

## DONATIONS OF APPRECIATED STOCK TO SOCIAL WELFARE AND POLITICAL ORGANIZATIONS IN CANDIDATE CAMPAIGNS

**E**ven after the passage of the McCain-Feingold campaign finance reform legislation, donor interest in large gifts to politically active nonprofit organizations is at an all-time high. Donors will not always want to use cash to make such gifts. Some will want to use appreciated stock for gifts to social welfare organizations exempt under Section 501(c)(4) or to a political organization classified under Section 527.

To illustrate how the complex overlay of tax rules operates, the Social Cause Center (The Center) will serve as a hypothetical Section 501(c)(4) entity in the following discussion, and the Social Cause Political Fund (Political Fund) will be the hypothetical Section 527 entity.

Under Section 501(c)(4), The Center is limited to conducting a “less than primary” level of political activity—although it may, from time to time, have one or more separate political funds that fall within Section 527. In this example, the Political Fund is The Center’s only such separate segregated fund, and because the Political Fund does not engage in express advocacy to elect or defeat candidates, it operates outside of the jurisdiction of the federal and state laws that impose upper limits on individual donations to political candidate campaigns.

The donor in this example wants to contribute \$100,000 in publicly traded securities to The Center or to the Political Fund, with the

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understanding that the donated funds may be spent on political activities that meet Section 527’s broad definition of exempt functions (i.e., activities attempting to influence the “selection, nomination, election, or appointment” of candidates for public office). The donor’s basis in the stock is assumed to be very low—zero for purposes of this discussion—and it is also assumed that the recip-

ient organization would sell the stock as soon as it was donated.

The donor has several available options. Choosing between them requires consideration of the impact of three separate types of tax—capital gains tax, investment income tax, and gift tax—and whether the identity of the donor will be publicly disclosed in each situation.

### Option A—Contributing appreciated stock to The Center’s general fund

No capital gains tax would be assessed on a gift of appreciated stock to The Center’s general fund because a Section 501(c)(4) organization receiving a gift takes the donor’s basis in the contributed asset.<sup>1</sup> Thus, no gain would be realized for tax purposes until The Center sold the stock. Since The Center is qualified and recognized as exempt from income tax under Section 501(c)(4), it would pay no tax on the sale.

Because The Center would take over the donor’s basis in the stock, the value of any appreciation above that basis would be considered investment income to The Center. Normally, Section 501(c)(4) organizations are exempt from tax on their net investment income. If, however, a Section 501(c)(4) organization makes political (“exempt function”) expenditures from its general treasury in the same year that it has net investment income, it is subject to tax at the highest corporate rate—currently 35%—on the lesser of those expenditures or the investment income, thus losing its tax exemption on investment income to the extent of that year’s political expenditures.<sup>2</sup> The theory is that since Section 527 political organi-

zations must pay tax on their investment income (as discussed under Option C, below), Section 501(c) organizations should also be taxed when they are doing the same thing—namely, spending investment income on political activities. Therefore, if The Center received stock valued at \$100,000, liquidated it promptly, and also spent at least \$100,000 during the same year on political activities, it would have to pay \$35,000 in tax under Section 527(f). Transfers of general fund money or in-kind contributions from The Center to the Political Fund would be considered political expenditures, and also taxed at the 35% rate.<sup>3</sup>

If The Center never makes political expenditures or transfers of value from its general fund to a political fund, the 35% tax under Section 527(f) would not apply.

The investment income tax also can be avoided to the extent that the liquidation of the stock and the political expenditures take place in different years. For example, assuming that The Center has made no political expenditures in one tax year, it could avoid the Section 527(f) tax by taking in and selling the stock in that tax year and making the political expenditures in the next tax year.

Donations of more than \$11,000 in a single year to a Section 501(c)(4) organization may be subject to gift taxation under Section 2501.<sup>4</sup> Whether any gift tax must actually be paid, however, and the rate to be applied if it must, depends on a variety of factors, including (1) whether the donor has already exhausted his or her lifetime “unified credit” against gift and estate taxes and (2) the understanding between the donor and The Center as to the purposes of the donation. The maximum gift tax rate in 2004 is 48%. Donors are always encouraged to consult with their individual tax advisors about the possible gift tax effects of any contributions valued at more than \$11,000.

The Center is not required to publicly disclose the identity of its donors because it is a

Section 501(c)(4) organization. It is required, though, to annually file Schedule B with its Form 990, disclosing to the IRS the name and address—as well as the amount, type, and date of contribution—of every contributor who donates money, securities, or other property to The Center aggregating \$5,000 or more in the past year. Although the IRS will withhold the names and addresses of such contributors, it may release all other information for public inspection, including amounts, dates, and descriptions of each item of donated property.<sup>5</sup> The Center therefore should take care not to provide more information than is required by Schedule B in disclosing donor contributions. For instance, The Center may describe a stock contribution in Part II of Schedule B as “publicly traded securities” rather than providing the name of the company and the exact number of shares of stock. Such detailed information may inadvertently reveal the identity of the donor.

### **Option B—Selling appreciated stock and contributing cash proceeds to The Center’s general fund**

A donor who sells the stock would have to pay capital gains tax at a rate of 15% on the proceeds of the sale, assuming he or she held the shares for longer than one year. Ordinary income rates would apply if the stock had been held for a year or less.

Because The Center would be receiving a cash gift, it would have no investment income, and no tax would result under Section 527(f), whether or not The Center has political expenditures in the same year.

The above discussion of gift tax on donors to Section 501(c)(4) organizations, and disclosure of donors by Section 501(c)(4) organizations, applies here as well. Because the donor would contribute cash as opposed to securities, there is less risk that The Center’s disclosure



**THE OPTIONS REQUIRE CONSIDERATION OF THE IMPACT OF THREE SEPARATE TYPES OF TAX.**

<sup>1</sup> Section 1015(a). If, however, the donor’s adjusted basis (the base price of the stock, as adjusted in accordance with 1016 and Section 1017) is greater than the fair market value of the stock at the time of the gift, the basis will be that fair market value for the purpose of determining a loss. Section 1015(a).

<sup>2</sup> Section 527(f). If the stock is sold at a loss, however (i.e., for less than The Center’s basis determined under Section 1015(a)), that loss may reduce the amount of investment income from other sources on which The Center otherwise would have to pay investment income tax. Certain limitations apply if an organization has net capital losses. Reg. 1.527-4(b).

<sup>3</sup> Alaska Public Service Employees Local 71, TCM 1991-650.

<sup>4</sup> Rev. Rul. 82-216, 1982-2 CB 220. See Rhomberg, “The Law Remains Unsettled on Gift Taxation of Section 501(c)(4) Contributions”, 15 Exempts 62 (Sep/Oct 2003); Rhomberg, “Constitutional Issues Cloud the Gift Taxation of Section 501(c)(4) Contributions,” 15 Exempts 164, 176 (Jan/Feb 2004).

<sup>5</sup> The IRS will not release such information if it “clearly identifies the donor.” See Instructions to Schedule B of Form 990. The IRS provides no guidance as to what “clearly identifies” means, however.

to the IRS on Schedule B of Form 990 will inadvertently reveal the identity of the donor to the public.

### Option C—Contributing appreciated stock to the Political Fund

Stock transferred to a Section 527 political fund or organization is subject to a 15% capital gains tax on the difference between its fair market value on the day of transfer and the donor's basis in the stock. This tax is assessed against the donor, because the Code treats the donor as having sold the stock to the Section 527 political fund or organization (provided that the fair market value of the stock exceeds its adjusted basis), even though it is the recipient fund and not the donor that actually sells the stock.<sup>6</sup> Again, if the donor held the stock for 12 months or less, ordinary income tax rates would apply.

A "contribution of money or other property" to a Section 527 political fund or organization is not subject to tax to the extent it is segregated for use for political ("exempt function") activities.<sup>7</sup> The investment income of Section 527 political funds or organizations—including stock appreciation—is subject to the investment income tax, however, at the current top corporate tax rate of 35%. Therefore, if the Political Fund promptly sold the shares for cash on receiving them from the donor, the fair mar-

ket value of the stock at the time of its contribution would not be subject to tax under Section 527. Only the amount of any increase in the value of the shares after their receipt by the Political Fund and prior to their liquidation would be taxable as investment income.

Contributions to a Section 527 political fund or organization are not subject to gift tax.<sup>8</sup> In some cases, this factor alone has caused donors to prefer donating directly to a Section 527 political fund, rather than to the parent Section 501(c)(4) organization, especially because the gift tax rate (currently as high as 48%) is so much higher than the long-term capital gains rate (currently 15%).

Section 527 political organizations are required to file periodic reports with the IRS disclosing the names and addresses (and occupation and employer, if an individual) of all people and entities who contribute \$200 or more to the organization after 7/1/00.<sup>9</sup> Therefore, if the Political Fund received a stock gift worth \$200 or more, it would have to report

<sup>6</sup> Section 84. The author presumes that if the fair market value of the stock is less than its adjusted basis, the transfer to the political fund would be treated the same as a gift to a Section 501(c)(4) organization, discussed under Option A, above.

<sup>7</sup> Section 527(c)(3)(A).

<sup>8</sup> Section 2501(a)(5).

<sup>9</sup> Section 527(j)(3)(B). A "contribution" includes anything of value, including securities. Section 271(b)(2).

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## EXHIBIT I. Summary of Four Contribution Scenarios

	<i>Capital gains tax cost<sup>a</sup></i>	<i>Investment income tax reduction in gift<sup>b</sup></i>	<i>After-tax value of gift to the center</i>	<i>Gift tax<sup>c</sup></i>	<i>Public disclosure of donor</i>
<i>Option A:</i> Donor gives \$100,000 of appreciated stock to The Center's general fund.	\$0	– \$35,000 <sup>d</sup>	\$65,000	Maybe	No
<i>Option B:</i> Donor sells appreciated stock worth \$100,000 and contributes after-tax proceeds to The Center's general fund.	– \$15,000	\$0	\$85,000	Maybe	No
<i>Option C:</i> Donor gives \$100,000 of appreciated stock to the Political Fund.	– \$15,000	\$0	\$100,000 <sup>e</sup>	No	Yes
<i>Option D:</i> Donor sells appreciated stock worth \$100,000 and contributes after-tax proceeds to the Political Fund.	– \$15,000	\$0	\$85,000	No	Yes

<sup>a</sup> The capital gains tax would be assessed against the donor.

<sup>b</sup> The investment income tax would be assessed against the center to the extent of its political expenditures in the same year.

<sup>c</sup> Donors should consult with their individual tax advisors about any possible gift tax effects of contributions valued at more than \$11,000. If any gift tax were due, it would be assessed against the donor; however, the center, as the recipient of the gift, is secondarily liable if the donor fails to pay, under Section 6324.

<sup>d</sup> See option a, in the text, for a suggestion as to how to avoid this tax by receiving and liquidating the stock in one year and making political expenditures, if any, in the following year.

<sup>e</sup> The donor could, of course, reduce the size of the gift in order to adjust for his or her capital gains tax liability.

to the IRS on Form 8872 (“Political Organization Report of Contributions and Expenditures”) the donor, the amount and date of the contribution, and the donor’s aggregate contributions for the year up to that point. The IRS then will make these reports available to the public on its Web site dedicated to political organizations.

For years that include a regularly scheduled federal election, such as 2004, the Political Fund may file its disclosure reports on either a quarterly or monthly basis, as long as it files on the same basis for the entire calendar year. The organization also may need to file a pre-election report, a post-general election report, or both. In odd years, Form 8872 is filed semi-annually at the end of January and July.

The Political Fund also would have to file an annual IRS Form 990, with the attached Schedule B and all identifying information

regarding the donor and the donated property, open to public disclosure.

### **Option D—Selling appreciated stock and contributing cash proceeds to the Political Fund**

As stated under Option B, above, a donor who sells the stock will have to pay capital gains tax at a rate of 15% or ordinary income tax, depending on whether or not he or she had held the stock for more than a year.

Because the Political Fund would be receiving a cash gift, it would have no investment income, and no tax would result under Section 527. Because the contribution was made to a Section 527 political fund or organization, the donor would face no gift tax, but the disclosure issues would be as described under Option C, above.

Exhibit I on page 47 is a chart summarizing the effects that the capital gains and investment income taxes would have on the size of the gift ultimately put to political use in the four scenarios discussed above, along with the resulting public disclosure requirements.

### Conclusion

If donor wishes to donate to The Center and not the Political Fund, and The Center expects to make political expenditures during the same year, it would be preferable for The Center if the donor were to sell the stock, pay the resulting capital gains tax at the relatively low rate of 15%, and contribute the after-tax cash to The Center.

If the donor wishes to avoid capital gains tax by giving to The Center, and if The Center

wishes to avoid the 35% Section 527(f) tax, The Center must receive and sell the stock in one year and make its political expenditures, if any, in a different year. The Center would have to fully pay for all of its political expenses in the year of the stock gift from separate gifts to its Political Fund.

For donors wishing to give to the Political Fund, the capital gains tax result is the same whether the donor gives the stock or sells it first and donates the proceeds.

If the donor is subject to the highest gift tax rate, and wishes to avoid the uncertainty of gift tax enforcement on donations to Section 501(c)(4) entities, a gift to the Political Fund is the best option, but the donor will be required to pay the capital gains tax whether or not he or she liquidates the stock before making the gift. ■

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