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Auctions Conducted by Charities

Charities often use auctions as part of the fund-raising program. Too often, some donors who provide goods or services to be auctioned and those who win goods or services at the auction believe their donation of goods or services and their payment for these items as winning bidders represent charitable donations. While a charitable deduction may result in some situations, it is certainly not true in every instance. This is why it is important to have an understanding of the tax rules in the planning stage of an auction.

Form 990 and 990-T implications. For purposes of reporting auction data on a charity's Form 990, an auction is a "special event," not a program activity. The unrelated business income tax generally does not apply to charity auctions, because auctions are typically not regularly carried on (an annual auction is a common practice for some charities), the merchandise sold at an auction is generally donated, and the work related to the auction is generally performed by volunteers. If none of these exceptions are available, it is possible that the net revenue from the auction would be subject to unrelated business income tax.

Items donated to a charity's auction. Generally, the contribution of an item of property to a charitable organization, for the purpose of being auctioned, gives rise to a charitable contribution deduction for federal income tax purposes. The amount of the deduction is usually equal to the fair market value of the contributed property.

There are important exceptions to the above rule:

1. **Tangible personal property.** The charitable deduction for gifts of tangible personal property, such as artwork and furniture, is limited to the donor's basis in the property, even if the property has appreciated in value. This limitation applies because the property is to be used in a way that is unrelated to the charity's tax-exempt purpose (a gift made for the purpose of auctioning by a charity is an unrelated purpose).

2. **Right to use property.** The gift of a right to the use of property provides no charitable deduction. For example, a donor may give the use of a vacation property for a certain period of time. This is not a gift of the property but merely the right to use the property.

3. **Services.** There is no charitable deduction available for the donation of services for auctioning. A lawyer or an accountant may donate some of their time or someone may donate free lessons of a certain type. There is no income tax charitable deduction for a gift of services.

4. **Inventory.** Inventory items are those items held for sale to customers in the ordinary course of a trade or business, representing ordinary income property. Contributions of inventory present unique challenges in determining the deductible amount. In virtually every case relating to an auction, however, the amount of the deduction will be limited to the donor's cost of the item.

5. **Ordinary income property**. As with inventory property, the amount of a deduction for contributions of other types of ordinary income property is generally subject to a reduction rule effectively limiting the deduction to the donor's basis in the contributed property. Ordinary income property is property that, if sold, would give rise to ordinary income rather than long-term capital gain.

6. **Real property**. Real property that would have generated long-term capital gain if sold by the donor generally will produce the most favorable charitable contribution deduction for property contributed to an auction. The reduction rules applicable to inventory, ordinary income property, and tangible property not used in the donee organization's charitable function do not apply to long-term capital gain property even if sold immediately by the donee. Thus, land and buildings (not used in a trade or business) contributed to an auction are deductible by the donor at full fair market value. (Federal and State regulation of transactions with securities would limit or prohibit selling of appreciated securities at a charity’s auction.)

7. **Property with a fair market value of less than its basis**. A charitable donation of depreciated property results in a nondeductible loss (the difference between the higher, nondeductible donor's basis and the lower, deductible fair market value). A better tax result would be to sell the property, recognize the loss for property held for use in a trade or business or for investment, and contribute the proceeds from the sale.

The gift substantiation rules apply to gift of items to a charity to be auctioned (assuming a charitable contribution deduction is available and claimed) and to situations where a person is claiming a gift to the charity (made as part of the property acquisition transaction—see the “items purchased at an auction” discussion below). The basic gift substantiation rule is that a donor who makes a separate charitable contribution of $250 or more in a year must, to be able to deduct the gift, obtain a written substantiation from the donee charitable organization.

Gift acknowledgments should reflect a description of the property donated, including condition, the date of the contribution, but not the value of the gift. An example of a gift acknowledgment is shown at the end of this document.

Items purchased at an auction. When an individual acquires an item at a charity's auction, there is generally no charitable deduction available. The prevailing bidder in a charity auction is presumed to be paying fair market value of the item. Based on this view, the transaction is solely a purchase; there is no gift element and therefore no charitable contribution deduction.

In certain instances, an item of property may be auctioned for an amount far in excess of its true fair market value. In this case, it is not unreasonable to take a position that a charitable deduction is available for the amount paid that exceeds the property's fair value. It may be required, and certainly would be beneficial, to support the deduction for the organization to provide the bidders with the organization's estimate of the fair market value before the bidding takes place. In these instances, it would be appropriate, and perhaps required under the quid pro quo rules, for the charity to state the estimated fair market value on the donor's receipt.

The quid pro quo rules apply in a charity auction setting if the amount paid to the charity for items exceeds $75. In connection with the receipt of the payment, the charity must provide a written statement that:

1. Informs the donor that the amount of the contribution that is deductible for income tax purposes is any excess of the amount of money paid to the organization over the value of the goods or services provided by the organization, and

2. Provides the donor with a good faith estimate of the value of the goods or services.

Vehicle, boat, and airplane issues. The sale of a vehicle, boat, or airplane at an auction would generally qualify as an arms-length sale, which would determine the amount of the donor's deduction based on the gross amount of the sale. A sale of this property at an auction with the proceeds given to a needy individual does not qualify the donor for a charitable deduction based on the fair market value of the property as of the date of the donation.

Sales tax issues. Every transaction at a charity auction is, in whole or part, a purchase. Therefore, the charity is engaging in sales activity, which may trigger the state's sales tax rules. A review of the applicable state law is very important.