**FINANCIAL STRATEGIES**
For Estate Planning and Planned Giving
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UNIVERSITY of ROCHESTER

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# Protecting Stock Gain with Creative Charitable Planning

Many of us have experienced it. You have inched your way to the top—ratcheting to the apex, then plunging down at a furious pace, sometimes into a dark abyss, only to emerge breathless as you start another climb upward.

A ride on one of America's iconic roller coasters? No, a ride on America's equally iconic stock market. And this year it seems like it has been an even more familiar ride than usual, with the market making wide swings in short time frames. On August 24 the Dow Jones Industrial Average plummeted more than 1,000 points at the opening before ending the day down almost 600 points. Just two days later the Dow ended the day up by more than 600 points over the previous day's close—its third biggest one-day gain ever and the largest in almost in seven years.

While the swings most days are not as dramatic as those of August 24 or August 26, those days are perfect examples of the kind of volatility that has many investors thinking about how to protect the hard-fought gains they have garnered over a historic multi-year run-up in the Dow. The easy answer is to sell and lock in gain. ***The problem with that:*** A sale at a profit also locks in taxable capital gain—gain that can lead to taxes that eat up as much as 23.8% of that gain if the stock has been held more than one year and up to 43.4% if the holding period is shorter.

## Charitable Solutions

For those with charitable objectives the most effective and productive way to protect stock gain may well be to give it away. ***Reason:*** While donors are entitled to deduct the full fair-market value of outright gifts of long-term appreciated stock to charity, they do not have to recognize or pay tax on any of the appreciation in the value of the stock since the time they purchased it.

> **Example:** Each year for the last several years, James G has made a cash gift of $100,000 to his favorite charity.

This year James has found himself a little uneasy about the future prospects of some of his stock holdings he has owned for a few years that have done quite well. After conferring with his investment advisors and a member of the charity's staff, he decides to fund his gift for 2015 with some of his most highly appreciated stock.

He transfers to the charity shares worth $100,000 that he purchased in 2011 for $25,000. The gift generates an income-tax deduction equal to the full fair-market value of the stock. In his 39.6% tax bracket this saves James $39,600 in federal income tax.

If James had sold the stock and instead funded his gift with the proceeds of the sale, he would have recognized a long-term capital gain of $75,000. Assuming he does not have offsetting capital loss and assuming he is subject to the 3.8% surtax on gain applicable to those whose income exceeds specified thresholds, James would incur a tax on his gain of $17,850. Because the charity is tax-exempt, it can sell the stock and not have to pay income tax on the gain.

Using the stock to make the gift lets him lock in his gain and realize the full benefit of the value of his stock. In effect, the $17,850 of capital-gain tax he avoids creates a kind of "bonus" for funding his gift with the stock as opposed to selling it.

***Planning Pointer:*** This strategy can be beneficial even if an investor remains optimistic about the prospects of a particular stock. If a donor wants to continue to own a particular stock, he or she may still want to use appreciated stock instead of cash to make a gift and then use the cash to repurchase the same amount of stock contributed.

This would result in a step-up in the donor's basis in the stock. Suppose, for instance, that James, in the example above, repurchased the stock he gave and then sold it two years later for $150,000. His taxable gain would be only $50,000 as opposed to a gain of $125,000 ($150,000 – $25,000) had he initially chosen to keep the stock and make a cash gift.

## Retained Benefits

Some donors may want to use highly appreciated stock to capture the value of their gain and reduce their capital-gain tax exposure but want to—or need to—continue to benefit from the value of the stock. There are many creative charitable options available to such donors.

A holder of appreciated stock with charitable objectives may want to consider one of a number of charitable strategies that provide a stream of payments, either for life or for a specific period of time. The strategies generate payments, create income-tax charitable deductions, and allow the donor to reduce or eliminate immediate long-term capital-gain tax.

An option that completely eliminates any recognition of immediate long-term capital-gain tax is a charitable remainder trust. The benefit is available with either a charitable remainder annuity trust (CRAT) that distributes a fixed amount of annual payments for the entire trust term or with a charitable remainder unitrust (CRUT) that makes variable distributions based on the annual value of the trust corpus. At the end of the trust term the remaining trust assets pass to a designated qualifying charity or charities.

The donor can choose a trust payout that fits his or her circumstances, but that payment must be at least 5% of the value of the corpus and not more than 50%. With either a CRAT or a CRUT the actuarial value of the charitable interest must be at least 10% of the amount initially contributed to the trust.

CRATs must also pass an additional test. If the chosen payout rate creates more than a 5% probability that the trust corpus will be exhausted prior to the end of the trust term, no charitable deduction is allowed pursuant to **IRS Revenue Ruling 77-374**. This is true even if the resulting value of the charitable interest is at least 10% of the trust's value.

If a CRT is funded with appreciated long-term stock, the donor is entitled to a deduction based on the full fair-market value of the stock and does not have to recognize or pay tax on any of the paper gain at the time of creating the trust. Because of the rules that govern the distribution of payments from a CRT, there is a possibility that the donor may eventually pay tax on some gain if the stock is sold by the trust.

Annual distributions are considered to come first from any current or accumulated ordinary income of the trust. If all such funds are distributed, then the next portion of the payment is deemed to come from realized current and accumulated capital gain.

**Example:** Rebecca T, aged 70, creates a CRAT with $200,000 worth of long-term appreciated stock and retains a 5% annual distribution, or $10,000, each year for as long as she lives. She is entitled to an income-tax deduction of $92,196. Even though she only paid $100,000 for the stock five years ago, she does not have to recognize the gain when she creates the trust.

The trustee decides to sell the stock immediately, and the trust—which inherits Rebecca's basis—realizes a gain of $100,000. As a tax-exempt entity, the trust does not pay tax on the gain. However, capital gain may eventually be distributed to Rebecca in future years to the extent the ordinary income of the trust available to be distributed is less than $10,000.

In many cases only a portion of the realized capital gain will ever be distributed. And in those cases when it is distributed, it is in relatively small amounts and deferred into the future.

Many charitably inclined taxpayers find setting up a CRT to be an attractive way to convert stock holdings that pay little or no dividends to a source of increased cash flow in retirement years. This strategy allows them to significantly enhance spendable cash, lock in gain in appreciated stock, and reduce or avoid capital-gain tax.

A charitable gift annuity is a close cousin to a charitable remainder trust. Rather than existing as a separate charitable entity, a charitable gift annuity is a contractual arrangement between a donor and a charity in which the charity agrees to pay a fixed amount of annual income to one or two beneficiaries in exchange for a specified gift.

If a charitable gift annuity is funded with long-term appreciated stock, the donor does not recognize any capital-gain at the time of creating the gift annuity as long as the annuity is nonassignable—or assignable only to the issuing charity—and the donor is the only annuitant or the initial annuitant when there is a survivor annuitant.

The portion of the gain attributable to the retained annuity interest is, however, distributed in equal amounts over the donor's life expectancy.

## Generating a Lump Sum

Some donors may want to use stock to make a gift but have a need to retain a lump sum portion of the stock's value rather than payments over time. In such cases a bargain sale may be exactly what the donor is looking for.

In a bargain sale a donor sells an asset to a charity for less than its fair-market value. With publicly traded securities that amount is readily ascertainable.

For instance, if a donor sells long-term appreciated stock worth $100,000 to a charity for $40,000, the donor is entitled to a deduction for $60,000. The donor does, though, have to recognize a percentage of the paper gain equal to the percentage of the fair-market value represented by the bargain sale price—in this case 40% ($40,000 divided by $100,000).

Accordingly, if the donor had a basis of $60,000 in the stock, the donor would have to recognize a gain of $16,000 (40% of a $40,000 gain).

While no one can take all of the uncertainty out of the stock market, those who have significant charitable objectives do have a number of options to lock in gain that are not available to those who don't.

## Tax Court Rejects Claimed Conservation Easement Deduction

In a case filled with multiple twists and turns, the Tax Court has denied deductions claimed by the taxpayers for contribution of a conservation easement. Costello v. Commissioner—T.C. Memo. 2015-87 (May 6, 2015). In 2006 the Costellos decided to participate in an agricultural land preservation program and granted a land conservation easement in favor of Howard County, Maryland, where they owned a home and more than 73 acres.

By granting the easement, the Costellos became entitled as part of "density exchange" to sell to a developer the development rights pertaining to their land. They transferred these development rights to a developer who then used them to develop other land in the county for $2.69 million.

The taxpayers then claimed an income-tax charitable deduction in the amount of $5,543,309 as the difference in value of the land with and without the development rights pursuant to an appraisal.

The Costello farm had 17 development rights attached to it, of which they sold 16 to the developer and retained one for their home. Based on the conclusion that the size and nature of the farm would have actually allowed the taxpayers to purchase eight additional development rights and, theoretically, build up to 25 homes on the parcel, the appraiser determined the value of the land with those development rights to be $7.69 million. Without the rights he determined the value to be $2.1 million.

The Tax Court upheld the denial of the deduction by the IRS, citing multiple problems with the substance and process of the claim. It determined that the appraisal on which the taxpayers based their original claim was not a "qualified appraisal." The Court noted that the appraisal did not mention the deed of easement and did not purport to be an appraisal of the easement. Rather, according to the Court, it stated that "the property rights appraised comprise the fee simple interest in the subject property," which he determined to be $5.59 million net of the owner's residence.

In addition, the Court concluded that the appraiser was not informed of several key facts —including the $2.56 million the taxpayers received in exchange for selling the development rights, the fact that the owners were required to place the easement on the property as a condition of obtaining the right to sell the development rights, and that at least a portion of the land had failed "percolation" tests related to suitability for development of their property. After Howard County refused to sign an IRS Form 8283, the taxpayers did obtain a revised appraisal that did take into account the proceeds of the sale and other changes in determining that the appraisal was, indeed, of the value of purported easement and was $3.03 million. The taxpayers subsequently filed amended returns.

In rejecting the claim, the Court—in addition to finding fault with the appraisal—determined that the transaction did not in any event qualify for a deduction because it was a "quid pro quo" transaction in which the owners received value for the transfer. Further, the court ruled that there were deficiencies with the Form 8283—including the fact that it was not signed by the donee and did not reference the consideration passing to the taxpayers. The Court affirmed the finding of deficiencies of almost $1.3 million and accuracy-related penalties of nearly $260,000.

## Briefly …
## Treasury Issues Final Regulations on Portability of Unused Estate-Tax Exemption

A surviving spouse may use any portion of the estate-tax exclusion amount not used by the decedent spouse—known formally as the Deceased Spousal Unused Exclusion (DSUE) amount. The amount currently available to the estates of all decedents is $5.43 million. This amount can be used by the surviving spouse to shelter lifetime gifts that otherwise would be taxable, as well as testamentary distributions.

The Treasury Department has issued final regulations clarifying the process on how the surviving spouse asserts an effective election to claim the DSUE of a deceased spouse. (T.D. 9725). The election must be made on a properly filed estate-tax return for the estate of the deceased spouse. This means that spouses of deceased spouses whose estates did not reach the threshold for being required to file an estate-tax return must be vigilant to be sure a return is filed to claim the DSUE.

***Financial Strategies*** *is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep these planners up to date on developments in estate planning as they relate to testamentary and lifetime plans in support of qualified charities.*

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