

PROFESSIONAL TAX & ESTATE PLANNING NOTES

JUNE 2012

Donating Mutual Fund Shares to Charity

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Timing of Charitable Contributions

More than \$12 trillion is now invested in United States mutual funds, nearly double the amount ten years ago.¹ As more and more individuals hold appreciated assets in mutual funds—both personally and in their retirement plans—shares in mutual funds are an increasingly important source of charitable gifts. Contributing these assets to charity can be somewhat more complicated than the typical donations of cash or individual securities. The New York Community Trust can ease the contribution process.

Charitable gifts of mutual fund shares confer the same tax benefits as gifts of individual securities. *But there are distinctions between mutual funds and other stocks*, and those differences need to be taken into account when donating mutual fund shares. This issue of *Professional*

Notes discusses the tax reasons for donating mutual fund shares and suggested steps for their transfer.

Regulated Investment Companies

Mutual funds generally are structured as open-end investment companies that qualify as “regulated investment companies” (RICs), governed by Sections 851-860 of the Internal Revenue Code.² The tax rules governing RICs are very complicated, but, in general, mutual funds are not subject to income tax on distributed income. Instead, mutual funds pass along to their shareholders each year all dividends and gains, and the shareholders pay tax on these items as if they held the underlying securities directly.

Unlike other securities, shares in mutual funds are not purchased and

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Written by Jane L. Wilton, general counsel, The New York Community Trust

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¹Investment Company Institute, www.ici.org/research/stats/trends/trends_02_12. For earlier data, see www.ici.org/pdf/10fb_data6.pdf.

²All “Code” references are to Sections of the Internal Revenue Code of 1986, as amended, and all “Treasury Regulation Section” references are to regulations thereunder.

sold on an exchange; instead, they are bought and sold through the issuer. Despite this fact, mutual fund shares may be considered “publicly traded” under Treasury regulations. Classification as publicly traded securities has important tax implications for charitable gifts, which are discussed below.³

Charitable Contributions of Mutual Fund Shares

When appreciated stock (whether or not publicly traded) that has been owned for more than a year is contributed to a public charity such as The New York Community Trust, the donor generally is entitled to an income tax deduction for the asset’s full fair market value; there is also no tax on the inherent capital gain. The definition of publicly traded securities can be critically important. If stock that is not publicly traded is given to a private foundation, the donor’s deduction is limited to his cost basis.

Despite the fact that mutual fund shares are acquired from the issuer and are disposed of through a redemption process, they are considered to be “publicly traded” under Treas. Reg. Sec. 1.170A-13(c)(7)(xi)(3) if quotations are published on a daily basis in a newspaper of general circulation. In addition, no appraisal is required if the shares are considered to be publicly traded.

As with charitable gifts of appreciated stocks, it is imperative that the mutual fund company transfer the shares rather than redeem them and transfer cash. Otherwise, the donor will be taxed on the sale of the shares.

Procedure for Giving Mutual Fund Shares

Securities held in street name with a broker are commonly transferred to charity through the Depository Trust Corporation (DTC) wire transfer system. If a donor holds the stock certificate, the gift can be effected by mailing or otherwise delivering the certificate to the charity. The slowest, and generally least desirable method of giving stock to charity, is to deliver the shares to the issuing corporation, which then transfers ownership on

its books; the gift is not complete until the issuer records the transfer.

By their nature, mutual funds generally are transferred through a change of ownership on the issuer’s books. They cannot be transferred through the DTC system, and the shareholder does not hold a certificate of ownership.

The New York Community Trust has been involved in a substantial number of these transfers and suggests the following steps for effecting a charitable gift of mutual fund shares:

1. The donor should contact his or her account representative at the mutual fund company to ask about the process of making a gift of mutual fund shares. Specifically, the donor will want to know whether the mutual fund company has a required form for instructions to initiate the transfer, and whether those instructions will require a medallion signature guarantee. A signature guarantee is different from a notarized signature. It is a guarantee by a financial institution—usually the donor’s bank or brokerage firm—that a signature is genuine, and it requires the donor to go to the particular institution to have his or her signature guaranteed. We are advised that not all banks will provide this service.
2. The donor should notify The Trust of his or her interest in making a gift of mutual fund shares, identifying the mutual fund, the number of shares, and the telephone number and contact person (if available) at the mutual fund. We will then check with our own broker to determine whether the shares can be transferred to a gift account for our benefit or to an existing account already set up with the particular mutual fund company by our broker.
3. If our broker does not have such an arrangement with the mutual fund company, then we will have to open an account with the mutual fund company. In the past, we found that the donor generally could instruct the mutual fund company to establish an account using our taxpayer identification number. Recently, we find that mutual fund companies may

³ Although generally not considered mutual funds, *closed-end* investment companies, which have a fixed number of shares and usually are traded on stock exchanges, also meet the definition of “publicly traded,” as do exchange traded funds or ETFs.

be unwilling to do so at the behest of the donor, and will need to speak with us. When we confirm with the donor either that an existing account is available or that a new account is being established for the purpose of accepting his or her gift, then and only then should the donor instruct the mutual fund company to transfer the shares to our account. As previously noted, the mutual fund company may have a required form for directing the transfer of the shares, and this may require a signature guarantee.

4. Finally, the mutual fund company will send The Trust a transaction advice once the shares have been transferred to our account. If we know that a gift is in process, we can call the mutual fund company and check on whether the gift has been received in our account. However, mutual fund companies generally will not confirm that the transfer has been requested by the donor or that paperwork is complete unless we have the donor's social security number and account number and the donor has authorized the release of information. For the donor's protection, we are reluctant to have confidential information such as social security numbers.

Because these procedures can take time, typically from two to four weeks, we urge donors not to wait until the last minute to try to complete a charitable gift of mutual fund shares. *This is particularly important for donors who typically make gifts at year end. We recommend beginning the transfer before Thanksgiving if the year of the contribution is important.*

Retirement Plan Assets

Mutual fund shares constitute a sizable portion of IRA and 401(k) assets. These assets become "income in respect of a decedent" (IRD) when they are inherited,

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and in addition to being subject to estate tax, the previously untaxed income is subject to income tax. Both income and estate taxes can be avoided by allocating these assets to charity. The Trust can be designated as the beneficiary of the retirement plan or the estate can be made the beneficiary and the IRD assets allocated to The Trust by will.

In addition, since 2006, the so-called IRA charitable rollover provision has allowed donors over 70 and 1/2 years of age to gift up to \$100,000 to charity annually from IRA accounts during the owner's lifetime without tax implications. Although not permitted for transfers to private foundations, donor-advised funds, or supporting organizations, transfers to public charities, including The Trust (for field-of-interest or unrestricted funds), have been permitted. The rollover provision, which did not give rise to a deduction but freed donors of income tax on the distributed amount, expired at the end of 2011, and extension is under consideration in Congress.⁴

Conclusion

Charitable gifts of mutual fund shares have become relatively commonplace. Appreciated mutual fund shares held for more than a year provide the same income tax deduction for the value of the gift as stocks held individually, without being taxed on the capital gain. The essential difference—at least for the moment—is that the transfer of mutual fund shares can take significantly longer and needs careful monitoring to ensure that it is effected properly.

And for the growing number of people whose retirement accounts are invested in mutual funds, these assets offer an important estate planning opportunity. By specifically allocating IRAs and similar retirement accounts to charity and other assets to heirs, significant taxes that otherwise would be owed can be avoided, leaving more for both individuals beneficiaries and charity.

⁴ As this goes to press, extension of the IRA charitable rollover is under consideration. S. 557/H.R. 2502, introduced in 2011, would, among other things, expand the rule to include donor-advised funds, eliminate the \$100,000 cap, and lower the age at which the donor may take advantage of the tax-free transfer.

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About The Trust

We have been working with lawyers since 1924 to help clients with their philanthropy. With a seasoned staff, range of giving options, capacity to accept complicated assets, knowledge of our community, and efficient management, The Trust has been the right choice for thousands of New Yorkers.

One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the nonprofits that are crucial to a community's vitality.

Grants made from these funds—which now number more than 2,000—meet the needs of children, youth and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust is alert to emerging issues and develops strategies to deal with them, works with other funders and government, and gets out information to the public.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. Its staff is recognized for its expertise in grantmaking, financial administration, and donor services. Local divisions are located on Long Island and in Westchester. In 2011, The Trust made grants of \$137 million from nearly \$2 billion in assets.

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OUR SUBURBAN DIVISIONS

Long Island Community Foundation
1864 Muttontown Road
Syosset, NY 11791
(516) 348-0575
www.licf.org

Westchester Community Foundation
200 North Central Park Avenue
Suite 310
Hartsdale, NY 10530
(914) 948-5166
www.wcf-ny.org

THE NEW YORK
COMMUNITY TRUST



909 Third Avenue
New York, NY 10022
(212) 686-0010
www.nycommunitytrust.org