Tax benefits of giving appreciated property

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Every year, the federal government forgoes nearly $50 billion in income tax revenue as a subsidy to charitable giving.

More than half of this subsidy goes to taxpayers with incomes of $200k or more, and about a quarter of it supports noncash gifts -- stock, real estate, etc.

This subsidy is the charitable contributions deduction, one of those "tax expenditures" you have been hearing about lately in discussions of the budget deficit.

It seems straightforward enough: you give a dollar to charity, you deduct a dollar from your adjusted gross income, your tax liability is reduced by 28 or 33 cents, simple as that.

But the details are slightly more complex.

First, if your other itemized deductions -- mortgage interest, state and local taxes, medical expenses -- do not add up to at least the standard deduction amount, a portion of your charitable contribution is not subsidized. Only about one-third of taxpayers itemize.

Then, you cannot deduct more than 50 percent of your adjusted gross income. Any excess must be carried forward to each of the next five years, and any unused carryforward is wasted. On the plus side, the "Pease" limitation, which used to phase out itemized deductions in higher income ranges, has been repealed, for at least another two years.

If you give something other than cash, outright, to a public charity, other limits apply. The deduction for a gift to a non-operating private foundation is limited to 30 percent of adjusted gross. The deduction for a gift of inventory, or of tangible personal property that is not used by the charity in its exempt function, is limited to your adjusted basis. And so on.

But let's look specifically at a gift of appreciated property, for which the tax law provides additional incentives. Only about one-sixth of taxpayers report capital transactions.

Say you have Nike stock worth 100k, which you bought for 25k. If you sold the stock, you would recognize a capital gain of 75k. If you had held the stock more than a year, the gain would be long-term, and your tax at 15 percent would be 11.25k. A short-term gain would be taxed as ordinary income at let's say 33 percent, or 24.75k. That 13.50k differential is itself a tax expenditure.

But suppose instead you gave the stock to charity. If your gain would have been long-term, you can deduct the fair market value of the stock on the date of the gift against ordinary income, subject to a limit of 30 percent of your adjusted gross income. Not 50 percent, but again, you can carry any excess deduction forward.

The deduction would reduce your income tax liability by up to 33k, and because you did not recognize the gain, the tax subsidy is actually 44.25k. Since 1992, this untaxed spread has not been a

preference item for alternative minimum tax purposes.

In effect, the charity has purchased your 100k in Nike stock for 44.25k in tax benefits. Analytically, the transaction is similar to a bargain sale, but the tax consequences are rather different.

Here is how a bargain sale is taxed. Suppose you in fact sold your 100k in Nike stock to the charity for 44.25k, cash. The forgone 54.75k is deductible as a contribution, and your basis is allocated pro rata, 11.06k to the purchase price and 13.94k to the contribution.

You are taxed on the gain of 33.19k -- that is, 44.25k minus your basis of 11.06k --, at let's say 15 percent, long-term, or about 4.98k. And you get a charitable contributions deduction of 54.75k, which at 33 percent (again, subject to the 30 percent limit) would reduce your income tax liability by about 18.07k. And you avoid gains tax of about 6.12k on the unrecognized 40.81k spread in the contribution element.

Compared with the outright contribution, you are considerably ahead, as you have received net 63.46k. The charity is out of pocket 44.25k, and the federal subsidy is net 19.21k.

The purchase of a gift annuity, discussed elsewhere in these pages, is a special case of the bargain sale. In exchange for your transfer of 100k in Nike stock to the charity, you receive an annuity with a present value of, say, 44.25k.

Assuming a market rate of return of about three percent, which is what Treasury tables now assume in valuing annuities, this would roughly translate to an annuity of 6.7k for an annuitant aged 77 years. The deal is not available on quite these terms for a younger annuitant. The 33.19k gain would be recognized pro rata over your projected life expectancy, in this case about twelve years, effecting a sort of installment sale.

In either case, you could elect instead to deduct only your basis in the stock and still take advantage of the 50 percent limit. The election would apply to all gifts of appreciated property made during the year, and to carryovers of gifts of appreciated property made in prior years. You do not get to pick and choose.

In the outright gift example, at a marginal rate of 33 percent, we are looking at a deduction of only 8.25k. In the bargain sale example, the deduction on a deemed contribution of 13.94k would be only 4.60k. And the payout on a gift annuity would be treated entirely as ordinary income.

But the election could make sense if your basis were closer to current fair market value, or if you had made other charitable gifts that were subject to other limitations, or if you would not be able to fully use the carryforwards in the next five years.

Where a gift of appreciated property is "for the use of," rather than outright to, a charity -- for example, a charitable lead trust, discussed elsewhere in these pages --, the deduction is limited further, to 20 percent of adjusted gross income.

To see how the deduction limitations and carryforwards interact, you might want to look at IRS Publication 526, online at http://www.irs.gov/pub/irs-pdf/p526.pdf.