

# Professional Notes

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TAX & ESTATE PLANNING

## Charitable Gifts of Publicly Traded Securities

Individuals with philanthropic interests can receive significant tax benefits for gifts of appreciated property. This issue of *Professional Notes* focuses on gifts using publicly traded securities, which may be the single most popular type of asset for charitable gifts, other than cash.

### Appreciated Securities

Many people mistakenly believe that all donations of appreciated securities are deductible at full fair market value, but in fact it is only long-term appreciated securities—those held longer than one year—that are eligible for a full deduction. For individuals who hold short-term appreciated securities, there is likely to be little meaningful tax difference between contributing the stock and donating the gross proceeds from a sale of the stock.

**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 charitable 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.

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 limit of only 20 percent of the contribution base. Donations beyond this

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Charitable gifts of mutual fund shares confer the same tax benefits as gifts of individual securities.

limit may be carried forward for up to five tax years. Donors often ask whether the alternative minimum tax (the AMT) applies to these charitable gifts; under current law, the unrealized appreciation on the stock gift is *not* an item of tax preference.

Although a sale of long-term appreciated securities is taxed at a lower 20 percent rate, the charitable deduction is taken first against ordinary income, and the benefit of the contribution of those securities (without regard to state or local tax considerations and possible limitations on itemized deductions) is illustrated in Example 1.

**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. Effectively, only the basis of gifts of short-term appreciated securities may be deducted, as illustrated in Example 2.

**Mutual Funds.** Charitable gifts of mutual fund shares confer the same tax benefits as gifts of individual securities. Unlike other securities, shares in mutual funds are not purchased and sold on an exchange; instead, they are bought and sold—or contributed—through the issuer.

**Section 306 Stock.** If an individual 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.

The proceeds attributable to the sale of 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.

## Example 1 Gift of Appreciated Long-Term Securities

Ms. Fillmore, a donor in the 28% Federal tax bracket, makes a gift of stock worth \$100,000 that she bought for \$40,000 two years ago. The following calculations compare her Federal tax savings if she gives the stock to charity with selling the shares and donating the proceeds:

### Contribution of shares to charity:

\$ 100,000	fair market value of gift
x .28	tax rate
<b>\$ 28,000</b>	<b>tax savings</b>

### Sale of shares and contribution of the proceeds:

\$ 100,000	fair market value
(40,000)	less basis
60,000	gain
x .15	tax rate on long-term gain
\$ 9,000	tax on gain
\$100,000	cash gift
x .28	tax rate
28,000	tax savings on gift
( 9,000)	less tax on gain
<b>\$ 19,000</b>	<b>net tax savings</b>

Of course, the higher the tax bracket, the greater the savings. If Ms. Fillmore finds herself in the 39.6% Federal tax bracket, her tax savings on a contribution of shares to charity could look like this:

\$ 100,000	fair market value
x .396	tax rate
<b>\$ 39,600</b>	<b>tax savings</b>

The capital gains rate is 20% for this tax bracket. Compare this with a sale of the securities and a cash gift:

\$ 100,000	fair market value
(40,000)	basis
60,000	gain
x .20	tax rate on long-term gain
12,000	tax on gain
\$ 100,000	cash gift
x .396	tax rate
39,600	tax savings on gift
(12,000)	less tax on gain
<b>\$ 27,600</b>	<b>net tax savings</b>

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## Example 2

### Gift of Appreciated Short-Term Securities

Mr. Morris, a taxpayer in the 28% Federal tax bracket, makes a charitable gift of securities worth \$100,000 that he bought six months ago for \$40,000:

\$ 100,000	fair market value
60,000	less short-term gain
40,000	charitable deduction
x .28	tax rate
<b>\$ 11,200</b>	<b>tax savings</b>

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

\$100,000	fair market value
(40,000)	less basis
60,000	gain
x .28	tax rate
16,800	tax on gain

\$100,000	cash gift
x .28	tax rate
28,000	tax savings on gift
(16,800)	less tax on gain
<b>\$ 11,200</b>	<b>net tax savings</b>

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, provided 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. There may be a planning opportunity for a donor who acquired bonds with a high interest rate if rates subsequently haven't gone down and the market value of the bond has increased as a result.

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. Any such OID on a bond contributed to charity will not be deductible, because the donor's fair market value deduction will be reduced by ordinary income that would be recognized if the asset were sold.

**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 he or she has held the stock for more than one year from the date the option was exercised.

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

## Depreciated Securities

For the individual 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 only the fair market value of a charitable gift of either long-term or 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.

It is more advantageous to sell depreciated securities and contribute the proceeds, rather than donate the securities.

### Example 3 Gift of Long-Term Depreciated Securities

Mr. Stern, a taxpayer in the 28% Federal tax bracket makes a gift to a public charity of securities worth \$100,000 that he bought for \$130,000 two years ago:

\$100,000	fair market value of gift
x .28	tax rate
<b>\$ 28,000</b>	<b>tax savings</b>

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

\$ 100,000	fair market value of gift
(130,000)	less basis
(30,000)	loss
x .15	tax rate on long-term gain/loss
\$ 4,500	tax savings on loss
\$ 100,000	cash gift
x .28	tax rate
28,000	tax savings on gift
4,500	tax savings on loss
<b>\$ 32,500</b>	<b>net tax savings</b>

## Securities Subject to Tender Offer

When a donor is considering a taxable sale of securities by accepting a tender offer or by redemption, it may be advantageous to make a gift of the securities for the reasons described above. However, it is crucial that the charitable gift be completed before the donor has committed to sell or is legally obligated to do so. In *Ferguson*, the Ninth Circuit upheld the tax court decision 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 had already 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 charitable 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 individual who makes contributions both to a public charity and a private foundation in the same year, and more complex still if the gifts consist of a mixture of cash and 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 Code 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 foundation 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 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, gift of cash will always be deducted first, and gifts of

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securities to public charities will always be deducted before gifts of securities to private foundations, subject, of course, to carry-forward rules.

## Conclusion

Gifts of publicly-traded securities, particularly those that have been held for more than a year, can be a vehicle for making substantial contributions to charity while generating valuable tax deductions. Instead of having gifts of shares transferred separately to a number of operating charities, donors may choose the convenience of a single contribution of shares to

a donor-advised fund at The New York Community Trust, from which they may then support the charitable issues and organizations they care about.

But before making any gift of securities, it pays to consider the following factors, in part to see whether the donor is better off with a gift of the securities or, if the securities have depreciated in value, a gift of the proceeds:

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

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### For further reference, see

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.

Treas. Reg. Sec. 1.170-A(4): Reduction in amount of charitable contributions of certain appreciated property.

*Ferguson v. Commissioner*, 174 F.3d 997 (9<sup>th</sup> Cir. 1999), affg 108 T.C. 244 (1997)

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