gross income (or 20% of an individual's adjusted gross income if the donation is to a private foundation). If a donor gives cash to purchase items to be auctioned, the donor's cash donation is deductible at fair market value up to 50% of the donor's adjusted gross income (or 30% if to a private foundation).

Valuation

Some items, such as those readily purchased at a retailer for fixed or suggested prices, are more easily valued than items such as art, memorabilia and meals with notable people. Both the donor and the charity must value the item.

The donor is responsible for valuing the item in order to substantiate his or her deduction, if any. The donor has the burden of proving to the IRS how he or she determined the fair market value of the donated item. If the donated item is worth more than $5,000, a written appraisal is required. Donors also are required to present a written acknowledgement or receipt from the charity for any non-cash contributions valued at more than $250. Sec. 170(f)(8); Reg. 1.170A-13(f).

In addition, the charity also has a responsibility to value the item, because it must provide this information to potential bidders, and more importantly, to the winning bidder for his or her deduction. Many charities include this information in their auction brochure or bidding list. Please see the section below entitled "Taxation of Winning Bidders" for further information.

Taxation of Winning Bidders

Another common misconception is that any item won at a charity auction is fully deductible as a charitable contribution. If a bidder wins an item, he or she is allowed to deduct only the amount over the fair market value of the item. A contribution for which the donor receives something in return is called a quid pro quo contribution.

For example, Bidder places the winning bid on a dinner for two at a local restaurant. The fair market value of the dinner is $75. If Bidder pays $75 or less for the dinner, Bidder cannot deduct any of the bid payment as a charitable deduction.

Alternatively, Bidder wins and pays $125 for the same dinner. Bidder may deduct $50 of his or her payment as a charitable deduction because Bidder paid $125 for a dinner with a value of $75. The difference, $50, is the value of Bidder's gift to charity.

Charity Documentation

As mentioned above, the charity must provide documentation to the donor and to the winning bidder.

The charity should provide the donor with a gift receipt that states the date and location of the charitable contribution, describes the donated item and states whether or not the donor received any goods or services in return. The charity is not required to provide the fair market value of the item in the gift receipt. As discussed above, it is the donor's responsibility to determine the fair market value of his or her gift.

In addition, the charity should provide a written disclosure to the winning bidder for any goods or services whose value exceeds $75. Sec. 6115; Pub. 1771. There is no set form for the disclosure. It may be an email, postmarked letter, postcard or computer-generated form. However, regardless of the form used, it should include a good faith written estimate of the service or item won at auction. The disclosure also should state the fair market value of the goods or services and how much, if any, of that value is deductible. Sec. 170(f)(8)(b); Reg. 1.170A-13(f). Any reasonable method of valuation is allowed. (Note: In order for a contribution to be deductible, it must be made to a qualifying charitable organization.)

For example, let us return to our Bidder example. Bidder won a dinner for two valued at $75. Bidder paid Charity $125 for this dinner. Charity should provide Bidder with a written disclosure similar to the one presented below:

> "Thank you Bidder for participating in Charity's Annual Auction. The fair market value of the item you won, a dinner for two at Local Restaurant, is valued at $75. Your winning bid was $125. Therefore, you have made a deductible charitable gift of $50 to Charity. No goods or services were provided in exchange for your contribution. We appreciate your support and thank you for your generous gift."

Notwithstanding the above disclosure stating that no goods or services were provided in return, a charity may award a "token" benefit for the gift by the winning bidder. Many charities give recognition, plaques, memorabilia and other items to donors. In general, the token benefit is disregarded if it is less than 2% of the payment up to $86 (in 2006). If the donor gives at least $41.50 (in 2006), then a token item such as a mug, poster or key chain with the charity's name or logo and an indexed value of $8.60 may be given.

The benefits to an individual do not include intangible religious benefits. See Rev. Proc. 90-12, Rev. Proc. 92-49, Reg. 1.170A-1(h)(3), Reg. 1.170A-13(f)(8)(i)(A). (Note: If a charity has provided an "intangible religious benefit," then this should be noted in the disclosure.)

If a charity fails to provide a written disclosure, the charity may be subject to a penalty of $10 per contribution, with a total penalty not exceeding $5,000 per fundraising event. Sec. 6714. In some cases, however, a charity may avoid the penalty if it can show reasonable cause for the failure to provide a written disclosure. Pub. 1771.

Conclusion

Charitable auctions can be a great way to raise money for a charity's general fund or a special project. By simply being aware of the above charitable deduction issues, the charity's staff will ensure a successful auction and many gifts.