Charitable Giving to Reduce Your Tax Burden

~ Jeffrey T. Troiano

We have all been approached by various charitable organizations and asked to contribute toward their fundraising efforts. If we are so inclined, we might choose to make some form of contribution to the organizations. Then, the following April 15, we make sure to tell our accountants about the donations so they can be deducted on our tax returns. Most people know that charitable giving can provide them with some form of tax benefit. While this benefit is generally not the sole reason people choose to give, it does provide an added bonus for those who are charitably inclined.

Few people understand that certain forms of charitable giving can be more powerful in reducing their overall tax liabilities than others. Many people think that simply writing a check to their chosen charitable organizations—or simply naming such charitable organizations as beneficiaries under their Last Will and Testament—is sufficient to provide them with the available tax benefits. While such forms of gifting generally provide some tax savings, there are often other avenues available that are even more powerful for donors.

This article will describe several techniques that you can use to more efficiently make charitable contributions. A little advanced planning can help you get the most out of your charitable contributions.

Donating Appreciated Assets

The past few years have provided us with an extended period of economic growth. Many of you have experienced a welcome increase in the value of various types of investments, including stocks, mutual funds, retirement accounts, and real estate.

If you decide to make a donation, you should examine all of your available assets before deciding which assets are most appropriate to donate. Many of you will think of donating something other than cash only when it directly relates to the charity's mission and purpose. For example, you may donate clothes to Goodwill or art to an art museum. However, with regard to investments, you may decide to first liquidate an asset and then utilize the cash proceeds for your charitable giving. With regard to assets that have increased in value, such steps generally trigger capital gains tax for you.

In many circumstances, you can gift the appreciated assets themselves to your chosen charity. Then, the charitable organization can liquidate the investments, if it so chooses, and utilize the proceeds for whatever purposes they desire. Public charities are generally not subject to the federal income tax regime, so the sale of such investments by the charitable organization will typically impose no capital gains tax. In most circumstances, you can still receive a charitable contribution deduction equal to the full, fair market value of the contributed property without ever having to recognize the corresponding capital gain. Therefore, we strongly recommend that you speak with your accountant or tax advisor prior to making your charitable gifts in order to decide whether you hold any appreciated assets that are suitable for gifting and that qualify for this technique.

Retirement Account Techniques

For many of you, your individual retirement accounts (IRAs) represent a significant portion of your personal net worth. Therefore, IRAs are one source that you might tap to make a charitable gift.

IRAs are accounts intended to encourage people to save for their retirement. In general, any income that you contribute to a traditional IRA is not subject to income tax as it is earned. In addition, the income and growth of the IRA is generally not subject to tax as it is earned. Essentially, the IRA is allowed to grow tax-free over time. However, the entire traditional IRA balance is generally subject to income tax when funds are withdrawn from the account. The IRA rules allow deferral, not elimination, of the income tax liability. The fact that IRA assets are generally taxable as they are withdrawn provides you with some significant planning opportunities for charitable contributions.

IRA Charitable Rollover

As we stated above, traditional IRA withdrawals are generally subject to income tax. In addition, once people reach a certain age, they are required to start withdrawing funds from their IRAs and, therefore, pay income tax on certain portions of their traditional IRA each year. These are known as required minimum distributions.

One exception to the general rule that traditional IRA withdrawals are taxable is that the charitable IRA rollover rules allow you to send funds directly from your IRAs to the charitable organizations of your choice, without having to first report the IRA withdrawal as income. This favorable tax treatment is only available to individuals who are over the age of 70 ½ and is limited to no more than $100,000 per year.

As we mentioned above, if you make a charitable contribution using an IRA rollover, you do not have to report the IRA withdrawal in your gross income; however, you are also not permitted to claim a charitable income tax deduction for the funds you contribute. This makes sense because you have never reported the donated funds as income. You may wonder what benefit this is to you if no charitable deduction is available. The benefit lies in the fact that your gross income is not ever increased by the amount of the IRA withdrawals. The taxation of many items under the Internal Revenue Code is based on the amount of gross income you report as a taxpayer. For example, the taxability of Social Security payments and the Pease limitation on itemized deductions are both impacted by the amount of gross income (including IRA withdrawals) you report.

As you can see, the opportunity to avoid income recognition can have numerous tax benefits outside of the traditional charitable tax deduction. Furthermore, you may be surprised to learn that the amount of a charitable deduction that you can claim may be limited in each given year. In general, the charitable deduction may be no more than 30 percent to 50 percent of the amount of gross income you report. Any excess charitable contributions are disallowed and may be carried forward to future years, so there is a possibility that large charitable contributions you make in a given year will not be fully deductible. As an added benefit, any funds that you give to charity via an IRA charitable rollover will count toward your required minimum distribution amount for that year, so you may not have to withdraw and pay tax on any other IRA funds that year. For all of the foregoing reasons, it is generally preferable for those (1) who are over age 70 ½, (2) who have assets in an IRA, and (3) who wish to make charitable gifts to utilize the IRA charitable rollover provisions for their contributions rather than make general withdrawals from their IRAs.

Making Devises Through Your IRA

As we discussed above, IRA withdrawals are taxable when you receive them. Many of you may be surprised to learn that after you pass away, IRA withdrawals are also taxable to your beneficiaries. IRAs are one of the exceptions to the general rule that a person's assets get a "step-up" in basis that washes away any previous taxable gain that would have been incurred by the decedent. In general terms, this means that an IRA left to your family will be subject to income tax over time and, therefore, serve to reduce the actual benefit to your family member. For example, after income taxes, a $100,000 IRA left to your child might actually be worth only $70,000 to the child on an after-tax basis. On the other hand, as we mentioned above, qualified charities are not subject to federal income tax. Therefore, a $100,000 IRA that is left to a charity will actually benefit the charity in the amount of $100,000, even after taxes. So, to summarize, if you are choosing between an IRA asset or another asset to benefit charity, it is almost always better to direct that your IRA be utilized for your charitable giving rather than your other assets.

The next question is: How can you best facilitate your estate plan to ensure that your IRA is used in this manner? The first thing to point out is that IRAs are generally handled separately from your other estate planning documents. This means that the beneficiary designation that is on file with the IRA custodian will generally control where the IRA passes following your death, regardless of what your estate planning documents say. If no beneficiary is named, or if the only named beneficiary is deceased, then the IRA proceeds will pass through your estate to the beneficiaries named in your Last Will and Testament.

People often visit their estate planning attorneys and indicate that they would like to make a change to their wills. They may indicate, for example, that they have found a charity they like and want to leave such charity $100,000 at their death. They ask to insert something in their will so that this occurs. Once this charitable gift is paid, the balance of their estate is to pass to their children. This is obviously fairly easy to accomplish, and many people add such a provision without giving it a second thought. However, the prudent course of action would be to first review whether you have an IRA. If so, the best course of action is for you to contact the IRA custodian and review and revise the beneficiary designation. These designations are generally very flexible, and it is almost always possible for you to say that you want the first $100,000 to pass to a selected charity, with the balance of the IRA, if any, passing to your children. Then a corresponding provision would be inserted into the estate planning documents, stating that to the extent the IRA is insufficient at the time of death to fully pay the $100,000 to charity, then a distribution will be made to the charity under your will to ensure that the charity gets the full $100,000. This makes the charity whole, as it receives the entire $100,000 and does not have to pay income tax. The entire distribution any of your children will receive consists of assets that pass under the will and that are likely income-tax-free to them. With this simple change, one that involves just a small amount of planning, your children come out ahead, the charity receives the same amount, and the only person out of luck is Uncle Sam.

Managing Your Contributions From Year to Year

As we've discussed, the amount of your charitable deduction may be limited in certain years, based upon the amount of income that you have earned. This can occur in several ways, with the most common being that charitable deductions are limited to a percentage of your gross income based on various factors and the second being that your overall itemized deductions may be phased out if your income is too high. For these reasons, it is often wise to give some thought to the total amount you contribute to charity each year. Many people have a set amount, say $50,000, that they devote to charity each calendar year. However, it may be more beneficial to make larger contributions in some years and no contributions in others. For example, if you make $50,000 annual charitable gifts, you might be better served to make a $200,000 gift in one specific year and then no gifts in the three years that follow. The total amount donated is the same, but the second option may produce a better income tax result for you.

Many of you will think such form of gifting is not appropriate, because you would rather the charity receive the specified amounts over time, rather than in one, larger, lump-sum amount. This can still be planned for if you choose to utilize a donor advised fund at a community foundation—or perhaps even a private foundation. With such vehicles, the charitable deduction is available to you at the time that the assets are contributed to the foundation. The assets can then be distributed to charity over time, as is best determined to be appropriate.

It is wise to have a conversation with your tax advisor or accountant prior to the end of the year so that you can determine whether you would receive any benefit from making additional gifts before the end of the year or by waiting until the following year. As with the other techniques we discussed above, a little advanced planning can provide a great deal of tax benefit.

Jeff is a Williams Parker shareholder.
He handles all aspects of estate, trust, and succession planning and works with individuals and families to develop customized and tax-efficient estate plans that meet their needs. Jeff earned his LLM in Taxation and JD from the University of Florida, and his MAcc from Samford University. He is certified by The Florida Bar as an expert in wills, trusts, and estates.