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Charitable Planning After Tax Reform

With 2017 quickly slipping away, Congress passed legislation late in December known as the Tax Cuts and Jobs Act (TCJA) as its attempt to bring major reform to the American tax system. Although the new legislation stops short of wholesale revision and sweeping simplification of the pre-existing tax system many sought, taxpayers will want to acquaint themselves quickly with a host of new provisions that may affect their personal and business tax situations.

While relatively few of the provisions directly target charitable planning, several of them have the potential to affect the way prudent taxpayers with philanthropic goals are likely to plan their support of charitable causes in the future.

In this issue of our newsletter we will focus on several of the most significant ways TCJA will have an impact on charitable planning in the coming year and beyond.

Lower Rates, but Same Number of Brackets

During the months—and even years—leading up to tax reform, much of the focus has been on simplifying the tax code. Often, the notion of reducing the number of tax brackets was a topic of keen interest of supporters of tax reform. That continued to be a major theme with the current Congress, with three or four brackets cited as worthy targets.

In the end, the new tax law has the same number of brackets as prior law: seven. Like the old law, the new brackets for individuals start at 10%, but all but one of the other brackets—35%—are lower than their corresponding predecessors.

The old law had brackets of 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. Now the brackets are 10%, 12%, 22%, 24%, 32%, 35%, and 37%.

Charitable Implication:

Reduced Tax Savings. Lower rates may mean that donors who itemize their deductions will realize less tax savings for a gift in 2018 than would have been generated by a gift of the same amount in 2017.

Example: Joyce and Phil annually make a gift of $10,000 to support the operations of a favorite charity. This year they expect their taxable income will be about $175,000, similar to 2017.

That will put them in the 24% bracket under the new tax law, meaning their gift will save $2,400 in federal income tax. Last year, when they were in the 28% bracket with the same taxable income, their gift saved $2,800.

Gifts of Cash Deductible Up to 60% of Contribution Base

TCJA increased the maximum allowable annual deduction for gifts of cash from 50% to 60% of taxpayers' contribution base—essentially adjusted gross income.

The new limitation would apply to gifts of cash to public charities. Deductions for gifts of long-term appreciated property continue to be deductible up to 30% of contribution base for gifts to public charities.

Percentage limitations are unchanged for gifts to private foundations (30% for gifts of cash, 20% for gifts of appreciated property) or gifts for the use of public charities (30% cash, 20% appreciated property). Likewise, deductions for gifts in excess of the annual maximum allowable amount can continue to be carried forward and be used as deductions for up to five additional years following the year of the gift.

Charitable Implication:

Higher Deduction in Year of Gift. The new, higher deduction limit can be a boon to donors who make large gifts of cash equal to or in excess of the percentage limitation in any given year. Such donors will now be able to deduct an additional 10% of their contribution base.

This will potentially enable donors of large gifts to realize more tax savings in the year of the gift even though the top tax rate is down from 39.6% to 37% under the new tax law.

Example: Margaret, a widow, intends to make a cash charitable gift of $700,000 this year, when her contribution base will be $1,200,000. She will be able to deduct the entire $700,000 this year because that is less than 60% of $1,200,000. Her resulting tax savings in the top 37% tax bracket are $259,000.

Under the old limitations she would have been able to deduct only $600,000, and her tax savings at current rates would be $222,000. She would carry a $100,000 deduction forward. Even under the previous top rate of $39.6%, her savings in the year of the gift with a 50% limitation would have been $237,600—more than $21,000 less than the amount she will save in the year of the gift at the current rates with a 60% limitation.

Standard Deduction Nearly Doubled and Deductions Eliminated

TCJA dramatically increased the standard deduction for all taxpayers. In 2017 the standard deduction for single taxpayers was $6,350, and it was $12,700 for married couples filing jointly. This year those amounts will be $12,000 for singles and $24,000 for couples.

It is estimated that between one-fourth and one-third of all individual taxpayers itemized deductions under previous law. With this increase in the standard deduction, the best guess is that number will drop to less than 10%.

Not only has the standard deduction risen, but the new law eliminates or caps certain other amounts that were previously available as itemized deductions or exemptions—including:

- The so-called “SALT” deductions for state and local property taxes, income taxes, and sales taxes are now limited to a total of $10,000—allocated between property taxes and either income taxes or sales tax. This will prove challenging for taxpayers in states with higher state income-tax rates and/or higher property-tax rates.
- Deduction of mortgage interest is limited to mortgages of $750,000 or less—down from $1,000,000 under prior law. Mortgages in place prior to December 15, 2017, are grandfathered in under the old rules. Again, taxpayers in areas in which there are high residential real estate prices may lose the ability to deduct some mortgage interest they could previously deduct.
- Taxpayers can no longer reduce taxable income by personal exemptions. According to Congressional reports on **TCJA**, part of the rationale for raising the standard deduction was rolling the benefit of the personal exemptions into the increased standard deduction. At $4,050 per exemption—the amount of each exemption in 2017—this could be challenging for larger families with lots of exemptions for children. That will be offset in some cases by increases in child tax credits.

Charitable Implications:

1. **Bunch Deductions.** More taxpayers may want to employ the time-tested strategy of bunching deductions into a single tax year since more taxpayers will find it harder to clear the standard deduction threshold than in the past.

   Charitable giving offers the most flexibility for this plan. Take the case of a couple who regularly incur annual expenses of about $6,000 for state and local income tax, $4,000 for local property tax, and $8,000 of mortgage interest, and who regularly make charitable gifts of about $10,000. Last year the total of all these expenses—$28,000—would have been well in excess of the $12,700 standard deduction, and they would have certainly chosen to itemize. That meant that they realized tax savings on every dollar of their charitable contributions.

   This year, though, they would still clear the $24,000 standard deduction bar but only by $4,000—meaning they realize no marginal tax savings on $6,000 of their total giving. They may want to consider making their 2019 gift this year as well, giving them a total of $38,000. Next year they will skip their giving and take the $24,000 standard deduction. For the two years they will deduct a total of $62,000. If they continue their typical pattern, they will deduct $28,000 each year for a

total of just $56,000—$6,000 less than if they bunch their giving into one year.

2. **IRA Rollover.** Older taxpayers with charitable motivations will want to give renewed consideration to an IRA charitable rollover. First enacted in 2006, the IRA charitable rollover allows account owners aged 70½ or older to make distributions to charity directly from their individual retirement accounts without the transfer being treated as a taxable distribution to them.

   For IRA owners who want to make charitable gifts and find their itemized deductions coming up short of the higher standard deductions, an IRA charitable rollover effectively turns a gift that otherwise produces no tax savings into one that does. ***Reason:*** An IRA rollover transforms IRA funds that are taxable to the account holder—or to a surviving noncharitable beneficiary—to tax-free distributions to charity.

   This is especially effective if the account owner does not have enough deductions to benefit from itemizing. However, since the amount of the distribution to charity never shows up in the taxpayer's taxable income, the net result is the same as if the IRA owner received the distribution personally and then made a fully deductible gift.

   The icing on the cake for this strategy is that amounts rolled over to charity in this manner count against the IRA owner's required minimum distribution (RMD) obligation. IRA owners can transfer up to $100,000 per taxpayer to charity each year in this manner.

Federal Estate and Gift Taxes Stay but Exemption Doubles

After much speculation about the demise of the federal transfer taxes—and a disagreement as to their continuing existence in the original bills passed by each house of Congress—the final legislation retained the federal estate and gift taxes. It did, however, increase the effective exemption by 100% from the previous amount of $5 million, indexed for inflation occurring after 2011, to $10 million, indexed for inflation occurring after 2011.

This means that, as of this year, individuals will be able to shelter $11.2 million from estate and gift taxes, both during life and at death. Couples will be able to transfer $22.4 million. Even under the previous exemption equivalent, only about two-tenths of one percent of all decedents would have been subject to federal estate tax.

This number now drops even lower. The effective tax rate for those who are subject to transfer tax remains at 40%, making it a significant concern for those who are affected by it.

Charitable Implications

1. **Accelerate Testamentary Charitable Gifts.** More people will want to consider accelerating intended testamentary charitable gifts if those gifts will not produce any federal estate- or gift-tax savings. By making inter vivos gifts, many taxpayers will be able to realize income-tax savings during their lifetimes. This will increase the total amount of assets, other than those earmarked for charity, available for distribution to beneficiaries.

   For instance, assume a donor anticipates her taxable estate will be in the range of $5 million and she intends to make a $500,000 charitable bequest at her death. Most likely she will not be subject to federal estate tax, and her testamentary gift will generate no tax savings.

   However, if she is in a position to make that gift now, she could realize as much as $185,000 in federal income-tax savings during her lifetime. These savings increase the amount she can leave to other beneficiaries at her death—or enable her to make an additional charitable gift at no cost to the other beneficiaries when compared to making the $500,000 gift at her death.

2. **CLT Powerful Tool.** A nongrantor charitable lead trust (**CLT**) remains a valuable planning tool to reduce federal transfer taxes for taxpayers who have, or expect to have, estates in excess of the new equivalent exemption. A **CLT** provides for payment of a stream of income to charity for a specified term of years or for the life of a qualifying person, after which remaining trust assets are distributed to other beneficiaries as directed by the grantor in the trust instrument.

   The reason a **CLT** is able to reduce transfer taxes is that the value of a charity's income interest is deducted from the total amount transferred to the trust to determine how much counts as a taxable transfer. The value of the charitable interest can greatly reduce the taxable portion. In fact, if the annual income payment to the charity is high enough and/or the trust lasts long enough, the entire taxable amount can be eliminated by the use of a **CLT**. A **CLT** is particularly effective when interest rates are low, which produces a low applicable discount rate—a factor that tends to increase the deductible value of the charitable income interest.

   When the trust terminates, the remaining assets are distributed to the designated beneficiaries without any additional transfer tax—regardless of how large the trust has grown.

   For example, assume a grantor creates a $2,000,000 nongrantor lead trust that distributes $120,000 to charity each year for 20 years and directs that trust funds remaining be distributed to his children. Less than $150,000 would be treated as a taxable transfer at the time of creating the **CLT**—and it is possible that no tax may currently be due if the donor had not made other taxable transfers in excess of the

$11.2 million exemption. If the trust realizes an average annual return of 7%, more than $2.8 million will ultimately be distributed to his children with only the original taxable amount of less than $150,000 ever being subject to estate or gift tax.

What Hasn't Changed

While some of the provisions of TCJA have created a new playing field for charitable planning, several important provisions remain the same as they have been.

1. **Gifts of long-term appreciated capital-gain property are still deductible at full fair-market value in many instances.** This has long been a bedrock strategy for prudent taxpayers with charitable goals.

   Example: Mark and Karen decide to use stock they purchased three years ago for $25,000 that is now worth $75,000 to fund their 2018 gift to charity. They are able to deduct the full $75,000 value of the stock. Better yet, they do not have to recognize any of the $50,000 appreciation on their investment.

   Planning Pointer: Even for those who will be using the standard deduction, it may still prove advantageous to give long-term appreciated capital-gain property. While it may not produce any regular income-tax savings if the donor does not itemize, the donor will still avoid potential capital-gain tax that would have been incurred if the donor sold the stock and donated cash.

2. **Despite serious consideration by Congress to the contrary, the new law does not put an annual dollar cap on deductible charitable gifts.** Some proposals would have made charitable gifts deductible only to a designated annual maximum dollar amount, and any value of any gift in excess of that amount would have been permanently non-deductible.

   While there continue to be percentage of contribution base caps on how much can be deducted annually, donors still have the year of the gift plus the next five years to fully use the deductible value to generate tax savings.

   Better still, TCJA eliminates provisions of prior law that require reduction of non-exempt itemized deductions (all itemized deductions except medical and investment-interest expense, casualty, theft, and gambling losses) for certain high-income donors. Popularly known as the Pease provisions, these rules could have reduced a taxpayer's non-exempt itemized deductions by 3% of the amount the taxpayer's income exceeded a specific threshold—up to a maximum reduction of 80% of the itemized deduction. Donors are now free to donate as much as they want in any given year, knowing that their deductions will not be reduced and that there will be no limits on their annual deductions except the percentage of contribution base rules.

Note: Sunset provisions in TCJA would result in the federal income-tax rates and brackets, standard deduction amounts, mortgage interest deductions, and federal estate- and gift-tax exemptions being determined after 2025 under provisions in effect prior to January 1, 2018.

Note: The new lower tax rates for individuals expire at the end of 2025 unlike new lower rates for corporations, which are permanent and reduce the top rate from 35% to 21%.

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