

PROFESSIONAL TAX & ESTATE PLANNING NOTES

MARCH 2012

1 Charitable Gifts of Publicly Traded Securities

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Individuals with philanthropic interests can receive significant tax benefits for gifts of appreciated property. This issue of *Professional Notes* will focus on gifts using publicly traded stock.

Appreciated Securities

Many people mistakenly believe that all donations of appreciated securities are deductible at full fair market value, but only long-term appreciated securities—those held for at least one year and a day—are eligible for a full deduction. For individuals who hold short-term appreciated securities, there is little or no tax difference between donating the stock or selling the stock and donating the proceeds.

Long-Term Securities. When appreciated securities held for more than a year are donated to The New York Community Trust or another

public charity, the donor generally enjoys an income tax deduction for the asset's full fair market value and avoids tax on the capital gain. This is probably the best known and most widely used tax benefit for charitable gifts. (Example 1.)

The donor may use this deduction up to a limit of 30 percent of his or her "contribution base," i.e., adjusted gross income computed without any net operating loss carryback. Donors to a private foundation have a deduction up to a limit of only 20 percent. Donations beyond this limit may be carried forward for up to five tax years. Although at one time a donor whose tax is measured by the alternative minimum tax (AMT) had to be concerned with the possible impact of the AMT on his or her deduction for a gift of securities, under current law, the

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EXAMPLE 1.
GIFT OF LONG-TERM APPRECIATED SECURITIES

Ms. Ellsworth, a donor in the 31% tax bracket, makes a gift of stock worth \$100,000 that she bought for \$40,000 two years ago. Her tax savings will be as follows:

\$100,000	fair market value of gift
x <u>.31</u>	tax rate
\$ 31,000	tax savings

If she instead sells the securities and donates the proceeds, her tax savings will be far more limited:

\$100,000	fair market value
(40,000)	less basis
60,000	gain
x <u>.15</u>	tax rate on long-term gain
\$ 9,000	tax on gain

\$100,000	cash gift
x <u>.31</u>	tax rate
31,000	tax savings on gift
(9,000)	less tax on gain
\$ 22,000	net tax savings

Of course, the higher the tax bracket, the greater the savings.

unrealized appreciation on the stock gift is not an item of tax preference.

Short-Term Securities. Gifts of securities held for one year or less do not receive the same favorable tax treatment as gifts of long-term securities. Although the general rule is that the fair market value of contributed securities is deductible, the deduction is reduced by the amount of gain that would be treated as short-term capital gain or ordinary income had the property been sold. In effect, only the basis of gifts of short-

term appreciated securities may be deducted. (Example 2.)

Section 306 Stock. If your client is considering a contribution of preferred stock, it is important to determine whether it is Section 306 stock. This type of preferred stock, typically received as a tax-free dividend on common stock, does not receive the preferential treatment of long-term capital gain stock. It is considered “tainted” to the extent that corporate earnings and profits are allocated to the stock when distributed.

When sold, this “tainted” portion of the stock will be taxed as ordinary income, not long-term capital gain, unless the sale terminates the seller’s entire interest in the corporation. Only the gain in excess of the total of basis and the ordinary income portion will be treated as capital gain.

The deduction for a charitable gift of Section 306 stock to a public charity such as The Trust is limited to the sum of (1) the donor’s basis in the stock, plus (2) the portion of gain that would have been treated as long-term capital gain had the stock been sold. However, if the contribution of Section 306 stock terminates the donor’s interest in the corporation, the full fair market value of the stock gift is deductible if the donor held the stock for more than 12 months.

Bonds. Bonds, like stock, generally are held as capital assets, and a bond held for more than 12 months qualifies as a long-term security for determining the charitable deduction.

However, if the bond had original issue discount (OID), the difference between the stated redemption price and the issue price generally is taxable as interest income as it accrues. The amount recognized as OID each year increases the bondholder’s basis.

If the bond is sold, any accrued OID that has not been recognized is taxable as ordinary income, and the difference between the proceeds and the holder's basis (increased by recognized OID) is capital gain or loss. A gift to charity of a bond with OID will give rise to ordinary income to the donor as if the bond had been sold.

Similarly, the disposition of market discount bonds acquired for less than the stated redemption price, or in the case of an OID bond, for less than their issue price plus accrued OID, gives rise to ordinary income to the extent of accrued market discount allocable to the period the seller—or donor—held the bond.

As a result, in the case of gifts of OID or market discount bonds held for more than 12 months, the donor's fair market value deduction will be reduced by ordinary income recognized on the transfer.

Incentive Stock Options. Incentive stock options are by definition non-transferable except at death. When contributing stock acquired through the exercise of an incentive stock option, a donor may be entitled to a fair market value deduction provided the donor has held the stock for more than one year from the date the option was exercised.

However, if it has not been at least two years from the date the option was granted, the donor will be required to recognize the difference between the exercise price and fair market value on the date of exercise as ordinary income.

Depreciated Securities

If your client is considering a gift of depreciated securities, it is more advantageous to sell the securities and contribute the proceeds, rather than donate the securities. This is because the donor may deduct the fair market value of a charitable gift of either long-term or

EXAMPLE 2. GIFT OF SHORT-TERM APPRECIATED SECURITIES

Mr. Howard, a taxpayer in the 31% bracket, makes a charitable gift of securities worth \$100,000 that he bought six months ago for \$40,000:

\$100,000	fair market value
<u>(60,000)</u>	less short-term gain
40,000	charitable deduction
x <u>.31</u>	tax rate
\$ 12,400	tax savings

If, instead, he sells the securities and contributes the proceeds, his savings are the same:

\$100,000	fair market value
<u>(40,000)</u>	less basis
60,000	gain
x <u>.31</u>	tax rate
18,600	tax on gain
\$100,000	cash gift
x <u>.31</u>	tax rate
31,000	tax savings on gift
<u>(18,600)</u>	less tax on gain
\$ 12,400	net tax savings

short-term depreciated securities, but the loss on the securities is not deductible.

Example 3 contrasts an outright gift of stock with the sale of the stock at a loss and the contribution of the sale proceeds to charity.

Securities Subject to Tender Offer

When a donor is considering a taxable sale of securities by acceptance of a tender offer or by redemption, it may be more attractive to make a gift of the securities for the reasons described above. It is crucial that the gift be completed before the donor has committed to sell or is legally obligated to do so. Otherwise the

**EXAMPLE 3.
GIFT OF LONG-TERM DEPRECIATED SECURITIES**

Mr. Sternberg, a taxpayer in the 31% bracket, makes a gift of securities worth \$100,000 that he bought for \$130,000 two years ago:

\$100,000	fair market value of gift
x <u>.31</u>	tax rate
\$ 31,000	tax savings

If Mr. Sternberg, instead, sells the securities and makes a gift of the proceeds, his tax savings are greater:

\$100,000	fair market value of gift
(130,000)	less basis
(30,000)	loss
x <u>.15</u>	tax rate on long-term gain/loss
\$ 4,500	tax savings on loss

\$100,000	cash gift
x <u>.31</u>	tax rate
31,000	tax savings on gift
<u>4,500</u>	tax savings on loss
\$ 35,500	net tax savings

donor will be taxed on the gain. The Ninth Circuit upheld the tax court decision in *Ferguson* that imputed gain to the donor where, at the time of a gift of appreciated stock, a cash tender offer was outstanding and enough shares already had been tendered to approve the merger.

Interplay Between the Limitations on Deductions for Contributions to Public Charities and Private Foundations

As previously discussed, the income tax deduction for contributions of long-term capital gain property to a public charity is subject to a limit of 30 percent of the donor's contribution base. This limit is reduced to 20 percent in the case of such contributions to a private foundation. The interplay of these rules can be complex for the client who makes contributions both to a public

charity and a private foundation in the same year and more complex still if the gifts consist partly of cash and partly of long-term capital gain property.

The annual deduction limitation for gifts of long-term capital gain property to public charities is the *lesser of*:

- 30 percent of the donor's contribution base, or
- the excess of 50 percent of the contribution base over the amount of contributions allowable under Section 170(b)(1)(A) (e.g., gifts of cash, which qualify for the 50 percent limit).

The annual deduction limitation for gifts of long-term capital gain property to private foundations is the *lesser of*:

- 20 percent of the donor's contribution base, or
- the excess of 30 percent of the contribution base over the value of gifts of long-term capital gain property to public charities that are allowable as deductions under the calculation above.

As a result, gifts of cash are counted first, up to the allowable percentage limit for gifts of cash to public charities and then, if those gifts do not exceed the limit for private foundations, up to the allowable remaining limit for gifts of cash to private foundations. Gifts of long-term capital assets to public charities are counted next, first up to any allowable remaining limit for gifts to public charities and then up to any allowable remaining limit for gifts to private foundations. In effect, gifts of cash will always be deducted first and gifts of securities to public charities will always be deducted before gifts of securities to private foundations, subject, of course, to carry-forward rules.

Timing of Gifts

The contribution of securities is completed and deductible only when the donor unconditionally relinquishes control to the charity or its agent. The

contribution should also be made before a donor has committed to a taxable sale. Otherwise, the donor will be taxed on any gain.

A gift of stock is effective on the date the donor delivers a properly endorsed stock certificate to the charity. If a stock certificate is mailed, the gift is effective on the date of mailing to the charity or its agent if received in due course. Because an endorsed stock certificate is negotiable, the donor should consider sending an unendorsed certificate and, by separate mail, an executed stock power.

Transfer of a stock certificate mailed or delivered to the donor's broker or to the issuing corporation or its agent is not effective until the stock is delivered to the charity or transferred on the issuer's books.

Where stock is held in "street name" and the donor uses a broker to transfer the securities, the gift will not be considered complete until the stock is transferred on the corporation's books. However, when the donor and charity have the same broker, the gift is complete when the broker transfers the shares to the charity's account. For this reason, if the timing of a gift is crucial, a donor's broker may suggest establishing an account for the charity so the broker can act as its agent. More typically, the broker will wire transfer the securities through the Depository Trust Corporation (DTC). We understand that the Internal Revenue Service regards DTC as the donor's agent, and that the gift is not complete until the shares are credited to the charity's account.

For a gift to a trust to be effective—including charitable remainder or lead trusts—the instrument creating the trust must be executed by both donor and trustee prior to the transfer of the gift.

EXAMPLE 4.

GIFTS TO BOTH A PUBLIC CHARITY AND A PRIVATE FOUNDATION

Mrs. Morris has a contribution base of \$300,000. She makes identical gifts to a public charity and a private foundation of long-term appreciated securities with a basis of \$50,000 and a value of \$75,000.

Her gift to the public charity is allowable to the full \$75,000, because it is well within the allowable limit of 30% of her contribution base (i.e., \$90,000). None of her gift to the private foundation will be allowed as a deduction this year, however, because her gift to the public charity exceeds 20% of her contribution base (i.e., \$60,000). She would therefore have a \$75,000 carry-forward for the next year.

Conclusion

Gifts of securities, particularly those that have been held for more than a year, can produce significant tax deductions for donors and allow them to make substantial contributions to charity. But before making any gift, it pays to consider the following factors:

- appreciation or depreciation in the value of the securities,
- holding period, and
- nature of the securities.

For further reference:

I.R.C. Sec. 170(b)(1)(A): Deductibility of gifts to public charities.

I.R.C. Sec. 170(b)(1)(C): Special limitations with respect to certain capital gain property.

I.R.C. Sec. 170(e)(1): Certain contributions of ordinary income and capital gain property.

I.R.C. Sec. 422(a): Incentive stock options.

I.R.C. Sec. 306(a): Dispositions of Section 306 stock.

I.R.C. Sec. 1271-1276: Original Issue Discount
Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999),
aff'g 108 T.C. 244 (1997)

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A Private Foundation and a Fund in a Community Foundation: Does Your Client Need Both?
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About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations 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 collaboratively with other funders and with government, and gets out information to the public. Recent initiatives have included programs that address youth violence, managed health care, immigration, child abuse, and public school reform.

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 \$1.9 billion in assets (unaudited).

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