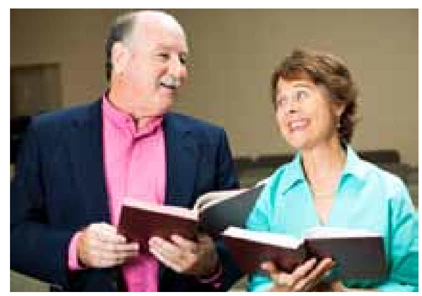
Tax and Business Alert™

July 2012

Charitable Donations of Publicly Traded Securities

Taxpayers with appreciated securities positions may be able to save on federal taxes by donating the actual securities (e.g., stocks) held more than one year (long-term gain securities) to a qualified charity rather than selling the securities and donating the cash proceeds. That's because a sale of those securities is a taxable transaction that results in less after-tax cash to be donated. In contrast, donations of long-term capital gain property, including securities, are generally deductible at their fair market value (FMV), with no federal taxes due on the transaction. However, donations of appreciated securities held one year or less (short-term gain securities) to a qualified charity are generally limited to basis (cost). Note that if the donated securities have declined in value since being purchased, the deduction is only equal to the FMV.

Charitably inclined taxpayers should note that federal regulations limit an individual taxpayer's total contributions to a percentage of adjusted gross income (AGI). For cash contributions to public charities, i.e., churches, schools, and hospitals, the limit is generally 50% of AGI. For the charity, a gift of publicly traded securities is very similar to a cash donation because of liquidity. However, differences exist for an individual donor. For an individual donor, the deduction for securities donations is generally limited to 30% of AGI if the donee is a public charity.



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Planning is essential in determining when to donate appreciated stock. As noted above, because long-term capital gain property contributions are generally deductible at FMV, a charitable gift of stock before a sale can produce a charitable contribution deduction for the full value of the stock. Also, the income tax liability that would have accompanied a stock sale is avoided. This is generally more beneficial to the donor than selling the stock and gifting the proceeds to the charity.

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Tax Calendar

July 16—If the monthly deposit rule applies, employers must deposit the tax for payments in June for social security, Medicare, withheld income tax, and nonpayroll withholding.

August 15—If the monthly deposit rule applies, employers must deposit the tax for payments in July for social security, Medicare, withheld income tax, and nonpayroll withholding.

September 17—Third quarter estimated tax payments are due for individuals and calendar-year corporations.

—If a five-month extension was obtained, partnerships should file their 2011 Form 1065 by this date.

—If a six-month extension was obtained, calendar-year corporations should file their 2011 income tax returns by this date.

—If the monthly deposit rule applies, employers must deposit the tax for payments in August for social security, Medicare, withheld income tax, and nonpayroll withholding.

2013 HSA Limitations

Health savings accounts (HSAs) were created as a tax-favored framework to provide health care benefits mainly for small business owners, the self-employed, and employees of small- to medium-sized companies who do not have access to health insurance.

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The tax benefits of HSAs are quite favorable and substantial. Eligible individuals can make tax-deductible (as an adjustment to AGI) contributions into HSA accounts. The funds in the account may be invested (somewhat like an IRA), so there is an opportunity for growth. The earnings inside the HSA are free from federal income tax, and funds withdrawn to pay eligible health care costs are tax free.

The recently released 2013 inflation-adjusted deduction for individual self-only coverage under a high-deductible plan is $3,250, while the comparable amount for family coverage is $6,450. This is an increase of 4.8% and 3.2%, respectively, from 2012. For 2013, a *high-deductible health plan* is defined as a health plan with an annual deductible that is not less than $1,250 for self-only coverage and $2,500 for family coverage, and the annual out-of-pocket expenses (including deductibles and copayments, but not premiums) must not exceed $6,250 for self-only coverage or $12,500 for family coverage.

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Example: Gifting appreciated stock versus sales proceeds to charity.

Harry and Sally have pledged an $80,000 charitable gift to their church. They have selected a block of stock currently worth $80,000 from their portfolio to use for the gift, but have not decided whether to gift the stock or sell it and gift the proceeds. The stock was purchased for $50,000 in a single transaction several years ago; however, they believe the stock price has peaked.

Harry and Sally would be better off gifting the stock to charity because they will never be taxed on the $30,000 of appreciation ($80,000 value – $50,000 cost). The net economic benefit to them of donating stock rather than cash is $4,500, the tax (assuming a 15% capital gains tax rate) they would have paid on the $30,000 long-term capital gain.

The preceding example assumes Harry and Sally have sufficient AGI to use the entire $80,000 deduction. However, if they are unable to use the full $80,000 this year, any unused balance will carry over for five years. This may actually be beneficial if they expect to be in a higher tax bracket in future years.

Deferring Taxable Gain with a Like-kind Exchange

Nontaxable exchanges of real estate give taxpayers an alternative to taxable dispositions and can provide federal income tax benefits. When a taxpayer considers disposing of real estate either used in a trade or business or held for investment, the nontaxable exchange provisions of Internal Revenue Code Section 1031 provide a beneficial means of acquiring a similar property in exchange for an existing property with little or no tax liability (see the example below).

The obvious benefit from a nontaxable like-kind exchange is that the taxpayer defers tax, and thereby has use of the tax savings, until such time as the replacement property is sold. If the taxpayer holds the replacement property until death, he or she has received a permanent deferral of the tax liability because of the current (2012) step-up-of-basis-at-death rules.

Nontaxable like-kind exchanges should be considered in any of the following situations:

a. When a taxpayer intends to replace the real property with similar property.

b. When the property being disposed of has appreciated in value so a sale would result in a significant tax liability.

c. When a taxpayer has nondepreciable, nonincome-producing property and wants to obtain depreciable, income-producing property. This may be particularly beneficial for taxpayers needing additional after-tax income during retirement.

d. When a taxpayer wants to convert from trade or business real property (e.g., active in management) to investment real property (e.g., triple net lease property), or vice versa.

Example: Using a like-kind exchange to generate retirement income.

Mary, age 63, has owned a 100-acre parcel of raw land for many years. The property is currently worth $1.5 million and her basis is $200,000. Mary wants to dispose of the property so she can use the proceeds to generate retirement income. If she sells the property, she will report a gain of $1.3 million and pay a tax of $195,000 (assuming a 15% long-term capital gains rate). She will invest her after-tax proceeds of $1,305,000 to yield 6%, so her annual pre-tax income from the investment will be $78,300.

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Mary's realtor helps her locate similarly-valued net leased warehouses generating an annual cash flow of 6%. If Mary enters into a like-kind exchange for the warehouses, she will not pay any tax on the disposition of her property and increase her annual income. If the warehouses yield 6% on $1.5 million, her annual pre-tax income increases to $90,000. By entering into a like-kind exchange, Mary will increase her pre-tax income by $11,700 ($90,000 – $78,300).

Like-kind exchange transactions are complex, and there may be valid reasons to recognize income rather than defer the gain. Please contact us to discuss the tax ramifications and economic benefits of a like-kind exchange or if you have questions on any other tax compliance or planning issues.

MRD Reminder

Taxpayers turning age 70½ during 2012 are required to take their first minimum required distribution (MRD) from a traditional IRA by April 1, 2013. In addition, their 2013 MRD must be taken by the end of 2013.

Taxpayers who expect to be in a higher tax bracket in 2013 should consider taking their 2012 MRD in 2012 to avoid higher taxes in 2013.

Kiddie Tax Update

In the good old days, highly taxed parents could shelter some of their investment income by attributing it to their lower taxed older children. No more. The kiddie tax captures that income at the parent's rate.

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Parents may not realize there are tax rules that could affect their child's investment income. Here's how it works. A child is subject to the kiddie tax if:

- He or she has not attained age 18 as of the close of the tax year; or has earned income that does not exceed half of his or her support and is either age 18 or a full-time student age 19–23;
- Either parent of the child is alive at the end of the tax year; and
- The child does not file a joint return for the tax year.

Note: The kiddie tax applies to children under age 18 regardless of their earned income level.

A child subject to the kiddie tax pays tax at his or her parents' highest marginal rate on the child's unearned income over $1,900 (for 2012) if that tax is higher than the tax the child would otherwise pay on it. The parents can instead elect to include on their own return the child's gross income in excess of $1,900 (for 2012).

An individual eligible to be claimed as a dependent on another taxpayer's return may not claim a personal exemption. Thus, a child cannot claim a personal exemption ($3,800 in 2012) if his or her parents can claim an exemption for him or her; whether they actually claim the exemption is irrelevant.

The 2012 standard deduction for a child claimed (or eligible to be claimed) as a dependent on another return is the greater of $950 or the sum of $300 plus earned income, but not to exceed the $5,950 (for 2012) standard deduction that would otherwise be allowable. For 2012, a child with no *earned* income (e.g., wages) may use a standard deduction to avoid tax on the first $950 of *unearned* income (e.g., dividends); the next $950 is taxed at the child's tax rate. Therefore, in 2012, the kiddie tax provision does not affect the child until unearned income exceeds $1,900 (or greater if the child itemizes deductions and deductible expenses directly connected to the unearned income exceed $950).

Example: Child with earned income.

Johnny, age 17, earns $2,000 delivering newspapers. He also had $1,300 of dividend income, for a total of $3,300. The earned income from the paper route ($2,000) is fully sheltered from tax by Johnny's standard deduction of $2,300 ($2,000 earned income plus $300; limited to $5,950 in 2012). So, the $1,000 excess ($3,300 – $2,300) will be taxed at a normal 10% tax rate. The kiddie tax does not apply because unearned income is less than $1,900.