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Charitable Gain Harvesting – A Tax Reduction Strategy for the Charitably Inclined

It is a well known fact that donors can eliminate capital gain taxes by transferring securities with significant appreciation to a qualified charity¹. This article explains how to use this strategy **within your investment program**. Whether you give directly to the charity, have your own donor advised fund or foundation, or serve as a board member to a charitable foundation, this information can help donors can save on taxes, and charities potentially increase gifts by educating donors on how to use this strategy.

As many of you already know, donating appreciated securities allows donors to receive a double benefit from charitable contributions in the form of 1) the market value tax deduction for charitable giving, and 2) elimination of the capital gain liability of appreciated securities.

Charitable development officers can suggest to donors that charitable gain harvesting will allow donors to increase their gifts without additional cost as a result of the tax savings involved in the strategy.

Think of **charitable gain harvesting** as a new twist on an old idea, in that most folks only think of donating appreciated securities when they want to get rid of a security. **Charitable gain harvesting works equally well when you want to keep the security in your investment portfolio.**

The process involves donating appreciated securities held more than one year² as your charitable gift and subsequently **repurchasing these same securities** with the cash you would have otherwise donated. This should not be confused with the wash sale rule³, which applies to losses, not gains and is a moot point because the donor is not the one selling the securities.

The End Result:

- ***Susan's charity receives a donation worth \$100,000***
- ***Susan gets credit for a \$100,000 donation and still holds shares in ABC Stock***
- ***Susan avoids paying any taxes on what would have been a \$60,000 capital gain***

Aside from any charitable deduction you may receive, charitable gain harvesting benefits both the donor and the charity. The charity receives shares that it can immediately sell and convert to cash without tax consequences. The donor then repurchases the securities using cash and establishes the purchase price as the new higher basis.

Admittedly, the concept of donating low basis securities to charity is not new, as most CPAs would likely list it as a way to get the most out of a charitable contribution. However,

what may be new is incorporating a combined strategy for managing taxes and charitable giving **within your overall investment program**. Just as tax loss harvesting⁴ is done to intentionally realize a loss, **charitable gain harvesting intentionally offloads the gain liability to the charity, which pays no tax on the capital gain.**

If you think you are unlikely to have any unrealized gains after the volatile markets we have experienced, you might be mistaken. Throughout the recent market decline, we harvested tax losses for clients, converting unrealized losses into tax losses that could immediately be used to offset gains or be held for future use. However, this practice also lowered the basis and as the market recovered, substantial **unrealized** gains have accrued (as a side note, I would be quite concerned if my advisor did not take advantage of this recent and enormous opportunity to harvest losses).

The following example details a recent use of the strategy for one of our clients (with names changed for confidentiality.)

Charitable gain harvesting process:

1. Susan desires to donate \$100,000 to her Alma Mater. Her Evensky & Katz advisor recommends that, rather than giving cash, she donate \$100,000 worth of her ABC, Inc. stock that has appreciated significantly over the few years she has owned the shares and is held in a taxable account.
2. Susan's advisor contacts the school's gifting department and obtains instructions on how to transfer her securities to the school's gift account.
3. Her advisor instructs Susan to deposit the \$100,000 of cash that would have comprised her gift into her investment account, and, when received, submits the paperwork for the transfer of \$100,000 of ABC, Inc. stock (with a cost basis of \$40,000) to the charity.
4. As soon as the transfer takes place, her advisor uses the \$100,000 of cash to repurchase ABC, Inc. stock in Susan's investment account, establishing her new basis in the stock of \$100,000.

The end result is that Susan's charity has received a donation worth \$100,000 (as the charity immediately sells the shares and is exempt from capital gains tax), Susan gets credit for a \$100,000 donation and she still holds a \$100,000 position in ABC, Inc. stock -- all without having to pay any taxes on what would have been a \$60,000 capital gain, had she sold the shares and then donated cash.

For charitable gain harvesting to be effective, one must adhere to and understand the following:

- 1) Securities must have been held for at least one year and be donated to a qualified charity.
- 2) Deductibility rules for appreciated securities differ from those governing cash donations. In order to benefit equally from a donation of appreciated securities, the donor must have a higher adjusted gross income⁵.
- 3) The loss of market exposure between the time securities are donated and subsequently repurchased involves risk. One can attempt to minimize this by repurchasing the shares as close as possible to the day that the transfer takes place.
- 4) The repurchased security must be held for at least one year in order to receive additional favorable capital gain treatment going forward.
- 5) Depending on the custodian and account type, there may be transaction costs to both the donor and/or the charity.

It is also important to realize that the value of this strategy becomes greater with larger donations and securities with considerable appreciation. In the example above and assuming a 20% long term capital gains rate⁶, Susan's \$100,000 donation could save her \$12,000 in taxes when compared to realizing the \$60,000 capital gain and paying the resulting taxes. In effect, in order to donate the same \$100,000 of value to the charity, the cost to Susan is \$100,000 while the cost to a donor who realizes a \$60,000 capital gain is \$112,000.

Charitable development officers can suggest to donors that charitable gain harvesting will allow donors to increase their gifts without additional cost as a result of the tax savings involved in the strategy.

With a long term capital gains rate increase of nearly 60%⁷ by 2013, **charitable gain harvesting** will only increase its value to offset tax expenses. While we do not believe that anyone can reliably predict long term capital gain rates, we recognize that with projected unprecedented government deficits, capital gain rates may face additional increases in the future.

About the Author

In his role as a Principal and Vice President of Evensky & Katz Wealth Management, Charles Sachs caters to the needs of affluent clients, their families, and businesses as part of a long-term consultative approach to help them achieve their investment and financial planning goals. He has been a guest speaker on television, radio programs and before many South Florida and national organizations, discussing financial planning and investment topics and has been featured in numerous national publications. He serves on the board of the Financial Planning Association and Neat Stuff (a local charity that provides new clothing to foster children), and is a Professional Advisory Council member for the Greater Miami Jewish Federation, United Way, and University of Miami. Please direct any questions or comments to csachs@evensky.com or 305-448-8882.

¹ Qualified charities are generally identified as 501(c)(3) organizations by the IRS and include groups that are religious, charitable, educational, scientific or literary in purpose, as well as those that work to prevent cruelty to children or animals.

² Securities must be held at least one year in order to be “qualified appreciated stock.” If held for less than one year, the security is considered “ordinary income property” and the deduction is limited to the cost basis of the security.

³ A wash sale happens when an investor realizes a loss from a security and has repurchased the same security within 30 days before or after the sale. The IRS disallows the use of a loss as a result of a wash sale.

⁴ Tax loss harvesting is a method whereby securities with losses are sold in order to realize the loss with the proceeds of the sale invested in a similar but not identical security for at least 31 days (in accordance with the IRS’s wash sale rule), after which time the investor can repurchase the original securities.

⁵ There is a **30%** of AGI limit on gifted capital gain property for 50% limit organizations such as the Jewish Federation, Make-A-Wish Foundation®, United Way, as well churches, schools, hospitals, etc. and a **20%** limit for non 50% limit organizations such as Private foundations. You can ask any organization whether it is a 50% limit organization and most will be able to tell you. Or you may check IRS Publication 78. For Private foundations, donations of closely held stock are generally limited to cost basis, however donations of most publicly traded securities are deductible at fair market value.

These limits are more restrictive than the 50% AGI limit on cash. However, unused charitable deductions can be carried forward up to 5 years.

⁶ While the long term capital gain rate is currently 15% as of this writing, it is set to revert to 20% in January 2011. Since 1958, long term capital gain rates have never been lower than they are now, and have been as high as 40% in the late 1970’s.

⁷ 2010 long term capital gains increase from 15% to 20% by 2011 and then to 23.8% by 2013 for those in the top three tax brackets (an increase of 58.7%) as the result of the Medicare Contribution Tax on unearned Income. This is part of the Health Care and Education Reconciliation Act signed into law on March 30th 2010 (see IRC section 1411 for more details.)