FSA 1999-916
Vaughn #55

FULL TEXT:
INTERNAL REVENUE SERVICE
MEMORANDUM
CC:TL-N-[redacted text]
FS:IT&A:[redacted text]
date: [redacted text]
to: District Counsel, [redacted text]
Attn:[redacted text]
from: Assistant Chief Counsel (Field Service) CC:FS
subject: [redacted text]

By memorandum dated[redacted text] you requested field service advice on the argument(s) the Service should make in the above-referenced case. Because the issue implicates I.R.C. sections 1231 and 1245, in addition to I.R.C. section 170, we requested the views of the Income Tax and Accounting Division. These views have been incorporated in our response.

ISSUE

Whether the fair market value of fully depreciated property may be deducted as a charitable contribution under I.R.C. section 170.

CONCLUSION

We agree with your conclusion that taxpayers are not entitled to a charitable contribution deduction in an amount of the fair market value of fully depreciated property. However, we believe the argument supporting this conclusion should be refined as indicated below.

FACTS

On[redacted text] the[redacted text] entered into a sale/leaseback transaction of certain property with the[redacted text] (AKA the[redacted text] a non-profit[redacted text] corporation.[redacted text] was on the Board of Directors of the museum and would on occasion make loans or charitable contributions to the museum. The sale/leaseback agreements provided that the[redacted text] agreed to purchase and then lease to the museum artifacts which included[redacted text] office equipment, a bus and glass display cases.

The total contract purchase price was $[redacted text] The[redacted text] paid this sum over a[redacted text] year period in the amounts of $[redacted text] and three equal payments of $[redacted text] covering years[redacted text] and[redacted text] respectively. The museum paid the[redacted text] annual rental fees of $[redacted text] in[redacted text] and respectively.

The[redacted text] fully depreciated the museum artifacts and presumably deducted their interest payments on the outstanding balance of the contract during[redacted text] and[redacted text] . Counsel is attempting to verify that the taxpayers claimed investment tax credit on the property. In[redacted text] , the museum filed for bankruptcy. The[redacted text] then donated all the museum artifacts back to the museum and claimed a charitable contribution deduction based on the original $[redacted text] contract purchase price limited by contribution base. The charitable contribution deduction was disallowed in full by the Examination Division and the disallowance was upheld by the Appeals Division.

You propose to argue that a deduction is not allowable under any of three theories, viz: (1) The assets subject to the sale and leaseback constitute section 1231 property and taxpayers' deduction is limited by Treas. Reg. section 1.170A-4(b)(1) to their basis in such property; (2) the assets are ordinary income property within the meaning of section 1245 for which a deduction must be reduced pursuant to section 170(e)(1)(a) by the amount of gain which would not have been long term capital gain had the property been sold at its fair market value; and (3) a charitable contribution deduction is prohibited under the "double deduction" theory set forth in Reg. section 1.1016-6(a)(1) and considered in Gen. Couns. Mem. 37, 982 (March 22, 1979). You have requested our views with respect to these theories.

DISCUSSION

Section 170(a) provides that there shall be allowed as a deduction any charitable contribution, payment of which is made within the taxable year.

Section 170(e)(1)(A) provides that the amount of any charitable contribution of property otherwise taken into account under section 170 shall be reduced by the amount of gain that would not have been long term capital gain if the property had been sold by the taxpayer at its fair market value.

Treas. Reg. section 1.170A-4(a)(1) provides that in the case of a contribution by an individual of ordinary income property, the deduction shall be reduced by the amount of gain which would have been recognized as gain which is not long term capital gain. Reg. section 1.170A-4(b)(1) defines "ordinary income property" as property any portion of the gain on which would not have been long term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution, e.g., property held by the donor primarily for sale to its customers in the ordinary course of his trade or business, a work of art created by the donor, a manuscript prepared by the donor, etc.

Reg. section 1.170A-4(b)(4) provides that for purposes of applying subparagraphs (1) and (2) of that paragraph, property that is used in a trade or business, as defined in section 1231(b), shall be treated as a capital asset, except that any gain in respect of such property which would have been recognized if the property had been sold by the donor at its fair market value at the time of its contribution shall be treated as ordinary income to the extent that such gain would have constituted ordinary income by reason of the application of section 1245(a).

Section 1231(b) provides for purposes of this case, that the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167.

Section 1245(a) provides in pertinent part that, for depreciable personal property sold during the taxable year, the amount by which the lower of (1) the recomputed basis or (2) the amount realized, exceeds the adjusted basis of the property shall be treated as ordinary income. "Recomputed basis" in the instant case means its adjusted basis recomputed by adding thereto all adjustments reflected in such adjusted basis on account of deductions allowed for depreciation.

Reg. section 1.1245-3 defines "1245 property" as any property which is or has been of a character subject to the allowance for depreciation under section 167. Section 167 allows a depreciation deduction for the exhaustion, wear, and tear of property used in a trade or business or for property held for the production of income. If property is held for the production of income it is depreciable regardless of whether or not the earning of such income constitutes a trade or business. The term "held for the production of income" includes both recurring income and gain from the disposition of the property. Mitchell v. Commissioner 47 T.C. 120 (1966). Generally, rental property under a net lease entailing little management or monitoring activity is held for the production of income, and depreciation will be available unless the sale/leaseback arrangement lacks economic substance or is a financing device. Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

Taxpayers claimed a depreciation deduction of $[redacted text] with respect to the donated property and have claimed a charitable contribution deduction of a similar amount. The application of sections 170(e) and 1245 operate to reduce the charitable contribution deduction to zero. We believe that this argument is preferable because the expansive language of section 1245 encompasses, but does not require inquiry into whether the income producing activity constituted a trade or business. Furthermore, the legislative history of section 170(e) evinces a Congressional intent to apply this provision to a contribution of depreciable property, the gain on the sale of which would be subject to recapture as ordinary income. See H.R. 13270, 91st Cong., 2d Sess. 77-78 (1970), 1969-3 C.B. 200, 235. Taxpayers' receipt of rental income of $[redacted text] in taxable years[redacted text] through[redacted text] conclusively establishes that the property was held for the production of income and, accordingly, section 1245 is applicable.

Alternatively, it is suggested that Reg. section 1.1016- 6(a)(1) provides that adjustments to basis must always be made to eliminate double deductions.

In Gen. Couns. Mem. 37, 892, the Chief Counsel's Office considered the application of Reg. section 1.1016-6(a)(1) to a situation where a taxpayer was eligible for a deduction under either section 170 or section 213. The G.C.M. concluded that under the authority of the regulation, the donor of certain medical equipment must reduce his/her basis in said equipment by the amount of the deduction for the cost of the equipment under section 213 that reduces the taxpayer's adjusted gross income. In the instant case, there is no question involving the amount of basis in the donated property because taxpayers fully depreciated the assets prior to the date of donation. Accordingly, we do not believe that a separate argument implicating Reg. section 1.1016-6(a)(1) is required or appropriate.

In summary, we prefer that you do not argue that the assets subject to the sale and leaseback constitute section 1231 property and taxpayers' deduction is limited by Reg. section 1.170-4(b)(1) to their basis in such property. Rather, the preferable argument is that the assets are ordinary income property within the meaning of section 1245 for which a deduction must be reduced pursuant to section 170(e)(1)(a) by the amount of gain which would not have been long

term capital gain had the property been sold at its fair market value. A separate argument implicating Reg. section 1.1016-6(a)(1) is not appropriate here.

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Any questions concerning this matter may be referred to[redacted text] at (202) 622-7900.
By: Daniel J. Wiles Income Tax and Accounting Branch Field Service Division