Giving Appreciated Property: How to Get the Most Out of It

Smart gift planning combines charitable intent with cost-efficient planning techniques. Of critical importance is the kind of asset used to fund the gift. Usually, long-term appreciated property can generate the most favorable tax benefits. ***Reason:*** Gifts of such property provide a double benefit—a charitable deduction, in most cases, for the full fair-market value of the property plus avoidance of any potential capital-gain tax.

The purpose of this booklet is to take an in-depth look at the benefits of using various kinds of appreciated property to implement some of the most popular planned-gift options available today.

Outright Gift: Securities and Real Estate

When donors think of appreciated property, securities and real estate probably come to mind most often. Gifts of such assets clearly demonstrate the double benefit of contributing long-term appreciated property.

Charitable deduction. A donor who contributes long-term capital-gain securities or real estate (i.e., property held for more than one year) earns a charitable deduction equal to the property's full fair-market value (FMV). ***Note:*** Gifts of short-term capital-gain property provide a deduction for only the donor's cost basis in the property.

A donor can deduct—in the year of the gift—the full fair-market value of the long-term appreciated property, subject to a limit of 30% of his or her adjusted gross income (AGI). Any excess can be carried forward for up to five years.

Example: Todd A owns securities with an FMV of $30,000; the stock was purchased several years ago for $25,000. If he contributes the securities to charity, he will receive a charitable income-tax deduction of $30,000, saving him $9,900 in his 33% tax bracket (*$30,000 x 33%*). The income-tax savings alone will reduce the cost of his gift to $20,100 (*$30,000 - $9,900*). Todd, who has an AGI of $80,000, can deduct $24,000 in the current year (*$80,000 x 30%*). The remaining $6,000 can be carried over and deducted in the following year.

Special election. A donor can choose to deduct gifts of long-term appreciated property under a 50% AGI limit, rather than the 30% limit previously mentioned. However, as a trade-off, the donor's deduction for the long-term capital-gain property will be limited to the property's cost basis. In Todd's case, for example, the gift will produce a deduction for the $25,000 cost basis of the securities, rather than the $30,000 FMV.

Capital-gain avoidance. A donor who makes an outright gift of long-term securities or real estate avoids paying capital-gain tax on the property's appreciation. With capital gain on these assets taxed up to 15%, a donor can realize substantial savings by contributing the property rather than selling it and contributing the after-tax proceeds.

Example: Karen B, who is in the 35% tax bracket, owns stock with an FMV of $25,000 that she purchased for $15,000 a number of years ago. She is considering making a gift to charity and is undecided whether to • sell the stock, pay capital-gain tax, and contribute the net proceeds; • contribute the stock; or • make a gift of $25,000 cash. ***Illustration 1 compares these three options.***

If she chooses the first option, she will owe capital-gain tax of $1,500 (*15% of the $10,000 gain*). This will leave her just $23,500 to contribute (ignoring any sales commission), saving her $8,225 in taxes in her tax bracket (*$23,500 x 35%*). The net cost of the gift will be $16,775 (*$23,500 + $1,500 - $8,225*).

If she elects to contribute the stock, her charitable deduction will be the full FMV of $25,000, saving her $8,750 in income taxes (*$25,000 x 35%*). In addition, she avoids paying the $1,500 tax on the appreciation. The combined tax savings reduce the net cost of a direct gift of the stock to $14,750 (*$25,000 - $8,750 - $1,500*). Finally, a cash gift will reduce her net cost to $16,250 (*$25,000 - $8,750*).

ILLUSTRATION 1
Gift Comparisons

	Net Proceeds	Stock	Cash
Asset's FMV	$25,000	$25,000	$25,000
Asset's cost basis	$15,000	$15,000	$25,000
Capital gain	$10,000	$10,000	- 0 -
Capital-gain tax savings (@ 15%)	<$ 1,500>	$ 1,500	- 0 -
Gift amount (deduction)	$23,500	$25,000	$25,000
Deduction tax savings (@ 35%)	$ 8,225	$ 8,750	$ 8,750
Net cost of gift	$16,775	$14,750	$16,250

Outright Gift: Tangible Personal Property

Donors who contribute long-term capital-gain tangible personal property (e.g., works of art, rare books, stamp or coin collections, etc.) also receive a double benefit. They avoid paying tax on the capital-gain element and receive a charitable deduction for the gift. However, the amount of the deduction depends on the standard of "related use."

If the use of the contributed property is related to the exempt purposes of the charitable organization (e.g., a painting to a museum or rare books to a library), then the donor can take a charitable income-tax deduction for the full FMV of the property, subject to the 30% ceiling and carryover. ***Caution:*** If the use of the property is unrelated to the exempt purposes of the charity (e.g., a stamp collection to a hospital to sell and use the proceeds), the donor can deduct only the property's basis.

Example: Mike C contributes long-term capital-gain tangible personal property to a charitable organization. The property's fair-market value is $50,000, and its cost basis is $15,000. If the property

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can be put to a related use by the charity, then Mike can deduct the $50,000 FMV. However, if the use is unrelated to the charity's exempt purpose, then his deduction is limited to the $15,000 basis.

Special note: Long-term tangible personal property is property held for more than 12 months. However, unlike securities and certain types of real estate, the maximum capital-gain tax rate for tangible personal property is 28%.

Income Plans

A donor may wish to make a significant gift of long-term capital-gain securities or real estate to charity but needs income from the assets to meet personal and family objectives. If this is the case, then using the appreciated property to fund a charitable remainder trust makes perfect sense.

A charitable remainder trust is similar to other types of trusts except that the amount that is distributed at its termination (the remainder) is paid to a charitable beneficiary. A donor transfers property irrevocably to a trust and specifies: • the amount of the payments to be distributed; • the beneficiary(ies) who will receive the payments; • the duration of payments, a period of years or the lifetime of the beneficiary(ies); and • the charity that will receive the remainder.

A donor who establishes a charitable remainder trust receives a charitable income-tax deduction in the year the trust is created. The deduction equals the present value of the remainder interest that will pass to the charitable beneficiary when the trust ends. The size of the deduction depends on many factors, including the value of the assets funding the trust; the age(s) and number of the beneficiary(ies), or the length of the fixed term; and the selected payout rate.

To receive favorable tax treatment, a charitable remainder trust must be either an annuity trust or a unitrust. ***Illustration 2 compares the two types.***

ILLUSTRATION 2
Charitable Remainder Trusts

	Annuity Trust	Unitrust
Payment level	Fixed	Variable
Payment amount	Fixed % of trust's initial FMV	Fixed % of net FMV valued annually
Payment percentage	At least 5%	At least 5%
Payment frequency	At least annual	At least annual
Trust term	Lives of beneficiaries or fixed term not to exceed 20 years	Lives of beneficiaries or fixed term not to exceed 20 years
Remainder beneficiary	Qualified charity	Qualified charity

The key difference between a unitrust and an annuity trust is in the nature of the payments. Payments from an annuity trust are fixed and do not change, even though the value of the trust may change. Payments from a unitrust, however, fluctuate according to changes in the value of the unitrust. Because of this difference, an annuity trust may be more appropriate when the beneficiary needs a fixed, dependable stream of income. The unitrust may be the better choice if some hedge against inflation is desirable, assuming that trust assets grow at least as rapidly as the cost of living.

Let's look at how funding a charitable remainder trust with appreciated securities or real estate can benefit everyone concerned.

Increasing Spendable Income

Historically, high capital-gain taxes have exacerbated the old investment dilemma of the "locked in" position. Essentially what happens is this: An investor may want to sell holdings in order to reinvest for a higher yield but is reluctant to do so and realize a taxable gain. Any tax on gain will reduce the amount available for reinvestment.

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Example: Carl E, 70 and in the 33% income-tax bracket, owns stock worth $100,000 that he bought several years ago for $50,000. The stock pays no dividends, and Carl would like to shift into an income-producing investment. If he sells, he will generate a $7,500 tax in his 15% capital-gain tax bracket, leaving just $92,500 to reinvest.

Carl faces a troublesome choice—he must either be content with no current income or sacrifice $7,500 of the principal. But, since another of Carl's objectives is to make a substantial gift to charity, he has a third option available to him.

Here's how it works: Carl uses the stock to fund a charitable remainder trust that will pay him 6% of its initial value each year for the rest of his life. At his death, the trust principal will pass to the named charity.

Because Carl avoids any tax on the appreciation, the entire $100,000 stays intact, generating a stream of income of $6,000 each year for him. Because the trust is tax-exempt, it is free to sell the stock and reinvest the proceeds in income-producing assets without paying tax on the gain.

Consider the benefits of this arrangement for Carl:

- He receives a deduction of $44,175, saving him about $14,575 in taxes;
- he avoids paying any capital-gain tax on the $50,000 appreciation;
- he increases his spendable income by $6,000 per year; and
- the charity will receive a significant gift when the trust terminates.

Augmenting Retirement Income

Individuals are taking an active role in planning their own retirement to ensure that sufficient income will be available to meet their needs. As they examine options, many are beginning to look to charitable plans as a way to augment their retirement income.

Example: Mary F, 55, is a very successful lawyer who wants to make a major gift to a favorite charitable organization. She does not need any more current income, but she could really use a current income-tax deduction. At the same time, she would like to take steps to enhance her retirement, which she anticipates being about ten years off.

Mary owns land near the edge of a growing metropolitan area. She paid $25,000 for it 15 years ago, and it is now worth $100,000. Because the land is right in the path of development, she anticipates that it will continue to appreciate in value at a healthy pace.

After careful consideration Mary decides to create a unitrust with the land that will pay her 6% of its value for life. The trust includes a so-called "flip" provision that, until the trust assets are sold, limits payments only to the extent the trust has available income. In the year following the sale, the trust reverts to a standard unitrust and will distribute the stated fixed percentage of the value of the trust each year. When Mary creates the trust, she receives a charitable income-tax deduction of about $28,000.

Knowing Mary's concerns, the trustee retains the land in the trust. Of course, Mary will not receive any payments as long as the trustee holds the land because it does not produce income. If, in ten years, the land appreciates to $300,000 and the trustee sells it, the following year Mary will be entitled to receive a payment of $18,000. In subsequent years Mary will receive 6% of the value of the trust as it is determined each year.

For More Information

Giving appreciated property rather than cash can provide a donor with enhanced benefits. We would be happy to discuss with you how a gift of appreciated property might fit into your own personal, financial, and charitable planning. For more information, please feel free to write or call.

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