Fundamentals of Planned Giving

Part Three: Assets Used for Charitable Contributions

PG Calc Webinar

July 30, 2014

© All rights reserved

Presented by:

Craig C.Wruck
Vice President of University Advancement
Humboldt State University
1 Harpst Street
Arcata, CA 95521
Phone: (707) 826-5145
craig@wruck.com

© 2014 Craig C. Wruck

Introduction

In a perfect world, all of our donors would contribute cash—which would certainly make the tax ramifications easier to explain. But that's not reality. In fact, donors have many options for giving. Whether it's 100 shares of IBM stock, that rickety old cabin, or grandma's beloved china, sooner or later a generous donor is likely to offer it up as a charitable gift. For the most part, tax law does allow taxpayers to deduct these gifts as charitable contributions … with some exceptions.

Types of Non-Cash Gifts

In addition to cash, a wide variety of other items of value can be donated to charitable organizations. In general, these are referred to as "non-cash gifts," and can be divided into four broad categories:

Securities – including stocks, bonds, and mutual funds

Real property – including personal residences, farms, or other real estate

Tangible and intangible personal property – including art objects, rare books, coin collections and other items

Gifts-in-kind – such as equipment or other items which can be used in the ordinary course of the charity's operations

Securities

Donors and prospects are likely to own securities as a part of their personal investments. Securities come in a wide variety of forms. Some are more advantageous as charitable gifts than others. Broadly, the most common types of securities used as charitable gifts are:

Stocks – proportionate share of ownership in a company, often referred to as "equities"

Bonds – essentially a loan to the company that issues the bond

Mutual funds – accept money from a number of individuals and pool it for investment purposes, may be highly specialized investing only in certain types of stocks, bonds, or other assets, or may invest in broadly diversified portfolios

Types of Stock

Common stock is the most frequently contributed asset. However, there are many specific types of stock and different varieties of corporate organizations. Some key types are:

Common stock shareholders may participate in the profits of the corporation in the form of dividends which can be distributed from the profit earned by the corporation. The amount and timing of common stock dividends are determined by the corporation and are neither fixed nor guaranteed. Some corporations elect to pay no dividends to their common stock holders at all,

© 2014 Craig C. Wruck

instead relying on increases in the value of the stock to provide investment return for the shareholders.

Preferred stock usually pays dividends that are pre-determined as to amount and timing regardless of how well (or poorly) the company performs. In addition, preferred stock shareholders often have a claim on corporate property if company assets are liquidated.

Closely-held stock is an equity security that is not publicly traded. Like common stock, these shares represent ownership and may pay dividends, but they are not generally bought and sold among the public. Depending upon the specific restrictions of the corporation, it can be difficult to sell shares of closely-held stock.

C-corp refers to the legal form under which most large publicly traded corporations are organized. In general, a C-corp must pay corporate income tax on its profits. C-corp stock presents no unusual challenges when contributed as a charitable gift.

S-corp refers to a special form of corporate organization which allows only a limited number of shareholders. For tax purposes, an S-corp is treated much like a partnership in that there is no corporate income tax, but rather the corporate profits are taxed as ordinary income to its shareholders. A charitable remainder *trust may not* own S-corp stock. If a charity accepts an outright contribution of S-corp stock it will have to pay Unrelated Business Income Tax on any distributions received from the stock and on any appreciation in value when the stock is sold.

LLP, LLC, PLC, PA, PA are acronyms that refer to specialized forms of corporate organization that may be authorized by state law. Great care should be exercised when considering acceptance of a contribution of any of these forms. Significant restrictions may preclude the contribution of these interests. For example, a medical practice may be organized as one of these specialized types, but state law may restrict ownership to licensed physicians.

Contributing Stock

A contribution of stock is straightforward. The donor transfers ownership of the shares to the charity and is allowed an income tax charitable deduction for the fair market value of the stock on the date the transfer is completed. For publicly traded stocks, the deduction is based upon the average between the high and low prices on the date the stock is transferred.

Note that in order to maximize the tax advantages, it is critically important that *the securities themselves be transferred* to the charitable organization. If the donor sells the shares and gives the proceeds to charity, the donor will be liable for capital gains tax on the sale.

Transferring Publicly Held Stock

Making a contribution of appreciated securities need not be complicated. These days most investors use a stock brokerage to manage their securities rather than holding physical certificates themselves. Securities held by a broker are relatively easy to transfer. The specific details of the transfer of securities depends upon how the donor holds the securities:

"DTC" or "book entry" – Most people no longer hold physical stock certificates. Instead their securities are held in "custody" accounts provided by an investment firm or bank. Most such brokerage accounts are serviced by the Depository Trust Company (DTC), which holds

 © 2014 Craig C. Wruck

custody of securities in the form of electronic files. The donor simply instructs the broker to transfer shares to the charity's account and then DTC makes the appropriate entries to transfer ownership to the charity. The date of the gift for a DTC transfer is the date when the shares actually enter the charity's account. Most DTC transfers are made in 72 hours or less.

certificates – If a donor holds physical stock certificates, he or she should sign a stock power (a legal form authorizing the transfer of ownership) for each certificate contributed and deliver the stock power and the *unendorsed*[1]certificates to the charity. A stock power form can be obtained from most brokers or financial institutions. Care should be exercised to make certain that the signature on the stock power is properly certified. The date of gift for a contribution of securities is the date the charity receives physical custody of the documents or, if mailed, the mailing date.

transfer agent – Occasionally the owner of the securities will direct the company's transfer agent to reissue shares in the name of the charity. This method offers the least certainty regarding the date of transfer because the timing relies upon the internal processes of the corporation and its transfer agent.

Transferring Closely Held or Restricted Securities

The transfer and valuation of closely held and restricted stock is complex and depends upon the specific conditions and requirements of the security. Often, the only purchasers for this stock are people involved with the company who may fully expect to buy the stock back from the charity. Great care should be exercised in these cases to avoid a pre-arranged agreement to sell the stock.

Stock Options

Sometimes donors will offer "stock options" as a contribution. A stock option is simply an agreement that gives the holder of the option the right to buy a certain number of shares in the granting company at a fixed price for a certain period of time. There are two types of stock options which are most likely to be encountered as a proposed charitable gift:

"Non-qualified" stock options – may be transferred to a charity if the company's stock option plan permits it to do so. These option contracts can be very complex. Donors should be urged to consult their own advisors to determine the suitability of non-qualified options as a charitable contribution.

"Incentive" stock options – are, by law, not transferable.

Although contributions of stock options may be have only limited value to the charity, a donor who exercises stock options often encounters significant tax liabilities as a result in addition to receiving a sometimes significant increase in income or net worth. These circumstances can provide an opportunity for other creative charitable gift planning.

[1] Although the donor may simply endorse the stock certificates themselves, for security reasons, it is preferable to use a stock power separate from the certificate because an endorsed certificate can be negotiated by anyone who is in possession of it. For this reason, if a donor wants to mail a gift of stock certificates, he or she should send the un-endorsed certificates in one envelope and the signed stock powers in a separate envelope.

© 2014 Craig C. Wruck

Bonds

The owner of a bond is a creditor who is owed money by the corporation (or other entity) that issued the bond. Unlike shareholders, bondholders do not own "a piece of the corporation." Like other loans, bonds pay interest to the owner for a specified period of time, after which the principal is repaid. Bond holders are usually entitled to a priority claim on company's assets – that is, bond holders would be paid before stockholders in the event of a bankruptcy or liquidation of the corporation.

There are many types of bonds:

Corporate bonds are a major source of corporate borrowing. Sometimes called "debentures," corporate bonds are usually backed by the general credit of the corporation. Specialized bond issues can be backed by certain specific corporate assets.

Municipal bonds (or "munis") are issued by state and local governments. General obligation bonds are backed by the general funds of the issuer; revenue bonds are backed by revenues of the particular project being financed. In general, the interest paid by municipal bonds receives favorable income tax treatment, often tax-free.

U.S. Treasury Notes and Bonds are issued by the Federal government and pay the holder a fixed interest payment. Although treasury bonds are no longer issued, many are still unredeemed and earning interest.

U.S. Treasury Bills (T-bills) are backed by the Federal government. As such they are considered a "zero risk" investment and therefore are often used by investors for cash reserves. T-bills are the largest component of the "money market."

Zero coupon bonds do not pay interest at all, but rather are sold at deep discount from their redemption value. Since investors in zero coupon bonds don't collect interest, they instead rely for their investment return on the increasing value of the bond as it approaches maturity.

Savings Bonds are in a class by themselves when it comes to charitable giving. According to the U.S. Treasury, millions of Americans own U.S. savings bonds. One of the reasons they are attractive to investors is that the interest paid on these bonds is usually exempt from state and local income taxes.

U.S. savings bonds are problematic as a charitable gift during lifetime because the bond cannot be transferred but must be sold first, which triggers all of the accumulated income tax liability. However, savings bonds can be left to charity through a bequest and avoid the income tax entirely.

Contributing Bonds

A contribution of a bond is similar to a contribution of stock. The donor transfers ownership of the bond to the charity and is allowed an income tax charitable deduction for the fair market value of the bond on the date the transfer is completed.

© 2014 Craig C. Wruck

It is critically important that *the bond itself be transferred* to the charitable organization. If the donor sells the bond and gives the proceeds to charity, the donor will be liable for capital gains tax on the sale.

Mutual Funds

Mutual funds are very popular investment vehicles for both individuals and institutions. Most American investors now own mutual funds—either individually or through a retirement plan—for some or all of their portfolio.

The transfer of mutual funds as a charitable gift must be completed by the mutual fund company at the direction of the donor. Since each mutual fund company has established its own forms and procedures, the process of making a charitable gift of mutual funds can be time consuming.

Notes: The date of gift for a mutual fund contribution is the date on which the shares are transferred to the account of the charity. Since the donor may have little control over the timing of this transfer, special care should be exercised if a donor wishes to make a year end mutual fund gift.

Special care should be taken to ensure that the mutual fund company transfers the shares themselves to the charity and does not sell the shares and forward the proceeds to charity.

Contributing Mutual Funds

Like contributions of stocks or bonds, the donor transfers ownership of the mutual fund to the charity and is allowed an income tax charitable deduction for the fair market value of the mutual fund on the date the transfer is completed.

Note: Determining the cost basis and holding period for mutual fund investments can be complicated if fund dividends are reinvested automatically. Dividend reinvestment is a common practice in which dividends are used to purchase additional shares of the mutual fund instead of being paid to the owner. However, dividend reinvestment can make it difficult to determine the cost basis and holding period because each dividend reinvestment purchase has its own acquisition date and cost basis.

If a donor is considering a gift of mutual fund shares, ask if the donor has fund dividends reinvested automatically. If yes, the donor should be encouraged to consult with his or her advisors to determine the cost basis and holding period.

As with stocks and bonds, it is critically important that *the mutual fund itself be transferred* to the charitable organization. If the donor sells the mutual fund and gives the proceeds to charity, the donor will be liable for capital gains tax on the sale.

© 2014 Craig C. Wruck

Special Note Regarding Depreciated Securities

Although we generally assume donors will contribute securities that have appreciated in value (are worth more than the donor paid for them), sometimes donors hold depreciated securities (those that have lost value and are now worth less than the donor paid for them). Usually donors should not contribute depreciated securities. The charitable deduction will be for the fair market value on the date of the gift. In the case of a contribution of a depreciated security, this means that the donor's income tax deduction will be less than the donor paid for the security. In addition, by donating depreciated securities, the donor loses the opportunity to sell the securities and use the realized loss to offset realized gains on his or her next income tax return.

Donors who own securities that have depreciated in value should consult with their own tax and financial advisors on the advisability of giving them to charity.

REAL PROPERTY

Real property, more commonly called "real estate," is generally defined as land and the structures and fixtures that are relatively permanently affixed to it. Examples of real property include:

- Undeveloped land
- Residential property
- Property held for investment such as apartments, office buildings, and malls
- Commercial property used in the taxpayer's business
- Agricultural property used for the production of crops or livestock

When contemplating contributions of real property, a charity will find it advantageous to have in place a set of ground rules:

- Don't be pressured into accepting a gift of real property. Even under the best of circumstances, the decision to accept real estate must be a careful and reasoned one.
- Develop gift acceptance policies that clearly define what will and will not be accepted, what the charity will and will not pay for, and a requirement for an environmental audit.
- Establish an objective process for reviewing proposed gifts of real property so that quick action can be taken when an opportunity arises.

Beyond the apparent economic value of the contribution, there are several other important questions a charity should consider before accepting a contribution of real estate:

- What is the property's marketability? How quickly can it be sold for a fair price?
- If the property is to be retained—either by choice or by unintended circumstances—what are the expenses required to hold the property?
- Are there restrictions, reservations, easements or other limitations that might affect the marketability of the property?

© 2014 Craig C. Wruck

- Is the property environmentally clean? Will the cost of the environmental audit and possible remediation override the value of the gift?
- What are the motivations behind the offer? Is there real donative intent or is it a self-serving offer?
- Is the offer acceptable according to the policies of your organization?

Contributions of Real Property

In order to contribute real property, a donor transfers ownership of the property to the charity, usually with the assistance of a real estate attorney, Realtor, or other professional. The donor is allowed an income tax charitable deduction for the fair market value of the real estate on the date the transfer of ownership is completed.

As with other gifts of appreciated assets, it is important that *the real property itself be transferred* to the charitable organization. If the donor sells the real property and gives the proceeds to charity, the donor will be liable for capital gains tax on the sale.

"Ordinary Income" Real Property

If the real property is considered ordinary "income property," then the donor's charitable deduction is limited to the fair market value less appreciation—generally the cost basis minus any costs already deducted. Real property may be considered ordinary income property if it is:

- Property that has been held less than one year by the donor
- Property held by the donor as a real estate dealer (owners may be considered dealers if they hold and develop property as inventory for sale to customers or if the owner is engaged in the frequent purchase and sale of real property)
- Property that is subject to depreciation recapture (depreciation recapture can occur when the owner has claimed depreciation deductions on prior tax returns)

The determination of real property as ordinary income property is a complex matter. Donors should be urged to consult their own tax advisors if this is in question.

Partial Interests

Partial interests occur when a property owner shares the ownership of property with another person or entity, or ownership is limited in some other way. In order to be deductible as a charitable contribution, the transfer to charity must be an undivided partial interest. This means, for example, that a donor could transfer a 20 percent interest in land and claim a charitable deduction for the contribution. The charitable organization would then join the donor in the subsequent sale of the land.

Notes: When a donor contributes a fractional interest in property, even if it is his or her entire share, the valuation for charitable deduction purposes must reflect that the gift is either a minority or majority interest, which may affect the

© 2014 Craig C. Wruck

marketability of the parcel.

Before accepting a partial interest in real estate, the charity should consider the potential for environmental liability (see below) since it will become an owner of the property.

Debt Encumbrance

A mortgage reduces the amount of the charitable deduction for a gift of real property. The deduction will be the fair market value minus the amount of debt outstanding. The transfer of debt encumbered property is usually considered to be a bargain sale (since the donor is relieved of the debt obligation he or she is deemed to have been "paid" that amount), which means that a portion of the capital gain will be taxable to the donor. In addition, the donor may incur income taxes as a result of having been relieved of the debt obligation.

The tax implications of contributions of encumbered property are complex. Donors should be urged to consult their own tax advisors in these situations.

Timeshares

Timeshares generally don't make good charitable gifts—at least not from the charity's point-of-view. They are usually difficult to sell, and the resale value can be significantly less than what the donor originally paid for the timeshare. In addition, the charity may find itself responsible for maintenance and other fees until the interest is sold.

Crops and Timber

Occasionally your organization may be asked to consider a gift of land that comes with crops. "Un-harvested" crops sold with the land on which the crops are located (and which has been owned by the seller for more than one year) are considered long-term capital gain property.

If harvested crops are contributed to charity, they are usually considered tangible personal property. However, if the donor regularly produces crops for sale to customers in a trade or business, they may be ordinary income property.

Contributions of timber represent one of the most complex of all property gifts. Factors that determine the tax treatment of charitable contributions of timber include whether the:

- Timber is standing and being contributed with the land
- Timber has been cut and is being contributed separately
- Donor holds the timberland primarily for investment
- Sale of timber to customers is in the ordinary course of business

© 2014 Craig C. Wruck

Mineral Interests

A mineral interest (sometimes a "mining interest" or an "oil and gas interest") is the legal right to exploit or produce minerals that lie below the surface of the land. In most cases the mineral interest is included in the ownership of the property. This combined ownership is referred to as a "fee interest" in the property. However, mineral interests can be separated from the surface rights to the land and the mineral interest can then be sold or contributed separate from the land itself. The separation of mineral interests is complex. Before accepting a contribution of real property the charity should be certain that it understands exactly what rights it will own. For example, in some states the owner of a mineral interest is given a right to use the surface land in order to access the mineral interest. In addition, the management and administration of mineral interests is a highly technical area requiring special expertise.

Environmental Audits

Under Federal law, the owner of a polluted property can be held financially responsible for the clean-up of the pollution. This includes a charity that becomes owner of a polluted property as a result of a contribution.

In light of the potentially enormous costs of environmental remediation, it is prudent for the charitable organization to conduct a careful environmental review of the property before agreeing to accept it. Professional environmental audits are conducted by specialists in environmental remediation and usually proceed in three phases:

> **Phase I** – a physical inspection of the property and review of the title history of the property to identify potential environmental hazards (e.g., Is there an un-capped well on the property? Was the property ever used for industrial purposes?)
>
> **Phase II** – a more in-depth review including some sampling of soils and materials from the property (e.g., Is there asbestos insulation in place? Are there abandoned buried oil tanks on the property?)
>
> **Phase III** – usually involves extensive on-site investigation possibly including drilling test wells and examination of soil samples

Of course, the costs of environmental audits increase at each stage. The good news is that the environmental review can be conducted in steps. For example, if a Phase I audit shows little cause for concern, the organization may decide that there is no need to proceed with further in-depth work.

It is prudent to conduct an environmental review even on seemingly mundane properties. For example, a personal home may have been built on the site of a former gas station where leaking storage tanks polluted the subsoil years before with no visible evidence.

Finally, note that even if an environmental issue is identified, the property may still be acceptable provided that the costs of remediation are reasonable and that the charitable organization is aware of these issues before accepting the gift.

© 2014 Craig C. Wruck

Note → The purpose of the environmental review is to identify potential environmental liabilities and remediation needs. Even the most careful environmental review cannot guarantee a perfectly clean property. Once the charity has accepted ownership of the real property, it will be liable for all environmental issues, even those that were not identified by the environmental audit.

TANGIBLE AND INTANGIBLE PERSONAL PROPERTY

Tangible personal property is property that can be held physically while intangible personal property has no inherent physical characteristics that lend value.

Examples of tangible personal property include:

furniture	store fixtures	old musty books
production machinery	storage equipment	mobile homes
office equipment	grandma's china	portable buildings
appliances	a doll collection	motor vehicles

Examples of intangible personal property include:

copyrights	installment obligations	partnership interests
royalties	life insurance contracts	securities
patents	annuity contracts	service contracts

As with real property, there are a number of questions the charity should consider before accepting a contribution of personal property:

- What is the property's marketability? How quickly can it be sold for a fair price?
- If the property is to be retained—either by choice or by unintended circumstances—what are the expenses required to hold the property?
- Are there restrictions, reservations or other limitations that might affect the marketability of the property?
- What are the motivations behind the offer? Is there real donative intent or is it a self-serving offer?
- Is the offer acceptable according to the policies of your organization?

Deductibility of Tangible Property Contributions

Contributions of tangible personal property present several special issues for income tax charitable deduction purposes.

© 2014 Craig C. Wruck

Related Use Rule – The donor is allowed a deduction for the full fair market value of the tangible personal property only if the use of the item is related to the tax-exempt purposes of the charity. Otherwise, the amount of the deduction is limited to the *lesser of* the donor's cost basis or the fair market value.

Example: **Related Use Rule**

If an individual donates a painting to a museum and it is of the type normally retained by the museum, the painting is a related use item and the contribution deduction will be for the full fair market value of the painting.

If the person donates the same painting to a food bank to be sold at a charity auction, the charitable deduction will be limited to the lesser of the cost basis or fair market value because the use of the item is unrelated to the exempt purposes of the charity.

The related use rule can be interpreted quite broadly. For example, a contribution of artwork to a hospital that then hangs the art in its lobby should qualify as a related use contribution even though the charitable purpose of the hospital does not specifically involve the study or display of art because the use of the artwork in this case enhances the patient experience which is related to the charitable purpose of the hospital.

Ordinary Income Property Rule – Another reason the charitable deduction might be reduced is because the asset is "ordinary income property," i.e., the individual would realize ordinary income if he or she sold the item. Ordinary income property, in this context, includes items created by the donor (such as artwork, music, or a manuscript), items of inventory held for sale to customers in the course of business, and items held for one year or less. When ordinary income property is transferred to a charity, the charitable deduction is the *lesser of* the fair market value of the item or its cost basis.

Long Term Capital Gain Rule – Tangible personal property that is acquired as an investment may be considered a long term capital gain asset (assuming it is held for more than one year). For example, a person who collects paintings by Monet as a passion, but then holds and trades them as investments, may be considered to hold long term capital gain assets because he or she trades them as investments.

Deductibility of Intangible Property Contributions

The deduction for donations of a patent or other intellectual property such as copyrights or software, is limited to the lesser of the fair market value or the donor's cost basis.

GIFTS-IN-KIND

Gifts-in-kind are non-monetary items that the charity is able to put directly to use for its charitable purposes. Examples include cribs donated to a crisis nursery, blankets to a homeless shelter, or computers donated to a school.

© 2014 Craig C. Wruck

Generally, the rules for tangible personal property apply in regard to the charitable deduction for gifts-in-kind. Note that in some instances, the fair market value of the tangible personal property is less than the donor's cost basis. This is often the case, for example, with donated computers and other equipment that has been surpassed and made obsolete by later technology.

It is important to note that there is no deduction for contributions of services. For example, the attorney who provides free services to a charitable organization may not claim an income tax deduction for the value of those services.

Notes: From time to time tax laws have been enacted to encourage certain types of gifts-in-kind. For example, the 2006 Pension Protection Act included a provision temporarily expanding the tax incentives for contributions of food inventory. Similarly, temporary special provisions have been enacted from time to time to encourage gifts of computers and other hardware.

Charities should check with their own advisors to determine the current availability of special incentives for gifts-in-kind.

(Text adapted from the book *Planned Giving in a Nutshell* and used with permission of the author.)

© 2014 Craig C. Wruck