

March 8, 2018

Maximizing the Value of Charitable Gifts Post-Tax Reform

Among the sweeping changes included in the federal tax reform legislation passed last year by Congress are various reforms that may affect the federal tax benefit of charitable giving. While the reforms discussed below will expire at the end of 2025 (unless extended by future legislation), they have sparked vigorous debate about their potential impact on charitable giving. Donors may want to consider the below strategies to maximize the value of their charitable contributions under the new law, as well as the impact of their gifts.

Increased Standard Deduction and Reduced Itemized Deductions

The new law increases the standard deduction to \$12,000 for unmarried individuals, \$18,000 for heads of household, and \$24,000 for married individuals filing jointly. In addition, it eliminates or limits various itemized deductions. In particular, the law generally caps the deduction for state and local property, income and sales taxes at \$10,000 annually. Likewise, it reduces the availability of the home mortgage interest deduction and eliminates miscellaneous itemized deductions in their entirety. As a result, the number of individuals who itemize their deductions is expected to decrease significantly. Individuals who do not itemize cannot claim a federal income tax deduction for their charitable gifts.

Real World Examples

Higher-Income Donor

Cathy, an unmarried professional who lives in a high-tax state, has annual gross income in excess of \$300,000, state and local income and property taxes of \$27,500 (limited to a \$10,000 deduction), and deductible home mortgage interest of \$15,000. Cathy has regularly made charitable gifts of \$20,000 annually to organizations that have been meaningful to her life and serves on the board of trustees of her alma mater. She would now like to increase the amount she gives to 10% of her annual income and would like to use this additional giving to support organizations in her immediate community.

Cathy previously itemized her deductions and will itemize under the new law. Her gifts were previously deductible in full in the year in which she made them, and her future gifts – including the increased contributions she is contemplating – will be deductible

Middle-Income Donor

Tom, an unmarried professional who lives in a high-tax state, has annual gross income of approximately \$140,000 and state and local income taxes of \$12,000 (limited to a \$10,000 deduction). Tom rents his home and has no debt. He has historically made modest charitable gifts each year, motivated in part by the tax savings. He is now concerned, though, that he will not be eligible to take a charitable contribution deduction.

While Tom previously itemized his deductions, he will not itemize now because his deductions do not exceed the standard deduction. If Tom does not itemize, he may not claim a federal deduction for his charitable gifts. However, Tom’s itemized deductions are only \$2,000 short of the standard deduction.

without any carryforward as well. Consequently, these changes should not adversely affect her giving.

- *Strategy #1.* The board of trustees of Cathy’s alma mater is concerned that gifts to the school from middle-income donors may decline because fewer of such donors will itemize under the new law (see right). Cathy might take advantage of her ability to give on a tax-favored basis by offering to match a certain dollar amount of gifts made by donors to the school. A matching gift program would encourage contributions by those who might otherwise be less inclined to give because of the increased standard deduction and enhance the impact of Cathy’s donations.
- *Strategy #2.* If Cathy would also like to assist smaller organizations in her community, she could support them directly (and the gifts would be deductible). Alternatively, if Cathy is concerned about the organizations’ ability to manage the gifts, she could consider making her contributions through an intermediary, such as a community foundation, that supports her local organizations. Community foundations and other intermediary organizations exist in many fields to direct funds and technical support to community-based entities. Cathy might also find a community foundation helpful if she is unsure of which organizations to support. Community foundations are often able to identify the organizations that best dovetail with a donor’s interests given their familiarity with local groups.

- *Strategy #1.* If Tom is able to afford it, he could “bunch” the donations he would otherwise give over the course of multiple years into one or more gifts this year that are large enough to exceed the standard deduction. Tom could then make “bunched” gifts every three years, for instance, rather than annually. This strategy would enable Tom to continue to support the organizations he cares about, while receiving a tax benefit for his giving.
- *Strategy #2.* If Tom is able to bunch his gifts, but is concerned that the recipients would prefer to receive (and will request) annual gifts, he could alternatively make his gifts through a donor-advised fund (a “DAF”). The entire amount of Tom’s initial contribution to the DAF would be deductible in the year he makes the gift. Tom would then have the flexibility to recommend distributions from the DAF to the charitable recipients of his choice at the times of his choosing (but would not receive any further deductions for such distributions). As an added benefit, the assets in the DAF would be invested and would therefore likely grow over time. A contribution to a DAF could therefore enable Tom to have an even greater charitable impact than if he made his gifts directly.

Reduced Marginal Income Tax Rates

Very generally, the new law lowers the marginal income tax rates, notably reducing the top marginal rate from 39.6% to 37%. Lower tax rates reduce the tax savings generated by a charitable contribution deduction. The tax brackets for capital gains remain at 0%, 15%, and 20%.

Real World Examples

Higher-Income Donor

Henry and Chris have annual gross income in excess of \$700,000, largely consisting of capital gains and

Middle-Income Donor

Pam and John have annual gross income of approximately \$175,000, consisting primarily of

dividends from well-performing investments. In particular, they hold publicly traded securities and complex investments in real estate and private equity. Their itemized deductions, primarily consisting of home mortgage interest, typically exceed \$30,000 annually. Having had significant financial success, Henry and Chris want to give back by contributing to charity.

compensation. They live in a state without an income tax, but pay property taxes and have a mortgage. Nonetheless, their itemized deductions typically do not exceed \$15,000. While Pam and John have children and a good deal of expenses, they manage their finances well and live comfortably. They would therefore like to add charitable giving to their budget.

While the federal tax liability on Henry and Chris’s ordinary income will likely decrease under the new law, the liability on their capital gains will be comparable to prior years.

Because of the reduction in tax rates, Pam and John’s federal income tax liability will likely decrease under the new law, resulting in increased cash in their pockets following the payment of taxes.

- *Strategy #1.* Henry and Chris could obtain two tax benefits for their charitable gifts, and therefore maximize the value of their philanthropy, by donating appreciated investments that they have held for more than one year, rather than cash. Gifts of appreciated capital gain property produce two tax advantages: The donor avoids recognition of capital gains tax on the property and is generally eligible for a deduction equal to the fair market value of the assets. A gift of investment assets, instead of cash, would also have the benefit of leaving Henry and Chris with increased liquidity for expenditures.
- *Strategy #2.* If Henry and Chris’s chosen charitable recipients do not have the capability to accept a property gift, Henry and Chris could instead contribute their assets to a DAF and support the organizations by recommending distributions from the DAF to them. DAF sponsors typically have the resources and expertise required to accept and manage non-cash assets – whether marketable securities or more complex investments.

- *Strategy #1.* While Pam and John may not itemize under the new law, they might take advantage of their tax savings from the reduced tax rates to make a charitable contribution they otherwise could not afford.
- *Strategy #2.* As discussed above, Pam and John might also strategically structure their gifts to take advantage of the charitable deduction – by “bunching” their donations and using a DAF. In particular, if Pam and John need to retain cash for expenses but have some appreciated assets that they have held for more than one year, they could maximize their tax savings by contributing a portion of the assets to a DAF. Pam and John would receive a charitable deduction in the year of contribution. Moreover, as discussed left, donating appreciated capital gain property would be an especially tax-efficient giving strategy because it would provide two tax benefits – avoidance of capital gains tax as well as a fair market value deduction. This approach would also enable Pam and John to provide regular support to the causes they care about through periodic distributions from the DAF.

Increased Charitable Contribution Limit

The new law increases the amount an individual who itemizes may deduct with respect to cash gifts to public charities and certain private foundations to 60% of the donor’s contribution base (up from 50%). The law also temporarily repeals the so-called “Pease” limitation on certain higher-income taxpayers. When applicable, this provision limited certain of a taxpayer’s otherwise allowable deductions, including the charitable contribution deduction.

Real World Examples

Higher-Income Donor

Susan is a wealthy, 72-year-old retiree. She has substantial IRAs and investment assets, producing gross income in excess of \$400,000 annually. She has paid off the mortgage on her home, but has state and local income and property taxes of \$25,000 (limited to a \$10,000 deduction). She is extremely generous and would like to give away as much of her income as possible in the form of charitable gifts while she is able.

Susan previously itemized her deductions, although the Pease limitation restricted them. She will itemize under the new law as well, but will no longer be subject to the Pease limitation. She will consequently be eligible to take advantage of the increased charitable contribution limit.

- *Strategy #1.* Under the new law, Susan will be able to contribute a materially larger amount of cash to public charities and certain private foundations on a tax-favored basis. By way of example, if Susan’s adjusted gross income (“AGI”) was \$400,000 in 2017, she was eligible to deduct cash gifts to charity of up to 50% of her AGI or \$200,000. Susan’s itemized deductions were also subject to the Pease limitation, however, reducing her charitable deduction by approximately \$4,000. As a result, Susan could ultimately take a charitable deduction of only \$196,000 for a \$200,000 gift, leaving her with \$204,000 of taxable income (prior to the application of the state and local tax deduction). If Susan has the same \$400,000 of AGI in 2018, she may make deductible cash gifts to charity of up to 60% of her AGI or \$240,000. In addition, the Pease limitation is no longer applicable. The entire amount of Susan’s gifts would therefore be deductible, leaving her with just \$160,000 of taxable income (prior to the application of the state and local tax deduction).

Middle-Income Donor

Mark, a 75-year-old retiree, lives in a state without an income tax and rents his home. He consequently does not have any itemized deductions. Mark has annual gross income of approximately \$75,000, primarily consisting of distributions from an IRA. He also recently received a moderate inheritance from a family member and would like to make a \$10,000 charitable gift in the family member’s memory. At the same time, Mark anticipates his expenses increasing with age and so has some reservations about making the gift.

Mark did not previously itemize his deductions. He was therefore not subject to the Pease limitation, but was also unable to deduct his charitable gifts. Going forward, his income and expenses might prevent him from strategically “bunching” his donations (see above). As a result, Mark may continue to be prevented from deducting his charitable gifts.

- *Strategy #1.* Mark could obtain a meaningful tax benefit for a gift in his family member’s memory – regardless of whether he itemizes – by using the charitable IRA rollover. The charitable IRA rollover permits all taxpayers age 70 ½ or older to transfer up to \$100,000 annually from their IRAs directly to most types of public charities (but not, for example, to DAFs) without recognizing the amount as income. Donors who make qualified charitable distributions from an IRA therefore avoid federal taxation on their gifts. They can also use the charitable rollover amount to satisfy their required minimum distribution for the year.
- *Strategy #2.* If Mark remains concerned about future expenses, he could alternatively consider using a portion of his inheritance to fund a charitable gift annuity (“CGA”) or other planned gift. Mark would not receive a charitable deduction if he does not itemize. However, a CGA would enable him to accomplish his charitable objectives while providing him with a meaningful lifetime income stream that would mimic the investment

- *Strategy #2.* If Susan would like to give away even more, preferably on a tax-favored basis, she could obtain significant additional tax benefits by using the IRA charitable rollover (discussed right) as well. For example, assume that Susan anticipates having \$400,000 of income in 2018, \$150,000 of which will constitute IRA distributions. If Susan makes qualified charitable distributions of \$100,000 from her IRAs, the \$100,000 would be excluded from her taxable income and Susan would have \$300,000 of AGI remaining. Of this, she could make deductible cash gifts to charity of up to 60% of her AGI or \$180,000. By combining tax incentives, she would therefore be able to make \$280,000 of charitable gifts on a tax-favored basis and would have only \$120,000 of taxable income remaining (prior to the application of the state and local tax deduction).
 - *Strategy #3.* Susan might also consider making a charitable bequest. A bequest would not be deductible and is currently unlikely to produce federal estate tax savings since Susan is unlikely to be subject to the tax (see our [prior alert](#)). However, if Susan would like to increase her philanthropic impact through a charitable bequest, the bequest could be structured to produce tax efficiencies (see right).
- income that he would otherwise have earned on the inherited assets.
- *Strategy #3.* Alternatively, if Mark ultimately concludes that he is uncomfortable parting with capital-producing assets during his lifetime, he could consider making a charitable bequest. A bequest would not provide Mark with any federal income or estate tax savings, but it would enable Mark to honor his family member while retaining assets for lifetime expenses.
- In particular, if Mark takes this approach, the most tax-efficient strategy would be to make the bequest out of any retirement funds remaining in his estate. If Mark names individuals as beneficiaries of his retirement plans, withdrawals from the plans after Mark's death would be taxable to the individuals as ordinary income. If Mark names a tax-exempt charitable organization as the beneficiary, in contrast, the organization would not be subject to tax on withdrawals and Mark could bequeath other assets in his estate that have more favorable tax profiles to his family or other chosen individual beneficiaries.

Miscellaneous Changes

See our prior alerts, [Congress Sends Tax Reform Bill to President for Signature](#), [Tax Reform Doubles Gift, Estate and GST Tax Exemptions](#), and [Tax Reform: Key Provisions for Tax-Exempt Organizations](#), for a discussion of other provisions in the new law that may affect charitable giving.

If you have questions about the impact of the tax reform legislation on charitable giving, please contact a member of the [private client](#), [charitable foundations](#), or [tax-exempt organizations](#) groups.