

[Jeffrey Frye](#) - Tue, 12/20/2016 - 00:00

Everyone likes to avoid capital gains – or more specifically, we should say, everyone likes to avoid *the taxes on realized capital gains*. That’s a given. When an investor sells assets that have appreciated over time, typically there is tax on the built-up appreciation in those holdings, at least by the federal government, and frequently by the state government as well. The owner of the stock reports capital gains even if the owner of the stock uses the sale proceeds immediately to make charitable gifts. On the other hand, if the donor uses appreciated assets for outright charitable gifts, there is no taxation on the long-term appreciation in the holdings. (Note that assets held for less than one year are subject to tax as short-term capital gains. Short-term capital gain income is taxable at the same rate as ordinary income.)

Nevertheless, what if the donors use the assets instead to make planned gifts? What if the solution for the donors is neither a complete sale nor an outright gift? Many planned gift arrangements are funded by highly-appreciated assets that the donors have owned for many years. The most common examples of these assets are stocks, but they can also include real estate and other types of holdings. Do complex gift arrangements allow the donors any relief from the consequences of those long-term capital gains? The answers are a bit complicated and vary by gift vehicle. And sometimes we focus so much on the details of the various gift calculations that we lose sight of the meaning of the overall results. Let’s take a look at some examples of planned gifts that illustrate the potential effects of capital gains.

Capital Gains Tax Background

For basic review, let’s say that a potential donor owns property – real estate or stocks – worth \$250,000. She purchased the property 10 years ago for \$70,000, and it has appreciated \$180,000 in value over time. If she sells the property now, she will have to report \$180,000 in realized long-term capital gains on her income tax return. The federal government will tax her at a rate of 15% on the realized gains – so the net effect will be tax due in the amount of \$27,000. Please note, that computation is based on the assumption that the donor is not in the top income tax bracket; if she were, the tax rate for her capital gains would be 20% instead of 15%, resulting in tax due of \$36,000 instead of \$27,000. On top of the 20% capital gain

tax rate, the 3.8% net investment income tax could apply if the donor's income exceeds the applicable adjusted gross income threshold. And that's just at the federal level – it doesn't include any tax on the realized gains by the state in which the donor resides. (AL, FL, NV, NH, SD, TN, TX, WA, and WY have no state income tax and therefore no state capital gain tax.)

As we said above, if the donor is ultimately interested in making a substantial charitable gift, she could transfer the property outright to a not-for-profit organization. The \$180,000 of capital gains would be permanently forgiven, and she would get an income tax charitable deduction for the entire value of the property. But what if she is not interested in making a gift of the total value (or if she cannot afford to do that), and she still wants to avoid any unnecessary reporting of realized capital gains? Working with a charity, she could structure some sort of split-interest gift arrangement that would provide a generous gift to the charity, earn the donor a significant tax deduction, and avoid taxation on a significant portion of the \$180,000 of capital gains.

Bargain Sale of Appreciated Property

In this case, it might make sense to consider one of the oldest types of planned gifts, the bargain sale arrangement. The details are simple: the donor sells the property valued at \$250,000 to a charitable organization, but she sells it for less than the total value. Let's say she takes \$100,000 off the sales price, so the charity only pays \$150,000 for the property. In that case, the donor is making a charitable gift of the \$100,000, and she is entitled to a charitable income tax deduction for that amount.

And what about the capital gains on the property? How much of the \$180,000 in long-term appreciation will be taxed as part of this charitable gift arrangement? In this example, the charitable portion of the transfer of assets is \$100,000 – 40% of the total – and the non-charitable portion of the property transfer is \$150,000, or 60% of the total. The IRS says that only 60% of the \$180,000 in capital gains (i.e., the non-charitable interest) will be reportable by the donor, and she will have to pay tax on that reduced amount; the remaining 40% is a charitable gift and the capital gains for that portion will not be taxed.

So the donor will be taxed on 60% of \$180,000, or \$108,000. The tax at a rate of

15% comes out to \$16,200. The rest of the capital gains – 40% of \$180,000 or \$72,000 – are attributable to the charitable gift portion, and therefore, will not be taxed. That saves the donor \$10,800 in capital gains taxes. And the savings would be greater for most donors once we added in the tax levied by the applicable state.

Example of Bargain Sale of \$250,000 Property with a \$70,000 basis

Bargain Sale Price of Property: \$150,000

Income Tax Charitable Deduction: \$100,000

Total Reportable Capital Gains: \$108,000

Total amount of capital gains on funding assets permanently forgiven by federal government: \$180,000 - \$108,000 = \$72,000

Capital Gains Tax on Reportable Capital Gains: \$16,200

Tax Savings on Charitable Portion of Capital Gains: \$10,800

Charitable Gift Annuity Funded with Appreciated Property

But what if the charitable organization is not interested in purchasing the property – or is not able to purchase the property, for one reason or another? And what if the donor is interested in some kind of life-income gift arrangement, such as a charitable gift annuity (CGA) or a charitable remainder unitrust (CRUT)? How would the capital gains be taxed under those situations? Does she get to walk away from all of those realized capital gains? Does she completely escape taxation on those gains? The answer is no, and it's critical to understand how the consequences of the capital gains become intertwined with the gift annuity payments over time.

If the donor uses her appreciated stock to fund a charitable gift annuity, the federal government will forgive her *for a portion* of the capital gains – but she will be taxed on the *rest* of the capital gains. These are what the IRS categorize as “reportable gains.” In most cases, the taxation on the reportable gains will occur over the annuitant's life expectancy– assuming the donor names herself as the annuitant (or first annuitant).

The gift annuity, in fact, is considered a form of a bargain sale transaction. Here is how the numbers turn out in *Planned Giving Manager (PGM)*:

Example of a 5.4% Charitable Gift Annuity for a 72-year-old \$250,000 Property with a \$70,000 Basis

Income Tax Charitable Deduction: \$99,155

Annual Payment Total: \$13,500

Capital Gains portion of payments: \$7,494

Ordinary Income Portion of payments: \$3,092

Tax-free portion of payments: \$2,914

Number of years to report gain: 14.5

Total reportable capital gains: \$108,608

Total amount of capital gains on funding assets permanently forgiven by federal government: $\$180,000 - \$108,608 = \$71,392$

Charitable Remainder Trust Funded with Appreciated Property

Now what if the organization does not offer charitable gift annuities, or at least, does not offer gift annuities funded with appreciated property? What if the donor wishes to establish a charitable remainder unitrust instead of a gift annuity? The outcome has similarities with the outcome of a gift annuity, but there are some differences worth noting.

The charitable deduction for a standard 5% CRUT for a 72-year-old is \$138,403 assuming a 1.8% discount rate. That is markedly higher than the deduction for the CGA – or for the bargain sale we have illustrated – but notice that we kept the payout for the trust at the minimum (and most common) rate of 5%, which is lower than the 5.4% rate on the gift annuity. So the annual payment for the first full year of the trust is \$12,500, compared to \$13,500 for the gift annuity.

The capital gains are more difficult to calculate for the CRUT, as compared to the CGA, because they can only be estimated at the outset. The *taxation of payments for the trust are actually calculated on an annual basis, from year to year, unlike the taxation on the gift annuity payments, which is determined at the establishment of the gift arrangement.* We have to make assumptions about how much the trust will earn in dividends and interest, and also about how much the value of the assets will increase each year. Using some fairly common assumptions, we find that the trust, in the first full year, will report \$5,000 of taxable capital gains, compared to \$7,494.12 with the gift annuity. That means the trust will distribute much more “ordinary” (fully taxable) income than the CGA; the ordinary income from the trust in the first full year will be \$7,500, compared to \$3,091.50 for the gift annuity. The rest of the gift annuity payment (\$2,914.38) will be considered tax-free, whereas the trust typically doesn’t distribute any tax-free income.

Example of a 5.0% Charitable Remainder Unitrust for a 72-year-old \$250,000 Property with a \$70,000 Basis

Income Tax Charitable Deduction: \$138,403

Annual Payment Total (first full year): \$12,500

Capital Gains portion of payment in first full year: \$5,000

Ordinary Income portion of payment in first full year: \$7,500

Tax-free portion of payment in first full year: \$0

Number of years for capital gains: Not limited, but let's assume average remaining life expectancy = 14.5

Total reportable capital gains: Not limited, but as much as \$85,432 over 14.5 years

Total amount of capital gains on funding assets permanently forgiven by federal government: \$94,568 (if donor dies after exactly 14.5 years)

Capital Gains and Other Planned Gift Arrangements

We have seen that there are significant consequences of capital gains when appreciated assets are used to fund certain planned gift arrangements such as the Bargain Sale, the Charitable Gift Annuity, and the Charitable Remainder Trust. None of these gift options allow the donor to walk away completely from the realization of long-term capital gains, but rather, the donor will report a reduced portion of the gains and/or pay capital gain tax on income paid over time.

Are there planned gifts that avoid tax on any of the long-term capital gains? There are a couple of prominent examples. The pooled income fund (PIF) is the only life-income gift arrangement whereby a donor can completely escape the tax consequences of long-term capital gains – no matter how much appreciation has built up over time, a donor can contribute stock to a pooled income fund and never be taxed on the gains. This is because of the specific nature of a PIF – it is a *net-income-only* life income vehicle; the PIF can only distribute earned income to its participants. Because PIFs can never distribute any kind of principal to the participants, they can never be taxed on any gains that are realized inside the PIF. The *net income unitrust* functions much the same way – as long as the trust never flips or converts to a standard (regular) unitrust, it can only distribute earned income and so its donors can never be taxed on capital gains.

One other planned gift through which donors can completely escape capital gains is the Retained Life Estate (RLE). There is no capital gain tax because there is never any distribution of money back to the donor from the RLE. This same logic does not hold, however, *with an RLE that is combined with a charitable gift annuity*. As with

other gift annuities funded with long-term capital gains property, the donor will have to report a portion of their capital gains unless they can use the \$250,000/\$500,000 capital gain exclusion for personal residences.

Conclusion

In summary, some planned gifts allow the donor completely to escape long-term capital gain taxation, but there is a realization of long-term capital gains with certain other planned gifts. If a planned gift will cause realization of even just a portion of capital gains, the donor will have to provide a cost basis for the assets. If the donor is unwilling or unable to establish their cost basis, the gift planner will have to assume a zero cost basis - which produces the highest possible amounts of realized capital gains. We recommend having a frank conversation with your donors regarding the implications of capital gains as early as possible, to save them from frustration later in the process. Please feel free to give us a call if you have questions about this - we'd love to help you!

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