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## TAXING SUBJECT

### The Gift of Stock

*New and overlooked corners of the revenue code*

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**COMMON SENSE IS SELDOM A RELIABLE GUIDE** even to the least complex transactions covered by the tax code. Consider, for example, your sale of 100 shares of ABC you received as a gift. The tax consequences of such a sale may surprise many a veteran trader or investor.

It's clear that your gain or loss on the sale is the difference between the sales proceeds and your tax basis. But what is your basis? Suppose your uncle "Donor" had bought 100 ABC for \$10,000 some time ago and, after it appreciated to \$17,000, turned it over to you as a graduation present. Then, ABC moved up further and you sold the 100 shares for \$18,000.

At tax time you learn, to your dismay, that the tax code (section 1015) says your basis for a gift "for the purpose of determining gain" is the same as it was in the hands of Donor -- which means you must report an \$8,000 gain (your \$18,000 sale less Donor's \$10,000 cost) on the ABC, and not merely the \$1,000 growth in its value since the gift date.


The notion that you must pay taxes on the portion of the appreciation from the time the Donor owned the shares may not go down easily. Isn't this an income tax on some else's income? The issue was settled in 1929, when the Supreme Court, in *Taft v. Bowers*, pointed out that when one Elizabeth Taft sold her gift stock, she enjoyed the growth in its value that had occurred while her father -- her donor -- owned it as well as its rise after she received it. The high court ruled that the entire appreciation was properly taxable to her. So it's clear that if your sale nets an amount above your donor's basis, your gain is figured on that basis and not on the value of the shares when you received them.

Your holding period for the stock, and the classification of your gain as long- or short-term, follows the general rule that if you take your donor's tax basis, your holding period is deemed to include his or her period of ownership. In other words, your holding period goes back to the date Donor bought the ABC. That may offer the consolation of long-term treatment of your gain -- with a 15% maximum tax -- even when you have held the stock for only a brief period yourself.

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But what if you have a loss? "Hold on," you might ask, "how can I have a loss on something that didn't cost me anything?" Well, you have a loss if your sale is below your donor's basis. And in that case, the tax code goes on to say, if the value of the shares when you received them is also below your donor's basis, then instead of your donor's basis, you take the lower value as your basis.

Back in our example, suppose the ABC stock was worth \$8,500 when you received it, and you sold it some time

later for \$7,000, or \$3,000 below Donor's \$10,000 cost and \$1,500 less than its value at the date of the gift. Since both conditions apply -- you have a loss, and ABC was worth less at the gift date than Donor's basis -- your own basis is reduced to the \$8,500 gift-date value, and your loss is recognized only to the extent of \$1,500.

Your holding period for ABC, if you sell at a loss, begins the day following the date of the gift.

Notice, from your standpoint as well as that of Donor, how the tax benefit of Donor's \$1,500 paper loss (the \$10,000 cost less the \$8,500 gift-date value) has gone up in smoke. The moral is that if you're planning to make a gift of property that's fallen in value since you bought it, you would do better to sell it first, so that you realize and capture the tax benefit of your paper loss, and use the proceeds of the sale as your gift. This is the same advice that applies, for the same reason, when you plan to make a deductible contribution of property on which you have an unrealized loss.

Only one scenario remains unaccounted for: The ABC stock, at the date of the gift, has declined below Donor's cost, and later, while you hold it, it rises to a price at above its gift-date value but below Donor's cost; then you sell it.

Remember, whether you have a gain or loss depends only on whether your sale of the gift property brings more or less than Donor's cost. Also, the gift-date value comes into the equation only if you have a loss. Assume, in our last example, that you sell the ABC shares for \$9,300, or \$700 under Donor's cost and \$800 above the gift-date value. In determining your loss on a sale for \$9,300, your basis would have to be the gift-date value of \$8,500 -- but that would indicate a gain. To compute a gain, you must use Donor's \$10,000 basis, which paradoxically results in a loss. You are mired in a classic "recursion" -- a situation not provided for by the Tax Code. Rescue came from the IRS, which will recognize neither gain nor loss in this case.

Note: Our discussion, for simplicity, focused on corporate stock as the gift property, since the tax basis for purchased stock is generally equal to its cost, and adjustments for depreciation, capital improvements and such are not involved. However, the same rules of section 1015 apply to gifts of any kind of property, including real estate and automobiles, when deciding how a gain or loss should be recognized for tax purposes.

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