

The Charitable Contribution Tax Deduction



By Ken Dike, Esq., CPA, CLPF

We all know that the tax code and government spending will be reviewed in the near future with the objective of increasing revenues and/or decreasing expenditures. The charitable contribution income tax deduction will undoubtedly be included in these discussions. Although most people do not make charitable contributions solely because of the related tax benefits, the tax benefits certainly enhance a taxpayer's ability to give.

Charities depend on the voluntary financial support of their donors. The only charities that survive are those that "convince" enough of the public, through their good works and efficient administration, that the charity "deserves" the public's financial support. Charities do not require a broad-based, politically-determined national consensus

continued on page 2

The Income Investor's Dilemma



By Peter J. Boyle, CFA, CIC

In response to the 2008 financial meltdown and resulting Great Recession, the Federal Reserve has lowered the Federal Funds rate ten times, implemented two rounds of quantitative easing (nicknamed QE1 and QE2), and, in a recent announcement, indicated that interest rates could remain low for up to two years.

Whether the Federal Reserve's approach has been the proper prescription for our economic ills is a topic for debate, but the effect has been lower interest rates across the board. The increased demand for bond investments—fueled by both the Federal Reserve (QE1 and QE2) and investors seeking yields, safety, and profit in light of their belief in continuing economic softness—is reflected in the drop in 10-year Treasury yields from 4.8% in August 2007 to 2.0% as of this writing. Because yields on other bond investments, including investment-grade corporate and municipal bonds, move in relation to Treasury yields, these investments are also at historic lows. This downward pressure on fixed income yields began with shorter-term Treasuries, but has spread to other fixed income investments and longer-term maturities.

Today, as the U.S. and European economies remain mired in an anemic recovery at best, or on the edge of a double-dip recession at worst, it appears as if rates will remain at current levels longer than once

thought. So, in such an environment, where does one look for income to replace maturing bonds? Below is a list of several strategies to explore:

- 1) Extend bond maturities
- 2) Adjust asset allocations
- 3) Investigate non-traditional income sources such as foreign bonds
- 4) Consider dividend-producing stocks

Despite the natural urge to lengthen maturities in search of higher yields, we have been cautious in doing so, limiting our extensions into the four- to seven-year range with an eye to inflationary concerns. While we continue to push out our timetable regarding the onset of problematic inflation, earning 1.5% on a 5-year municipal, or even 2% on an A-rated corporate bond with similar maturity, is uninspiring as an income-replacement strategy.

Asset allocation has also traditionally been a tool for increasing portfolio income. Within prudent bounds, moving assets from stock investments into fixed income can provide additional income, but at the cost of reduced growth potential. Unfortunately, with interest rates at current levels, implementing this approach may do more harm (reduced growth) than good (additional income). That said, we continue to scrounge for income from the usual fixed income sources and, as of late, from municipal bonds which are now finding their way into tax-exempt accounts. Until recently, increased demand for municipal bonds was not as great as for Treasuries and

continued on page 3

The Charitable Contribution Tax Deduction *continued from page 1*

as to the appropriateness of what they do. Charities effectuate the charitable motives of their donors, resulting in the incredible diversity of charitable organizations

No government program could consistently serve this diverse constituency in the long term.

in the United States today. The needs serviced by the nonprofit community are extensive and include education, research of all kinds, health care, the arts, religion, civil rights, social services, environmental protection/beautification, and youth recreation to name but a few. No government program could consistently serve this diverse constituency in the long term.

The charitable tax deduction operates as a type of government matching gift incentive program. The deduction obviously reduces the amount of tax a donor is required to pay, assuming the donor's total itemized deduction (including charitable gifts) exceeds the standard deduction amount. Accordingly, the charitable tax deduction can be viewed as a system whereby the government subsidizes charities by subsidizing the charity's donors. This "subsidy" is not a one-for-one match; the reduction in tax revenue is only a portion (donor's tax rate) of the amount given to charity.

The federal tax code has encouraged private charity since 1917. The first charitable deduction was instituted to subsidize charities and protect their private funding in the face of the recently enacted federal income tax. Over the years, the charitable deduction has grown more complex. The following summary of the charitable deduction provisions in the current tax code is provided to remind us of what we have at this time.

How are charitable contributions deducted?

Charitable contributions are deductible as an "itemized expense" on your tax return. You should itemize if the amount donated exceeds your standard itemized deduction. Otherwise, you will have to look a little closer at other itemized deductions, such as home mortgage interest, to see if, when combined with the charitable deduction, the standard deduction amount is exceeded. The 2011 standard deduction for individuals is \$5,800 and \$11,600 for joint returns.

How are gifts to public charities valued and what are the limits?

Cash donated to a public charity can be deducted up to 50% of adjusted gross income (AGI). Amounts exceeding 50% of AGI can be carried forward for five years.

The gift date fair market value (FMV) of securities and real estate held long-term (more than one year) that are donated to a public charity can be deducted up to 30% of AGI. This 30% ceiling can be increased to 50% if the donor reduces the value of their long-term property gifts

The charitable tax deduction can be viewed as a system whereby the government subsidizes charities by subsidizing the charity's donors.

by all appreciation (lower of cost or FMV) for the current year and any unused charitable deductions carried forward from prior years. Amounts exceeding these AGI limits can be carried forward for five years.

Securities and real estate held short-term (one year or less) that are donated to a public charity are valued using the lower of the donor's cost or FMV. These gifts can be deducted up to 50% of AGI. Amounts exceeding this limit can be carried forward for five years.

If the FMV of a security is less than the donor's cost basis, the security should be sold by the donor and the resulting proceeds transferred to charity.

How are gifts to private charities valued and what are the limits?

Private foundations are generally those with little diversity of control or support such as family and corporate foundations. Cash donations to a private foundation are limited to 30% of AGI. Gifts of appreciated property, such as securities and real estate, are limited to 20% of AGI. FMV is used to value gifts of publically-traded securities. Gifts of closely-held stock and real estate are valued using the lower of the donor's cost basis or FMV.

Gifts to private pass-through foundations and supporting organizations follow the same rules as gifts to public charities. In general, private pass-through foundations make "qualifying" charitable distributions of all gifts they receive by the 15th day of the third month following the year of the gift. Supporting organizations are closely related to a public charity through interconnected governing boards or their stated charitable purpose (can only distribute funds to a particular public charity). An example of a supporting organization is a college foundation.

The charitable organization receiving your donation should be able to tell you if they are a public (50%) charity, private (30%) charity, pass-through foundation, or supporting organization. More complex rules exist for gifts of other types of assets such as ordinary income property, depreciable property, and tangible personal property. There are also additional "ordering" rules that come into play when a donor makes gifts of different types of assets (cash, personal property,

etc.) or gives to different types of charities (public or private).

What about Charitable IRA Rollovers?

The 2010 Tax Relief Act extended, through 2011, a taxpayer's ability to make tax-free transfers from an IRA account to a qualified charity. The IRA withdrawal is

The next several months will test our resolve in the belief that charitable giving is an essential part of life in the United States.

not considered income to the taxpayer but "counts" towards the taxpayer's required minimum distribution. Although no tax deduction is allowed, the non-recognition of income equates to a charitable deduction with no income ceiling that you need not itemize.

Where do we go from here?

The next several months will test our resolve in the belief that charitable giving is an essential part of life in the United States. Suggested reforms include changing the charitable tax deduction to a tax credit. Some believe that only charitable gifts over a certain percentage of the donor's taxable income should qualify for the tax credit while others feel there should be no income-based limit. It has also been suggested that the government send the tax credit directly to the charity.

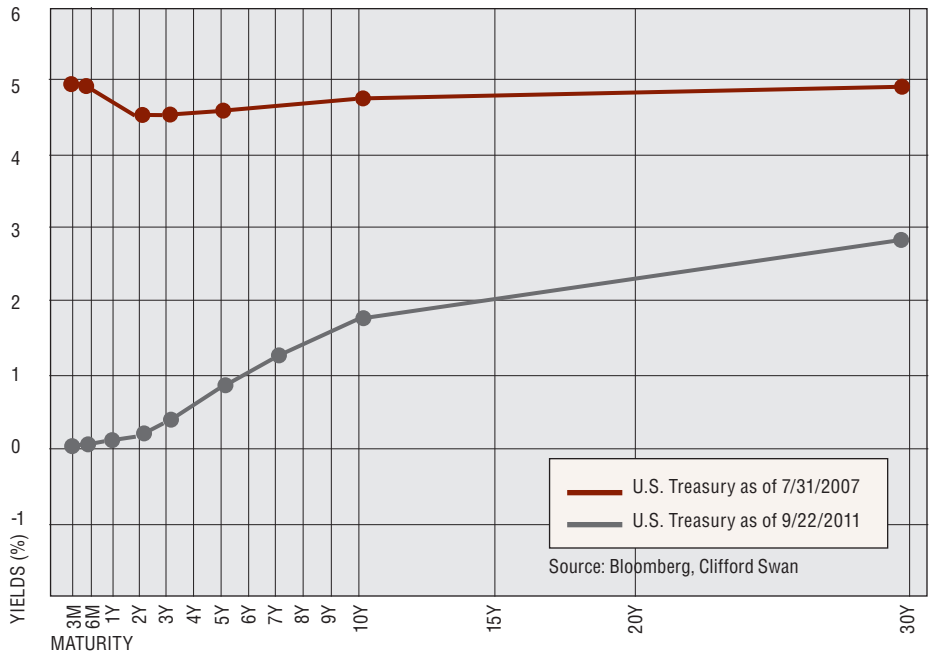
Whatever happens, our legislators need to know how our charities benefit the common good. Congress must understand the importance of tax laws that promote philanthropy and the consequences of reductions in private charitable giving. ♦

Income Investor's Dilemma *continued from page 1*

corporate bonds since municipal bond issuers are less homogeneous and more analysis is required before purchase. In addition, their issue sizes are often too small to attract large institutional buyers.

panies to record profits this year. As a result, these companies have large and growing levels of cash on their balance sheets. While some firms will use these funds for acquisitions, debt repayment or stock buy

U.S. Treasury Yield Curves



For experienced investors, however, the inefficiencies inherent in the municipal bond market can create the opportunity to find relatively better yields.

Small allocations to foreign bonds (or funds) may also present an opportunity to enhance income. These instruments currently offer better yields for similar maturities (duration), and, in many cases, are backed by diversified sovereigns with better economic characteristics than our own federal and/or state governments. Additionally, non-dollar denominated investments offer an opportunity should the U.S. dollar continue to weaken. But, this approach is not without risk.

Lastly, another strategy for obtaining additional income involves higher dividend-paying stock investments. A bright spot in recent years has been the increasing health of U.S. corporations. Cost cutting and a focus on overseas revenue growth will push many compa-

backs, a large number of firms will choose to increase dividends.

Jeremy Siegel, in a recent opinion piece in the *Wall Street Journal*, points out, "Per share dividends of the S&P 500 firms have grown at 5% per year over the last half-century, which handily beat the average rate of inflation of 4% during the period. In fact, dividend growth has beaten inflation both during the low-inflation periods of the 1960s, 1990s and 2000s and the high inflation periods during the 1970s and 1980s." In other words, not only do these dividends provide income, but the growth in dividends over time provides an inflation hedge—a characteristic not shared with traditional fixed income investments.

While we don't possess data for the last 50 years, Clifford Swan's companies¹ show similar dividend growth character-

continued on page 4

Income Investor's Dilemma *continued from page 3*

istics. On average, our companies increased their dividends 12.5% over the last 12 months. As these companies emerged from the recession, profits accelerated, allowing them to grow dividends in excess of historic norms. In the last three years, which included the financial crisis that negatively impacted the dividends of many firms, dividend growth for these companies still remained positive at 2.4%. Lon-

**In such an environment,
where does one look for
income to replace
maturing bonds?**

ger-term, this growth is equally compelling as dividends grew at an 8.7% rate in the last five years. So, not only do these companies offer yields (2.4% average) today in excess of any 5-year bonds we recommend, but the prospect also exists for increased dividends in the future. As an additional benefit, these qualified dividends are taxed at a favorable rate compared to all bonds with the exception of municipals.

Chasing yields can end badly, and how well this final approach performs overall depends on the economy and markets. Should the economy continue to muddle along as it has, companies with reasonable dividends and modest dividend payout rates will be able to use their cash troves to pay, and maybe increase, dividends. Since payout rates are a measure of how much of a company's profit is returned to the investor in the form of dividends, a lower payout rate might signal the ability of a company to increase dividends in the future. Yet, even in the absence of future increases, these current dividend yields may still exceed fixed income alternatives.

Alternatively, when we do transition into higher economic growth, corporate earnings ought to accelerate, allowing for continued dividend growth and for

potential stock appreciation. However, in such a scenario, these dividend-paying stocks may underperform the broader market since investors might rather see profits used to enhance further growth, thereby rewarding low-to-no dividend payers with price premiums. Remember that we are seeking an income alternative and not necessarily growth. Importantly, in such a scenario, since bonds pay fixed rates, any increase in inflation expectations accompanying this higher growth could undermine the purchasing power of bond income.

The obvious risk of investing in dividend-paying stocks, and stocks in general, is a double-dip recession. While not currently in our outlook, this possibility has certainly increased given austerity talk in Washington, continuing issues in Europe, and China tapping the breaks. Should such a scenario come to pass, it is less likely that dividends would grow, but low payout rates (34% Clifford Swan average) could be a cushion against outright dividend cuts.

Importantly, regardless of the economic scenario, such an approach is not undertaken by simply buying stocks with higher yields; as we witnessed during this summer's spike in volatility, a 3% dividend yield can be more than wiped out in a market downturn. The key here is finding stocks with downside price protection, a reasonable dividend yield, and a low payout rate. Bloomberg recently compiled data indicating that after the recent downturn, the market traded at a price-earnings level lower than the average during the previous ten market contractions. While Bloomberg's data refers to the "market," we similarly see value in some of our individual stocks.

As previously mentioned, bond yields are set in relation to U.S. Treasury yields, and for good reason. Despite their recent downgrade, U.S. Treasuries are assumed to identify the "risk-free" rate; hence, every alternative presumably possessing more risk ought to be compared to that rate and afforded a yield premium. So, while these strategic options, which include extended maturities, small municipalities, foreign bonds and dividend-paying stocks, can

marginally enhance portfolio income, they are not without their own specific risks. Each of these approaches ought to, therefore, be considered in relation to your individual goals and risk tolerances. There truly is no free lunch. ♦

I. Companies followed by Clifford Swan research. Those companies whose dividends have been impacted by corporate actions such as spin-offs or changes in their payment frequency have been excluded from the calculations in this article. Data provided by Bloomberg LLC.

CLIFFORD SWAN INVESTMENT COUNSEL

Professionals

Maye Albanez, CFA, CIC
S. David Andrew
Carolyn S. Barber, CFA, CIPM
Peter J. Boyle, CFA, CIC
James R. Brown
Kevin J. Cavanaugh
Michael G. Davis, CFA, CIC
Kenneth H. Dike, Esq., CPA, CLPF
Roger L. Gewecke, Jr., CFA
Kathleen Gilmore, CFP®
Anil Kapoor, CFA
Maxwell R. Pray, CFA
Terrell H. Price
Linda Davis Taylor
Ralph E. Weil, CFA
Bruce C. White
Lloyd Wong, CFA
Randall L. Zaharia, CFA

Offices

Pasadena

200 South Los Robles, Suite 320
Pasadena, CA 91101
626.792.2228 PHONE | 626.792.2670 FAX

Costa Mesa

650 Town Center Drive, Suite 845
Costa Mesa, CA 92626
714.846.2851 PHONE | 714.668.9302 FAX

Evergreen

P.O. Box 2945, Evergreen, CO 80437
720.746.1244 PHONE | 720.294.9896 FAX
www.cliffordswan.com