Funding CGAs with Mutual Funds (What Is the Problem?)

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Many Americans have extensive holdings of mutual funds representing significant portions of their investments, and a majority of individuals invest exclusively in mutual funds. This makes sense – mutual funds are easy to purchase, simple to understand, and they allow for continual reinvestment of income over the long run. As planned gift donors review their financial assets and determine which ones to use as the funding for charitable gift annuities, mutual funds present an obvious choice. As an added bonus, mutual funds are easy to value for gift purposes – their prices are determined daily by the sponsoring companies and quoted as the "Net Asset Value (NAV)". Unlike with gifts of publicly-traded securities, computing the average of the high and low trading prices is not required! But gift planners should be aware of some particular aspects of mutual funds that can cause significant complications in the process.

Capital Gains Can Be an Issue

When potential donors are considering establishing charitable gift annuities, and they own shares of mutual funds that have grown incrementally and appreciated considerably over time, those mutual funds would seem likely candidates for the funding assets. As with appreciated stocks, mutual funds can reach a point where their current market values are considerably higher than their total historical costs – the amounts the donors have paid for them. And also as with appreciated stocks, the donors can realize significant capital gains if the mutual funds are redeemed (sold), resulting in substantial taxes on those capital gains.

Nowadays, with practically everything being handled electronically, mutual funds are as easy to transfer to charitable organizations, as are appreciated stocks. If a mutual fund is donated as an outright gift to a charitable organization, technically, the donor's cost basis transfers to the charity along with the shares, just as it would with a gift of stock, but non-profit organizations pay no tax on realized gains. If the donor cannot produce the historical tax accounting information, the charity can simply declare that the cost basis was zero, and there is no need to delve any further into the matter. When an appreciated mutual fund or stock is used to fund a charitable gift annuity, however, the amount of capital gains becomes important.

Complexity in Tax Accounting

With a gift annuity arrangement, the long-term capital gains will be reduced, following IRS rules, into what are known as the “reportable capital gains.” The reportable capital gains are only a portion of the total capital gains that would otherwise be realized in an ordinary sales transaction; further, in most cases those reportable gains may be spread ratably over the donor’s life expectancy. But the potential issues with using mutual funds to fund a charitable gift annuity stem from the ever-popular automatic dividend reinvestment process and the resulting complexity of tax accounting. In this regard, the difference between using stocks and mutual funds can be quite dramatic.

With publicly-traded stocks, the initial purchase of a particular corporation’s shares is frequently the only purchase of that security that the investor will make. If a subsequent purchase is made at a later point, it will be a deliberate investment move to increase the owner’s holdings. A person who has 100 shares of a company that is healthy, strong, and growing over time may purchase another 100 shares at a later point in time because it makes good financial sense. It’s worth noting that each purchase of the stock – any stock – creates what is called a “tax lot” – a group of shares purchased at a specific point in time at a specific price. Under our tax laws, the computation of realized gains and losses is applied to each tax lot separately.

Here’s a general example: If an investor purchases 500 shares of a particular stock in February of 2016, and then another 500 shares of stock in February of 2017, he will have two tax lots of 500 shares each, and each tax lot will have a separate cost basis. If the investor sells all 1,000 shares in April of 2017, he will have to report 2 separate transactions for tax purposes. The sale of the first tax lot of 500 shares will be considered a realization of long-term gains; the sale of the second lot of 500 shares will be considered a realization of short-term gains; and these two sale transactions will be taxed differently.

Mutual Fund Transactions and Tax Accounting

The same types of transactions occur with mutual funds – a new tax lot is created every time a purchase is made. Another parallel between stocks and mutual funds is the regular periodic distribution of income; with both types of assets, dividends are typically paid on a quarterly basis; the income is paid per share for all shares in registered ownership as of a particular date. However, unlike stocks, the dividends from mutual funds are frequently retained within the owner’s account at the mutual fund company, and the money is used to purchase additional shares of the fund. That action creates a new tax lot – remember, a tax lot is a number of shares purchased at a particular price at a specific point in time. The tax lot created by the reinvestment of the March dividend will be separate and distinct from the tax lot created by the reinvestment of the June dividend, and so on. With this pattern, we have at least 4 new tax lots for each calendar year. And if a person owns a mutual fund for 30 years, and all of the dividends over time are reinvested, that person will have 120 or more separate tax lots for tax accounting purposes.

Here is a more detailed example of how the purchase of a mutual fund and the subsequent dividend reinvestment process might look like over a period of just one year:

Date	Action	# of shares	Price	Amount
1/15/2016	Initial purchase	1,000.000	13.867	13,867.00
3/31/2016	Dividend paid	1,000.000	0.132	132.00
3/31/2016	Dividend reinvestment	9.257	14.259	132.00
6/30/2016	Dividend paid	1,009.257	0.132	133.22
6/30/2016	Dividend reinvestment	9.398	14.176	133.22
9/30/2016	Dividend paid	1,018.655	.132	134.46
9/30/2016	Dividend reinvestment	9.088	14.796	134.46
12/31/2016	Dividend paid	1,027.743	.137	140.80
12/31/2016	Dividend reinvestment	9.354	15.052	140.80
12/31/2016	Ending balance	1,037.097	15.052	15,610.38

So at the end of 2016, thanks to the automatic dividend reinvestment process, we would have a total of 1,037.097 shares, made up of 5 separate tax lots. Here are the details of those tax lots:

Acquisition date	# of shares	Cost basis
1/15/2016	1,000.000	13,867.00
3/31/2016	9.257	132.00
6/30/2016	9.398	133.22
9/30/2016	9.088	134.46
12/31/2016	9.354	140.80

Totals	1,037.097	14,407.48

Funding a Gift Annuity

Now what if the donor decides to fund a charitable gift annuity with all of those shares on February 22, 2017? The current price is $15.293, making the shares worth $15,860.32. The total gain on the holdings is $1,452.84, which is the difference between the current value of $15,860.32 and the total historical cost basis of $14,407.48. But here's the tricky part: the IRS requires the donor – and the charity - to break out the short-term and long-term gains separately in the case of a sale, and a charitable gift annuity is treated under the bargain sales rules according to the tax code.

For the creation of the gift annuity arrangement, the charity has to know exactly how many shares are short-term, how many shares are long-term, and the exact amount of cost basis associated with each portion. To calculate this example in Planned Giving Manager (PGM), the charity would need to select "Multiple Property Types" as the "Property Type" in the "Principal Value – Cost Basis" screen, breaking the shares down as follows:

Short-term capital gain holdings

# of shares	cost basis	current value	STCG
37.097	$540.48	$567.32	$26.84

Long-term capital gain holdings

# of shares	cost basis	current value	LTCG
1,000	$13,867.00	$15,293.00	$1,426.00

How is this information used in the tax accounting and reporting for the charitable gift annuity? Some of the long-term capital gains are permanently forgiven under the IRS tax rules, and the rest are spread ratably over the donor's life expectancy (the reportable gains). The short-term capital gains are also distributed through the regular gift annuity payments, but they are included as ordinary income, since that is how they are taxed.

The breakdown between short-term and long-term capital gains is necessary not only for the tax accounting of a gift annuity, and for the tax reporting of gift annuity payments, but it is also necessary to compute the charitable deduction for the gift annuity. The charitable deduction for the portion of the gift annuity that is funded with long-term appreciated property is based on the current market value of the property, but the charitable deduction for the portion of the gift annuity that is funded with the short-term appreciated property is based on the cost basis – not on the market value. The deduction can be presented as one amount, but it must be computed separately.

Conclusion

From this discussion, it is clear that using mutual funds to establish a charitable gift annuity is similar to using appreciated stocks in some respects, but the calculations and tax reporting can be much more challenging. The automatic reinvestment of dividends provides an excellent way for the owners to increase the number of shares and accumulate greater wealth, but it leads to a proliferation of individual tax lots that greatly complicate the accounting process for any transactions that are considered as types of sales by the IRS.

In summary, mutual funds that have appreciated over time can indeed be used successfully as the funding assets for the establishment of charitable gift annuities, but the gift planner should be aware of the need for the donor's full tax accounting history. It is incumbent upon the donor to provide all of the historical cost basis information for the total number of shares used in the creation of the gift annuity; without those details, the gift planning professional will be forced to assume zero cost bases for both long- and short-term portions, thereby greatly exaggerating the amounts of reportable gains.

While not the subject of this article, it is worth mentioning that details on all of the tax lots are also needed when funding charitable remainder trusts with mutual fund assets. The same need to distinguish between short-term gains and long-term gains exists with CRTs as well. We simply chose to focus on funding CGAs with mutual funds because it is an area in particular about which we receive the most questions related to cost bases and capital gains.

We hope you found this article helpful. Please feel free to contact us if you have any questions or if you would like to discuss the subject matter more fully.