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Playing it Smart with Charitable Giving

In 2017, Congress passed changes to the income tax law that all but eliminated the tax advantages of charitable giving that many people were accustomed to receiving. Previously, a charitable gift to a 501c3 nonprofit organization would be among the itemized deductions that individual taxpayers would claim to determine their taxable income. If their itemized deductions collectively exceeded the standard deduction, then the taxpayer could use the higher of the two numbers to reduce their taxable income for that year, assuming that the taxpayer wasn't subject to the Alternative Minimum Tax (AMT). AMT is an issue that is well beyond the scope of this article.

However, beginning in the 2018 tax year, the standard deduction was nearly doubled for nearly all tax brackets. While this eliminated the headache of itemizing deductions for most taxpayers, it also eliminated the tax advantages of many charitable gifts. Now, while the donations are certainly appreciated by charities, the IRS won't be giving most people any further deductions for those gifts.

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But just because the IRS may not allow you to deduct your gift against your income doesn't mean that there aren't still ways to reduce your tax bill using charitable giving. You may also be able to make a bigger impact by donating to charities with a little forethought.

The following are a few ideas that you can use to your advantage when looking to give to charitable causes this year. In some cases, you can use charitable gifts to reduce, avoid or defer certain taxes. In other cases, you may be able to give more to charitable causes without feeling any more pinch to your own personal budget. Obviously, you should discuss these ideas with a qualified tax professional, estate attorney and/or financial professional to see if or how these can best be applied to your own personal situation.

Note: The issues discussed in this article are intended to be educational in nature and are not intended to be advice or guidance for any specific person. Endurance Investment Strategies, Inc. and Matthew D. White do not give tax or legal advice. Rather, I work together with your tax and legal professionals to create strategies that are specific to your situation and needs. All strategies discussed here are believed to be accurate at the time of writing (2023). However, this article may or may not be updated for future tax law changes.

Inside this article

1. Donating Highly Appreciated Assets

One of the easiest ways to maximize your giving is by donating highly appreciated assets like shares of publicly traded stocks or mutual funds. Normally, investors who realize a capital gain from selling an asset are subject to capital gains taxes at the federal level and sometimes at the state level too. These taxes can take a serious bite out of your net returns if they're not carefully managed.

Rather than donating cash to a charitable cause, donating shares of, for example, a highly appreciated stock or mutual fund, might be a better choice. When you donate appreciated shares, you don't realize a capital gain on those shares. After all, you didn't sell them. Without a sell transaction, there is no profit or loss. Meanwhile, the nonprofit can receive these shares and sell them without paying income or capital gains taxes since they are not subject to taxes. This is a win/win for you and the charity.

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For example, let's say you own 500 shares of XYZ stock that you purchased many years ago at $50/share and are now worth $100/share for a total of $50,000 market value today. You have, as we say, an embedded capital gain of $50/share or $25,000. This embedded gain may have federal and state taxes due, upon sale, of roughly 25%, depending on your tax bracket and state of residence. That's a tax bill of $6250 if and when you sell.

However, if you were already planning to donate to a charitable cause, you can reduce this tax bill down substantially. Furthering this example, if you were planning to donate $10,000 to a charity, then choosing to donate an equivalent value of shares would allow you to avoid the tax bill on the sale of those shares. In other words, donating 100 shares of XYZ stock, instead of $10,000 in cash, means that you now have a position of 400 shares of XYZ stock with an embedded gain of $20,000. Your looming tax bill potentially just dropped to $5,000, saving you $1250 in future taxes.

So what if you don't actually want to part with the stock? No problem. Donate it anyway and then repurchase the shares with the cash you had planned to donate instead. Repurchasing the shares at today's value of $100/share means that your cost basis averages up to $60/share for a gain of $20,000 but with a market value back where you started at $50,000 since you used your extra cash to repurchase the shares you donated.

You have effectively raised your average cost from $50/share to $60/share, lowering your future tax bill on those shares. Done over many years, you may end up taking a serious bite out of your unrealized capital gains taxes by using this strategy.

Obviously, this is an oversimplified example. Many times, shares are acquired over many years and with different prices over that time. In this case, you can work with your brokerage company or financial advisor to donate the most highly appreciated (lowest cost basis) shares using specified tax lots while retaining the shares with the highest cost basis (lowest embedded gains).

2. Bunching Donations

Bunching donations is a way that might help clear the hurdle of getting your itemized deductions to exceed the standard deduction. If, for example, you had planned to make annual contributions to a charity to show your ongoing support, you should consider making two or more annual contributions in a single year and none the following year(s) as a way to enable you to deduct the contribution against your income.

For example, in the 2022 tax year, the standard deduction for a married couple filing jointly is $25,900. If your itemized deductions total only $20,000, you would naturally take the standard deduction, which is the higher of the two numbers. If you had planned to make a $5,000 annual donation to a charity, you would still only have $25,000 of itemized deductions in the current year, meaning you would still take the higher standard deduction, not receiving any tax deduction for your gift.

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But if you lumped two donations of $5,000 into a single year ($10,000 total), then your itemized deductions would now equal $30,000 ($20,000 + $10,000) and you would now be able to deduct the contribution against your income.

Again, this is an oversimplified example. The Alternative Minimum Tax (AMT) can greatly affect one's deductions, as can other tax issues. It is always best to work closely with a qualified tax professional before committing to this strategy.

Bunching deductions could become increasingly more valuable if you have other windfalls, such as realized capital gains from property sales, the sale of a business or other highly appreciated assets sold in the same year. While these assets might be taxed to you at the long-term federal capital gains tax rate of 15% or 20% (depending on your adjusted gross income), you may get a deduction for that bunched, lump sum donation to a charity at your ordinary income tax rate. Because your ordinary income rate is likely higher than the capital gains rate, donating part of your windfall might end up reducing your tax bill a little. This is a form of tax arbitrage – swapping taxes at a lower rate (capital gains) for a deduction at a higher rate (ordinary income). Working closely with your tax professional before year-end is always best.

3. Donating Qualified Distributions from Retirement Accounts

For those who are taking qualified distributions from tax deferred accounts, such as IRAs and 401(k)s, consider using your distributions to make your charitable donations on pre-tax basis. Normally, when investors take distributions from these kinds of accounts, the money is taxed as ordinary income. So, for example, if an investor makes a charitable donation of $1,000.00 and is not itemizing, then they're donating $1,000 from their net income.

However, if the same person keeps their $1,000 in the bank and then has a check issued from their 401(k) to a qualified charity, then they will not pay taxes on that $1,000 distribution. It's effectively coming from their gross income instead of their net. This also can make it easier to donate more without feeling any hit to your personal budget or savings goals.

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Sketching out your options might look something like this:

Option 1: Donate cash of $1,000.00 = no taxable advantage.

Option 2: Receive a qualified IRA distribution of $1,000 and donate the after-tax amount. With 25% in taxes due = $750 net to you or the charity. Loss of $250 from taxes paid on the distribution.

Option 3: Donate a qualified IRA distribution of $1,000 to a charity = $1,000 to the charity and no taxes due.

If you were comfortable donating cash but would simply like to maximize your giving, then simply add your tax rate to the donation and give a little more without any further strain on your pocketbook. This gives us yet one more option:

Option 4: Maximize your giving. Send a qualified distribution directly to the charity of $1,333.33. This is what it would take to net you $1,000 in cash after taxes, assuming 25% is withheld. Retain your cash for other needs.

With this option, the charity actually receives 33% more money and no taxes are due – truly a win/win.

This can be especially valuable to those investors who are taking their Required Minimum Distributions from qualified accounts. Many people would rather not take the money out at all. So donating their distributions can help allow them to keep their own cash for personal expenses while still contributing to worthy causes.

4. Make a Charity a Named Beneficiary of your Qualified Account

With qualified accounts, such as 401(k)s and IRAs, distributions are fully taxable as ordinary income. They also have a named beneficiary in case you die before the account is fully depleted. Naming an individual as the beneficiary means that, after you die, they will be taxed on the value that they withdraw from the account each year. Before 2020, those withdrawals could be spread over the lifetime of the beneficiary, lessening the tax impact by spreading payments over a long period of time. But after 2020, these accounts must be fully liquidated within 10 years of the death of the original owner. Whatever the timeline, the IRS will almost certainly be taking their share before too long, reducing the value of the estate to your heirs.

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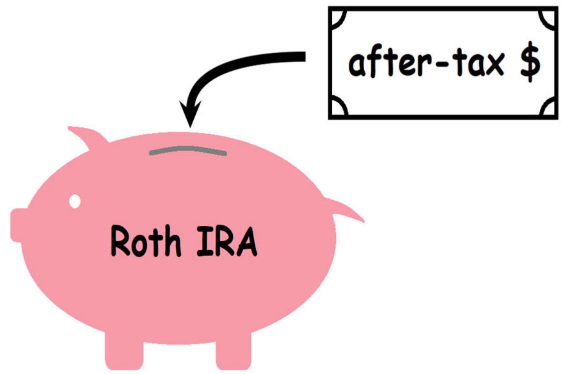
To help reduce or eliminate this grab by the IRS, if you had already planned to make a charitable donation from your estate, consider using your qualified accounts to do this rather than cash or other non-qualified assets. Your heirs can usually receive non-qualified assets without large tax hits because they receive a step-up of the cost basis on the date of your death (assuming you fall under the federal estate tax limits). In community property states, even spouses can receive a full step up of the cost basis to the fair market value on the date of death.

Qualified account distributions, however, will be taxed to the beneficiary as ordinary income whenever they take the money out of the account. Because qualified charities do not pay income taxes, they are the ideal recipient for these kinds of accounts. In most cases where part of the estate will be given to heirs and part to charity, it's best to pass on non-qualified assets to your heirs and other individuals while donating qualified account assets to charity.

5. Roth Conversions

Converting a traditional IRA to a Roth IRA could be another opportunity for charitable giving. For those taking normal distributions (over age 59.5) and wishing to convert their traditional IRA to a Roth IRA, they can first make a charitable donation from their IRA on a pre-tax basis. Since the conversion will be a taxable event, then anything that reduces the account value, such as that charitable donation or even market losses, will likely reduce the taxes due on the conversion. Once again, this allows people to give the same amount of money to the charity without feeling the full brunt of the financial cost or to give more without the larger donation impacting their personal finances. While the conversion itself isn't necessarily a core part of this giving strategy, it is simply an opportune time to use IRA funds to reduce the account balance using a charitable donation of pre-tax dollars rather than giving away cash.



6. Donate Through Your Business

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While individuals are subject to things like the Alternative Minimum Tax, standard deductions & such, businesses often have much more flexibility in how they classify their expenses. One easy way to make donations to charitable causes is to enter into some kind of transactional relationship with the charity. For example, if a charity is hosting an event, a donor can have their business help sponsor the event in exchange for some publicity, advertising or other service. Technically, this is now a business expense, not a charitable gift. As such, this can affect the charity's income situation so it's best to work closely with them on these kinds of things, along with your tax professional to ensure that the charity is able to receive the full amount of your gift.

But if it helps the charity, then it may be worthwhile to the organization to offer these kinds of incentives so that business owners can fully deduct their expenses against their business income. This has better potential for pass-through entities like S-Corps, LLCs and LPs where the usual charitable donation might pass through to the owner's personal returns where it may or may not be deductible due to the now higher standard deduction.

7. Charitable Remainder Trusts (CRTs) and Charitable Lead Trusts (CLTs)

These kinds of trusts are highly complex and will require you to work closely with tax, legal and financial professionals to ensure that everything is done correctly. The basic sketch is that a large donation of cash or highly appreciated assets are donated to a Charitable Trust, created by the donor. The donor then receives a partial deduction for assets donated to the trust, based on the current, fair market value of the assets. The exact percentage of the deduction varies depending on a few factors that are beyond the scope of this article. The donor or other beneficiaries can then receive income from the trust for a period of years to supplement their income, often late in life. Upon the eventual death of the donor or after the specified term, the remainder of the trust's assets are given to one or more specified charities.

This strategy can be more beneficial to those who are further along in their estate plans and have either highly appreciated assets, such as real estate (remember, donations are valued at the current fair market value but the charity can liquidate them without paying capital gains taxes), or those who expect a windfall from highly appreciated assets. Being able to still draw an income from the trust helps the donor continue to receive some benefit from their assets later in life while still supporting the long-term mission of the charity.

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It can't stressed enough that these trusts are highly complex and donors will need the support of legal, tax and financial professionals along with the willingness of the intended charitable organization(s) to receive funds in this way. A charity that needs funds today might not be as willing to wait for you, the donor, to die before they get their donation. Meanwhile, you, the donor, should be confident that the charities you plan to support will be around and financially solvent for long after you intend to be gone.

About Matt White

Matt White has been a practicing Financial Advisor since 2007. He serves middle- class families as they save, invest and plan for their futures.

Matt White also currently serves on the board of the California Chapter of Backcountry Hunters and Anglers, a non-profit organization dedicated to public land and wildlife conservation.

Final Thoughts

Overall, while you're considering various options for maximizing your giving to worthy causes, your best bet is to start with getting your professional team together. A good team creates synergies – potentially unveiling opportunities that would have otherwise remained hidden. Using these or other strategies may ultimately allow you to advance the mission of your favorite charities while making sure that the IRS doesn't take such a big bite out of your finances in the process.

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