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TAX-EFFICIENT STRATEGIES CREATE WIN-WINS FOR DONORS AND CHARITABLE ORGANIZATIONS

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As taxpayers prepare to file 2020 tax returns, a new tax year is already under way. The best time to plan tax-efficient strategies is well before the end of the tax year, since some strategies require lead time. Now is an ideal time to consider maximizing your charitable donations by using your retirement savings and other long-term appreciated assets.

Under our income tax system, higher earners pay higher taxes. The Tax Cuts and Jobs Act of 2017 greatly increased the standard deduction available to all filers[1], which eliminated the need for itemized deductions for many. Now, for most individuals, the standard deduction is higher than itemized deductions and the best choice to reduce taxes. And with the passage of the CARES Act, filers may deduct up to an additional $300 for charitable cash contributions for the 2020 tax year, even if utilizing the standard deduction. Taxpayers with philanthropic priorities who are past the planning stages of retirement have two easy options to create win-wins when donating to their favorite charities.

QUALIFIED CHARITABLE DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT ACCOUNTS

The SECURE Act increased the age when individuals generally must begin taking required minimum distributions (RMDs) from their retirement account(s) from 70½ to 72. RMDs are calculated using an actuarial table that considers a person's age and life expectancy. For example, a retirement account valued at $500,000 would be required to make a minimum distribution of $19,531.25 when the owner turns 72.[2] RMDs are taxable income and taxed at the applicable income tax rate.[3]

For individuals making charitable donations in cash or who are not otherwise reliant on income from their retirement accounts, a qualified charitable distribution (QCD) provides a tax-free transfer of funds from the plan to a qualified charity. By utilizing a QCD, the RMD and other distributions are not includable in the owner's taxable income. QCDs may also be used for routine donations and are not limited to directing RMDs. Account owners may direct small or large donations out of their retirement account with a QCD after the owner reaches age 70½, although there is a $100,000 annual limit per donor. Additionally, donations made via QCDs do not count toward the taxpayer's itemized deduction limits if not utilizing the standard deduction. QCDs can only be made from IRAs (not employer-sponsored retirement accounts, like 401(k) plans) and cannot be made to certain types of charities (supporting organizations and donor-advised funds).

To illustrate the potential impact of a QCD, James and Lila (married filing joint) expect to receive an additional $25,000 in income from RMDs in the new tax year. Lila is still employed, and James has other sources of supplemental income. Their gross income before the RMD is $340,000. If James and Lila receive the RMD, they would owe $70,422 in federal income taxes.[4] But if they directed the RMD to a qualified charity through a QCD, James and Lila drop into a lower tax bracket and could save $6,804 in federal income taxes for the year.[5] At the 24% tax bracket, every dollar directed to a charity through a QCD (instead of being received by the owner) reduces the owner's tax bill by $0.24. For even routine giving, utilizing a QCD can generate significant tax savings. Corresponding savings on state income taxes may only increase the tax benefit.

DONATING LONG-TERM APPRECIATED ASSETS

Charitable donors often make cash contributions but overlook the advantages of donating long-term appreciated assets such as stocks, mutual funds, or bonds. The sale of these assets is subject to capital gains tax upon a realization event. Capital gains are measured as the base value of the asset (its basis) deducted from the value of the asset upon a sale. For example, an initial $2,000 investment in stock sold years later for $10,000 has a capital gain of $8,000. Any asset held for more than a year is typically subject to a long-term capital gains tax of 15%, plus applicable state income tax.

In the case of James and Lila, they have an initial $5,000 investment (basis) in stock purchased more than 15 years ago that has grown to a fair market value of $25,000. The couple initially intended to sell the stock, pay the tax, and gift the balance to charity. The gain on the sale is $20,000, which is subject to a $3,000 federal capital gains tax (15% of $20,000). After tax, the charity only receives $22,000.

Under federal tax law, donations of appreciated property are valued at their fair market value at the time of donation, but the transfer to the charity is not a realization trigger for the built-in capital gains. Donating the appreciated stock directly allows the charity to receive the full value ($25,000) of the stock. The donation is not subject to capital gains tax, and James and Lila can generally write off the full value of the stock on their tax return (assuming they itemize; there are limits and exceptions).

PERFORM AN ANNUAL ESTATE PLAN CHECKUP

While thinking through tax strategies, this may be a good time to review your current estate planning documents. A will or trust is often the centerpiece of an estate plans, but for many individuals, their most significant assets are "non-probate" assets, such as retirement accounts, financial accounts, and life insurance. Accordingly, a checkup should include reviewing beneficiary designations. Many beneficiary designations can be reviewed or changed at home on the financial institution's website. Review executors and other fiduciaries to determine if they are still the right people to serve. For plans created several years ago, they may not be the right people now, or perhaps may not even be able to serve. The birth of a child, children who are now adults, guardian succession changes, marriage, and divorce are all reasons to update any related documents. And don't overlook powers of attorney. The ability to have a trusted agent make financial or health care decisions on your behalf during a period of incapacity or decline can be critical to managing assets and conducting necessary transactions.

FOR MORE INFORMATION

If you have questions or want more information regarding qualified charitable distributions or donating long-term appreciated assets, please consult your financial advisor or legal counsel. If you do not have regular counsel for such matters, Foulston Siefkin would welcome the opportunity to work with you to meet your specific planning needs. For more information, please contact **Jeremy Graber** at 785.354.9412 or jgraber@fouston.com, or **Jake Holly** at 785.354.9401 or jholly@foulston.com. For more information, please visit our website at www.foulston.com.

[1] For 2021, the standard deduction is $12,550 for single filers and $25,100 for married, joint filers.
[2] Assuming the owner is married and the spouse is not more than 10 years younger: $500,000 / 25.6 (applicable distribution period) = $19,531.25
[3] Distributions from a Roth IRA are not includable as taxable income but also not subject to RMD requirements during the owner's lifetime.
[4] Formula: $365,000 (gross income with RMD) - $25,100 (standard deduction) = $339,900 - $329,850 = $10,050 x 32% (marginal tax rate) + $67,206 (base rate) = $70,422 (taxes owed)
[5] Formula: $340,000 (gross income without RMD) - $25,100 (standard deduction) = $314,900 - $172,750 = $142,150 x 24% (marginal tax rate) + $29,502 (base rate) = $63,618 (taxes owed)

PRACTICE AREAS

- Estate Planning & Probate
- Tax-Exempt/Not-for-Profit Organizations
- Taxation