DO GOOD AND TRIM TAXES

By Julian Block

When we contribute to the Larchmont Public Library and other charities, most of us go the easiest, most familiar way and simply write checks or use credit cards. We receive income tax deductions; the charitable organizations receive money.

But donors who want to make major gifts and also lose less to the Internal Revenue Service should familiarize themselves with other, often-overlooked ways to fund philanthropies. One option that allows the charitably inclined to realize significant tax benefits is to donate appreciated properties they have owned for more than 12 months and that will be taxed as long-term capital gains when sold. Some common examples are shares of individual stocks, shares of exchange-traded funds, which resemble conventional mutual funds but trade like stocks, mutual-fund shares, bonds and real estate.

The “give ‘em away” gambit permits contributors of appreciated assets to deduct their full market value when donated. Savvy benefactors also avoid all of the federal and state taxes assessed on profits realized from sales of investments, effectively decreasing the cost of donations. But if the investors sell their holdings first and then donate the cash proceeds, the IRS will pocket a chunk of the profits.

For 2008, the top rate for long-term capital gains is 15 percent for individuals in income-tax brackets of 25 percent or higher (taxable income above $65,100 for joint filers and $32,550 for single filers). The levy drops from 5 percent for 2007 to zero percent for 2008 for individuals in the two lowest income-tax brackets of 15 and 10 percent (taxable income below $65,100 for joint filers and $32,550 for single filers). Beyond 2008, the top rate of 15 percent applies through 2010 and the zero rate also applies through 2010. Add to Uncle Sam’s take whatever his “nephews” and “nieces” exact for taxes at state and local levels.

The Wall Street Journal edition for Nov. 22, 1991, notes that “This tax-saving strategy is immortalized in the 1959 film ‘The Young Philadelphians,’ starring Paul Newman” as an ambitious attorney involved with the elite of the main line —the term for the affluent suburbs lining the Pennsylvania Railroad west of Philadelphia. The Newman character’s “suggestion of giving appreciated stocks to the local Society for the Prevention of Cruelty to Animals helps him win the business of Mrs. J. Arthur Allen, an eccentric millionaire, who arrives at his office with her precious pooch Carlos in her arms.” Mrs. Allen was played by Billie Burke, best known to television audiences as Glinda the Good Witch of the North, in “The Wizard of Oz.”

Donations of appreciated assets might seem to be an appropriate technique only for Mrs. Allen and her well-heeled acquaintances. But they also benefit people of far more modest means.

The numbers look like this: Let’s say Joan Rosten intends to fulfill a $10,000 pledge to the Larchmont Public Library. Her long-term holdings include some shares of stocks that she acquired for $4,000 and is now about to unload for $10,000. To reap a perfectly legal double benefit, Joan should contribute stock worth $10,000, not the same amount of cash.

Going the stock route makes no difference to the Larchmont Public Library, a tax-exempt entity that incurs no taxes when it sells the shares and ends up with close to the same amount of money. But it
does make a decided difference in the size of Joan's tax tab. A charitable gift deduction of $10,000
cuts taxes by $3,000, assuming Joan falls into a combined federal and state bracket of 30 percent. In
addition to that, she sidesteps forever the taxes that are due on the $6,000 gain if she sells the stock — a federal levy of as much as $900 and whatever New York State exacts.

A common situation is that Joan is at "sixes and sevens" about whether to relinquish her position in
some appreciated stock. Also, do her asset allocations need a makeover? The standard
recommendation is that Joan ought to donate the stock to the Library, anyhow, and use the money
that she would have donated to buy back the shares for their current market price. That way, tracking
the numbers in the example, she preserves a contribution deduction of $10,000 and dodges tax on the
$6,000 the shares have appreciated since she acquired them.

Even better, Joan reaps a benefit other than the deduction and diversification of her holdings.
Brokerage commissions aside, a repurchase of the stock makes it possible for her to measure any
gain or loss on a subsequent sale against the new, higher cost basis of $10,000, not the original one
of $4,000 — a tactic sanctioned by the IRS.

There are other concerns and complications to mull over — which is to be anticipated, given continual
changes to an already arcane Internal Revenue Code. For starters, the additional tax break is
available only for donors who hold their shares in taxable accounts, not traditional IRAs or other kinds
of tax-deferred retirement plans.

Nor do IRS party poopers look kindheartedly on donations of assets owned less than 12 months. The
tax collectors place a ceiling on Joan's charitable write-off. The cap is what she paid for them or their
current market value, whichever is less. They are uncompromising even though the shares are worth
more when she gives them away. With shares that have gone up a lot — and swiftly — that stings.
Unsurprisingly, the feds set other snares for Joan as she navigates this limitation.

Suppose she purchased some of those shares two years ago and purchased additional ones last
month or, in the case of mutual fund shares, acquired them through automatic reinvestments of
distributions of capital gains (profits from sales of stocks and other investments in the fund’s portfolio)
and income (dividends or interest paid by the securities held in the fund) less than 12 months ago. The
IRS allows the current value deduction only for her two-year-old shares and limits the deduction for
her newer shares to their purchase price.

Lots of people make their major donations in December, when they have fine tuned their end-of-year
planning. Every year, many December donors of mutual fund shares find out the expensive way about
some gritty details.

To illustrate, Joan has a taxable account with the Hoover Fund. She plans to give some of her shares
to the Library around the close of the year. Like most other fund companies, Hoover distributes capital
gains and income sometime in December, a payout that goes only to investors who own shares on
what is known in fund speak as the "ex-dividend date." The distribution reduces Hoover’s net asset
value and forces Joan to pay taxes on part of the fund’s gains, even if she has not sold any shares. It
makes no difference that Hoover distributes additional shares that are reinvested, not cash. Result:
Joan incurs unnecessary taxes on some of her own capital without any real increase in her investment
— and her subsequent donation deduction saves less taxes.

Fortunately, Hoover makes it easy for its investors to determine the dates and anticipated amounts of distributions. In common with many other fund companies, Hoover regularly posts payout estimates on its Web site weeks or months before it makes them. Given Hoover’s track record of price volatility, those postings caution that actual amounts might greatly exceed estimates. But not to be concerned because as long as Joan donates before an ex-dividend date, she hangs on to the maximum tax break.

To ensure that donations of appreciated stocks or other assets count as deductions for the current year, Joan must complete the gifts by Dec. 31. She needs to keep in mind that the legal paperwork can take longer than simply mailing checks, charging donations on credit cards, or making those routine account-to-account transfers that move shares out of her brokerage account and into the Library’s account.

An example: Joan needs to deliver or mail a properly endorsed stock certificate to the Library. The donation is considered completed on the date of delivery or mailing, provided the Library receives the certificate in the ordinary course of the mails.

To avoid a dispute about the date of mailing, it is advisable that Joan use certified mail and request a certified mail receipt. Note that the date of mailing provision applies only to the United States Post Office’s service, not to private delivery services. Another rule applies if she sends the certificate via Federal Express on Dec. 31. The date of delivery for tax purposes will be sometime in January of next year — the date on which the Library actually receives the certificate, meaning she garners no deduction in the current year for the gift.

Stricter regulations apply if it proves necessary to deliver the certificate to her bank, broker, or to the issuing corporation as her agent for transfer into the name of the Library. The regulations specify that the donation is not completed until the date the stock is transferred on the corporation’s books — a process that could take quite awhile.

The need to keep an eye on the calendar was made expensively clear to Joseph Alioto, a lawyer and former mayor of San Francisco, who donated real estate. The United States Tax Court held that he did not complete his donation by Dec. 31 of the year under review. While the deeds were executed in December, they were not recorded until well beyond the close of the year, and the recording date constituted the delivery date.

Other IRS guidelines spell out how Joan is supposed to determine the actual value of the shares she transfers. For shares of publicly traded companies, she should use the average of a stock’s high and low prices on the date of delivery — for instance, the average is $90 when the high is $100 and the low is $80. For mutual fund shares, she should use the fund’s closing price on the date of delivery. As for shares of non-listed companies, the value is what she would receive from a third party in an arm’s length transaction, a determination that might require her to obtain a written opinion from a qualified appraiser.
It’s a good idea for Joan to check with a tax expert before she makes sizable contributions, especially if she plans to donate appreciated property. The IRS wants a written appraisal if she claims a deduction of more than $5,000 for any gift of property (over $10,000 in the case of a stock in a closely held company). But it does not ask for an appraisal of shares of publicly traded companies. Stock markets determine their value daily.

The tax code clamps some ceilings on the deductions available for contributions. In general, Joan can deduct up to 50 percent of her adjusted gross income for gifts of cash to most charities, such as religious organizations and educational institutions. But the law also sets limitations of 30 percent or even 20 percent of her adjusted gross income on the amount she can claim for contributions of appreciated investments. Joan cannot claim any gifts in excess of the limits on this year’s return, although she can claim them for as many as the next five years, subject to the annual limits, which can get rather complicated to calculate. Five years should be sufficient time unless Joan makes substantial future donations or her income nosedives.

On no account, however, should she donate stocks or other investments that have dropped in value since their purchase. Why? Because their donation date value determines the amount of her charitable deduction, not their purchase date value. Worse still, Joan cannot write off the losses. Instead, she should sell the investments first and then donate the proceeds, a tactic that allows her to deduct the contributions and claim capital losses that reduce, or even erase, taxes on capital gains or ordinary income (salaries, business profits, pensions, withdrawals from tax-deferred retirement arrangements and interest, for instance).

An example: Joan’s long-term investments include some shares she bought for $15,000 that are now worth $10,000. If Joan donates the shares, $10,000 is the cap on her charitable deduction. If she sells the shares and donates the proceeds, she is able to deduct the $10,000 and claim a long-term capital loss of $5,000.

What if her sales of investments result in no gains or her gains are less than her losses? Then the law permits Joan to use excess losses to offset as much as $3,000 ($1,500 for married couples who file separate returns) of ordinary income. Any unused capital losses above $3,000 for 2008 can be carried forward into 2009 and beyond, should that prove necessary.

Julian Block is a resident of Larchmont. This article is excerpted from “Year Round Tax Savings.”
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