

Avoid Unexpected Tax Liability On Donations of Appreciated Assets

Susie and Joel wanted to sell stock they owned in XYZ Corp. But after finding a buyer and entering into preliminary negotiations, they learned that selling would cause them to owe large taxable gains because the stock had appreciated. Susie and Joel decided instead to donate the stock to charity to avoid paying capital gains tax.

As it turned out, the prospective buyer bought the stock from the charity 10 days after Susie and Joel made the gift. They were pleased because they had reduced their estate's value by disposing of the appreciated stock and were able to take a gift tax charitable deduction for the value of the appreciated asset. But what they might not have realized was that their tax-advantaged strategy succeeded because it avoided application of the "step-transaction" and "assignment of income" doctrines.

Step-Transaction Doctrine

The step-transaction doctrine treats a series of interdependent steps as one transaction even though the steps are formally separate. But the step-transaction doctrine will not apply if the steps have independent business significance apart from tax avoidance.

In our example, had Susie and Joel already entered into agreement with the prospective buyer at the time of the gift, the IRS likely would argue that the couple had gone too far in their dealing with the buyer and would apply the step-transaction doctrine. It would treat Susie and Joel as having sold the property to the buyer and donated the cash proceeds to the charity. Susie and Joel would have had to pay capital gains tax on all the property's appreciation in value.

The step-transaction doctrine could apply to other charitable giving scenarios, too. Let's

say, for instance, that within a short period the corporation redeemed the donated stock from the charity for cash. The IRS might view the transaction as one in which Susie and Joel received a cash dividend from the corporation in redemption of their stock and then contributed the cash to the charity. But as long as the charity was not obligated, and could not be forced, to give up the stock on the date of the gift, the step-transaction doctrine should not apply and the couple should not owe tax on the dividend.

Assignment-of-Income Doctrine

Another rule that can apply in charitable giving situations is the assignment-of-income doctrine. This in essence provides that taxpayers who earn income must recognize that income. In other words, taxpayers cannot transfer the right to receive income to other parties if events have already occurred fixing their rights to receive it. This doctrine prevents a taxpayer earning salary through his or her own efforts from attempting to transfer the right to receive that salary to another person, possibly someone in a lower tax bracket.

How could the assignment-of-income doctrine apply to Susie and Joel? Assume that they give publicly traded stock to a charity after a dividend has been declared. If Susie and Joel transfer the stock after the date on which all current shareholders are entitled to the dividend, they must report the dividend paid to the charity as income even though the dividend is paid after the stock is transferred.

Be Aware and Plan Carefully

Taxpayers who want to give property to a charity must be aware that some circumstances may cause them to recognize income unexpectedly. But with proper planning and documentation, they can avoid unexpected tax liability.

Please call us with any questions or concerns you may have. We would welcome the opportunity to help you achieve your charitable and other financial objectives.