DECEMBER 2019

TAX REFORM AND CHARITABLE GIVING

The Tax Cuts and Job Act of 2017 (TCJA), which became effective on January 1, 2018, was the most significant federal tax law that we have seen since 1986. Most of our clients saw their federal taxes decrease from 2017 to 2018. While it's true that every new "tax season" brings its own difficulties and stresses for taxpayers and their CPAs, last year ushered in unprecedented challenges and concerns, as well as the more advertised goal of tax reduction. One of the challenges is how to ensure our clients can benefit from their charitable intentions. The TCJA significantly reduced the value of donations for many taxpayers which makes me wonder whether the Act will discourage charitable giving, thereby putting many charities under significant financial strain.

The TCJA cut taxes for most Americans by lowering the tax brackets and by nearly doubling the standard deduction. The standard deduction for married taxpayers increased from $12,700 for 2017 to $24,000 for 2018. Taxpayers over the age of 65 receive an additional $1,300 deduction, per person. When taxpayers claim the standard deduction, they forego itemizing deductions and filling out Schedule A of Form 1040. Consequently, some people who had itemized deductions in past years found that in 2018 it was more beneficial to claim the increased standard deduction. This is borne out by recently released statistics from the IRS-- nationwide, thirty percent of taxpayers' itemized deductions in 2017; for 2018, that percentage had dropped to 10%.

The increase in the number of taxpayers taking the standard deduction also resulted from the TCJA's provisions that reduced or prohibited itemized deductions that were available before 2018. In 2017, taxpayers could deduct state income and local real estate taxes, without limit, against their regular federal tax liability. Also, some portion of investment management fees, tax preparation, and estate planning fees were valuable deductions to many of our clients. The TCJA capped the amount of state and local taxes deductible at $10,000 and entirely eliminated the deductions for investment management fees and legal and tax preparation expenses.

The curtailment of these deductions had the effect of making some charitable contributions have no federal tax benefit. For example, assume a married couple had itemized deductions totaling $30,000 in 2017 that consisted of state income and real estate taxes of $16,000, investment management fees of $5,000 and charitable donations of $9,000. In 2018, that couple would not have itemized because the state tax expense is limited to $10,000, no deduction is allowed for investment management fees, and the $9,000 in charitable gifts would make the itemized deduction only $19,000 for 2018. This couple would have elected to take the new standard deduction of $24,000. In this case, the $9,000 charitable deduction provided no tax savings.

While it is true that this couple had a lower tax bill in 2018 than in 2017, two questions should be addressed. First, are there ways to ensure that future charitable contributions receive a tax benefit for your charitable giving? Second, will the tightening of allowable itemized deductions lead to less charitable giving under the TCJA?

One excellent provision in the law creates tax savings when charitable gifts are made directly from Individual Retirement Accounts. Our Financial Advisors are well-versed and very experienced in helping clients execute gifts through their IRAs. Generally, any taxpayer over 70 ½ can give up to $100,000 yearly from their IRA directly to charity. So, if your Required Minimum Distribution from the IRA is $40,000, and you give $10,000 to charities, then the taxable amount of the IRA income is only $30,000. By doing this, you are excluding that $10,000 from taxable income, and you can do this without worrying about whether you have enough other deductions to itemize.

Another tax strategy available to ensure a benefit is received from a charitable gift is to “bunch” two years of charitable giving into one calendar year. Instead of responding to charitable requests this December, consider holding off until the following January. Then, in the following December, make the same, usual gifts before year end. That way your chances of itemizing deductions is much greater since you will be claiming two years of charitable gifts on one tax return. By claiming the standard deduction in odd years and itemizing in even years, many of our clients experience significant tax savings.

For our Vermont clients, I should point out that even though Vermont has decided to eliminate itemized deductions, it does allow a 5% tax credit on the amount of charitable gifts made. So, a charitable gift of $1,000 creates a $50 credit on the state tax return. This is true whether or not you itemize deductions on your federal return. The value of a deduction for state tax purposes should always be considered, whether or not there is a federal benefit from the gift.

The other question I wanted to raise concerns the long-term effect that the TCJA will have on the financial health of charitable organizations. The increase in the standard deduction will likely discourage some individuals from making charitable contributions. According to IRS figures, the amount of charitable contributions reported on 2018 income tax returns was only $102 Billion. In 2017, that amount was $160 Billion. Admittedly, the 2018 figures were somewhat understated because returns filed without a Schedule A would not report how much a taxpayer gave to charity. Nevertheless, the important point is that gifts to charities will likely be down by billions. I expect our clients will receive letters of appeal from charities acknowledging the financial distress they are facing under the new law. In recent town and city budget meetings in the Upper Valley, local charities have indicated that 2019 contributions from individuals are significantly down so they need to ask the local officials for more funding through municipal budgets to make up for the decrease.

While I'm sure most of my clients will give regardless, I am concerned that the new law will create significant financial difficulties for the national and local organizations that do the most public good for our communities. And, if our charities are unable to provide the needed support, then either the financial burden must be picked up by our local or state governments, driving up those taxes, or, those needing charitable assistance go without. That would be a very disappointing consequence of the 2017 tax cuts.

Although we strive to help clients reduce their tax burden, we frequently remind them that saving tax dollars should not be the primary reason to take a particular action. While we will always point out the tax effects of a particular financial strategy, we will also remind you to consider non-tax, non-financial matters. So, whether you have questions about the timing of charitable giving, moving to a more tax-friendly state, or want to know how a proposed law may affect you or your family, please let us know. We are here to help you make the tax season and the other nine months of the year as worry-free as possible.

Wishing you a healthy and happy 2020,

Douglas C. Gross, CPA, JD
Director of Tax and Financial Planning Services
douglas.gross@ledyardbank.com