Are Your Tax Strategies Working?

Winter is near and it's time to start thinking about end-of-year tax strategies for middle-class millionaires. For some readers, these may include gifts to charities and children that reduce tax liability.

Why is gifting becoming an important part of the financial planning conversation for middle-class millionaires in Montgomery County? Since the equity markets have rallied over the past five years, many individuals have unrealized capital gains on stocks and other securities. Some of these securities may be overweighing and dominating investment portfolios, so it might be time to reduce the ownership position in these securities.

For example, let's say you bought shares of Facebook stock a few years ago at a value that represented five percent of your portfolio. Today that stock, which is trading at a higher valuation, represents 20 percent of the portfolio. From an investment strategy standpoint, there is a need to reduce holdings in Facebook to maintain portfolio balance. This creates the opportunity to gift Facebook shares to a charity and receive a tax deduction on the full fair market value.

There are also tax-related gifting strategies for stocks that have not participated in the rally. Stocks that have gone down in value can be sold at a loss, and the cash can be used as a gift to a charity or family members. Meanwhile, the loss can offset other gains or ordinary income for tax purposes. Once gains are offset, one can deduct up to an additional $3,000 per year.

Here's an example. Let's say an investor bought $5,000 worth of stock in ABC Corporation, and the value went down to $2,000. The stock is sold and the $2,000 in cash is donated to a charitable cause. The investor takes a $3,000 loss on his or her tax return, and at the same time receives a $2,000 tax deduction for the donation – a total tax advantage of $5,000.

Gifting Strategies when Giving Securities to Charitable Organizations

Here are two primary gifting strategies to keep in mind for securities, including stocks, bonds, mutual funds and exchange-traded funds (ETFs):

• If the asset has appreciated in value and you have an unrealized (i.e., for tax purposes) capital gain, then you should either gift the appreciated securities directly to a charity or to a charitable donation fund (more on this to follow). In either case, you receive a charitable tax deduction for the full market value of the securities.

• If the asset has gone down in value and you have an unrealized loss, you should sell the securities and realize the loss to either offset other capital gains or earned income up to $3,000 per

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year. Then you can use the cash from the sale of the securities as a gift to your children or a donation to the charity or charities of your choice.

Stretching Gifting Dollars Through a Donor-Advised Fund

A donor-advised charitable fund has several advantages for the middle-class millionaire. According to the website for Schwab Charitable, "A donor-advised fund … helps you give to charities while potentially realizing the greatest tax benefits of charitable giving … You receive an immediate tax deduction and can recommend grants to your favorite charities at any time. Any growth in your investments is tax-free, and you can take your time choosing the charities you want to support."

As a financial planning client, you can specify each year the value of stocks you want the investment advisor to donate to the donor-advised fund. The advisor will select securities to be donated, and then you can log-on to the fund's website and direct checks to be sent directly to your desired charities. I use this approach for my own charitable giving and have been pleased with the results.

The advantage is twofold: Donations to a donor-advised fund can be timed for when the security's value is high and, on the opposite side, gifts can be given when the charities need the funds most. Donations from a donor-advised fund can be distributed for as little as $50 and it only takes a $5,000 donation to the donor-advised fund to open an account.

Managing a One-Time Financial Windfall

For individuals who have received a large financial windfall in the form of an inheritance or proceeds from the sale of a company, the Montgomery County Community Foundation is an option. This fund has a minimum donation of $100,000.

Here's how to combine the best of what a community foundation and a donor-advised fund has to offer in terms of charitable impact and tax advantages.

Let's say you own a company and you sell it for $2 million. You need a charitable deduction to offset the $2 million in capital gains from the sale of the company. So you start by gifting 10 percent ($200,000) to the Montgomery County Community Foundation for use in our local community. Then you contact your financial advisor, who opens up a $200,000 account in a donor-advised fund. These funds can be donated, as you specify, to any IRS-qualified charities at the local or national level.

Gifting to Individuals

As previously discussed, you can always sell a security and give cash to individuals (in 2014, up to $14,000 per year from each donor to each recipient), but sometimes it makes sense to gift securities to another individual. For example, if your children are in a lower tax bracket, it might make sense to gift appreciated stocks to them and have them sell the stock. The long-term capital gains rate is zero percent for tax filers in the 10 percent to 15 percent marginal tax brackets.

One more important thing to keep in mind with regard to gifting is that securities and real estate receive a step up in "cost basis" at death. Cost basis is defined as the value used to determine the capital gain, which is equal to the difference between the asset's cost basis and the current market value. For example, Grandpa paid $5,000 for Facebook stock and it's worth $20,000 at his death. When it's gifted to Junior in his will, Junior's cost basis is $20,000. That means Junior can sell the Facebook stock with no capital gains. For this reason, sometimes it makes sense to hold gifting of appreciated securities until your death to allow heirs the ability to receive a step up in cost basis and avoid paying capital gains tax, assuming they sell the stock soon after receiving it. If you want to gift now to heirs in a similar tax bracket as yourself, hold the appreciated securities and give them cash instead.

What is the key takeaway for middle-class millionaires? Gift your appreciated securities to charities and gift cash to your loved ones, unless you know they're in a lower tax bracket than you. While there are exceptions to this rule of thumb, it should apply 85 percent of the time for middle-class millionaires living in Montgomery County.

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