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Will Tax Reform Impact Charitable Giving?

A donor's guide to the new law

CAROL G. KROCH
National Director of Philanthropic Planning Wilmington Trust Company

KEY POINTS

- Reviewing the changes to the law from the lens of tax-efficient giving, it's clear that the 2017 Tax Cuts and Jobs Act created some philanthropic winners and losers for the next few years
- With the elimination of the phase-out of itemized deductions, donors who itemize can take advantage of the full amount of their charitable gifts, subject to AGI limits
- For donors who can no longer itemize, there are several good strategies to mitigate the loss of the deduction, including the use of IRAs, donor advised funds, and gifts of appreciated property

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The 2017 Tax Cuts and Jobs Act (the Act) created dramatic changes for taxpayers, and many charitable donors are wondering whether from a tax perspective they will still be able to "do well by doing good."

There are many reasons for giving to charity, but ultimately giving is driven by your passion for the causes and the institutions you support. But like many donors, you also hope to make tax-efficient gifts, allowing you to save taxes and in some cases to give more to charity. For some donors the tax consequences of charitable giving won't change or will even be enhanced by the new law, but other donors are wondering whether their charitable gifts will continue to be deductible for federal income tax purposes. And charities are worried that charitable giving will decline if donors lose tax advantages. This article will attempt to demystify the federal income and estate tax law changes that impact charitable giving and show how many donors can continue to find ways to make tax-efficient gifts. This article does not address state income and estate tax consequences of charitable giving, but it should be noted that in some cases state taxes will also be impacted by the federal tax law changes.

2018 tax landscape for philanthropic donors

Philanthropy is fundamentally about supporting charity, not tax efficiency. Donors across the country at all income and wealth levels are generous givers. According to Giving USA, in 2017 charitable giving nationally increased from $390 billion to $410 billion, and most of that represents giving by individuals[1]. In fact, it is estimated that even before the recent tax law changes,

FIGURE I
2018 Tax landscape for philanthropic taxpayers

Income tax rates lowered	Top rate of 37% applies to taxable income over: $500,000 (single) $600,000 (married)); rate returns to 2017 law after 2025
Capital gains (long term) and dividends highest rate unchanged	Top rate of 20% applies to taxable income over: $425,800 (single) $479,000 (married)
Surtax on net investment income unchanged	3.8% tax applies to Adjusted Gross Income (AGI) over: $200,000 (single) $250,000 (married)
Standard deduction nearly doubled	$12,000 (single and all other taxpayers); $18,000 (head of household); $24,000 (married); indexed for inflation after 2018, returns to 2017 law after 2025
Charitable deduction slightly enhanced	Charitable contributions of cash gifts to public charities are deductible up to 60% of AGI; returns to 50% AGI limit after 2025
Charitable deduction eliminated for college athletic seating rights	Eliminates charitable deduction for 80% of payment to colleges and universities for right to purchase tickets for athletic events
Itemized deductions reduced	Limits combined deduction for state and local income, sales, and property tax to $10,000 through 2025 Limits home mortgage interest deduction for new mortgages from 2018-2025 to $750,000 of indebtedness (grandfathers existing mortgages and some refinancings); repeals deduction for home equity interest unless used to purchase or improve home
Phase-out of itemized deductions	Eliminates the phase-out of itemized deductions through 2025
Estate, gift, and GST tax exemption increased	$11,180,000, as indexed for inflation. In 2026, returns to $5,000,000 as indexed for inflation
Highest tax rate unchanged	40% Charitable deduction retained

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almost 75% of taxpayers did not itemize deductions and thus received no tax benefit from any charitable gifts they made[2]. But at higher income and wealth levels, donors have typically been able to take advantage of tax incentives for giving.

Tax-efficient giving is a function of many factors: your adjusted gross income; the amount of your charitable gifts; the kind of asset you give; the charity you give it to; your tax rate; and your other deductions. Reviewing the changes to the law from the lens of tax-efficient giving, it's clear that the Act created some philanthropic winners and losers for the next few years. Note that most of the provisions of the Act that relate to individuals expire after 2025, and unless Congress acts, the law will revert to pre-2018 law. (Figure 1)

The winning philanthropists

For donors who still can itemize, in general, the new law provides a win. First and foremost, the charitable contribution deduction is still in place. In contrast to so many deductions that were eliminated or significantly cut back, the new law kept most of the rules for tax-efficient charitable giving. In fact, the charitable deduction is one of the few that was actually enhanced, as the new law increased the Adjusted Gross Income (AGI) for charitable gifts of cash to public charities from 50% of AGI to 60% of AGI through 2025 (see Figure 2). Furthermore, the Act eliminated the phase-out of all itemized deductions (the Pease limitations) through 2025. In 2017, the phase-out had applied to income above $261,500 (single) and $313,800 (married filing jointly) and could eliminate up to 80% of deductions. The only change reducing the charitable contribution deduction is that the deduction for 80% of the payment to a college or university to allow the donor to purchase tickets for athletic events is eliminated.

These two positive changes mean that high income donors making substantial charitable gifts are likely to have a greater deduction than they would have in years past. For example, take the case of a business owner, who sells her business in 2018 and receives taxable income of $5,000,000. In prior years, she could have given half of that to a public charity; but in 2018, to take advantage of the big income realization event, she could make a deductible cash gift of $3 million to a donor advised fund at a public charity, $500,000 more than she could have deducted in 2017. And none of her $3,000,000 gift would be lost under the Pease limitation, which would

FIGURE 2

Permitted deductible charitable contributions for federal income tax purposes

Charitable Gift Categories	Adjusted Gross Income [1,3,4]
Gifts of cash to public charities and certain foundations • Colleges, universities, museums, hospitals, United Way-type organizations • Donor advised funds • Supporting organizations • Conduit foundations • Operating foundations	**60%***
Gifts of long-term capital gain property (including appreciated stock) to public charities and certain foundations	**30%**
Gifts of cash to private foundations	**30%**
Gifts of long-term capital gain property to private foundations Additional limitations: Full fair market value deduction permitted only for gifts of qualified appreciated stock, which is stock traded on an established securities market.[2]	**20%**

[1] Adjusted gross income does not include income exempt from federal income tax.

[2] Qualified appreciated stock is limited to 10 percent of the outstanding stock of a corporation, including all prior gifts made by donor and family members to any private foundations.

[3] Does not address phase-out of deductions for higher income taxpayers (Eliminated for tax years 2018 until 2025).

[4] Does not address alternative minimum tax.

* Reverts to 50% after 2025.

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have taken away more than $140,000 in deductions in 2017. Gifts to charity are deductible from federal income tax under fairly complex rules, so it is always important to run the actual numbers.

The tax savings from a charitable gift is also a function of the tax rate of the donor. As shown in Figure 1, for the period 2018-2025 federal income tax rates were not significantly changed. The highest rate dropped from 39.6% to 37%, while the rates on capital gains and dividends (15 or 20% depending on income level), and the 3.8% surcharge on net investment income are unchanged. A brief example shows how minor this impact is: a tax deductible cash gift of $1,000 by a donor at the highest tax bracket previously saved the donor up to $396; today it will save the donor $370—hardly a big change. And this slight loss may well be offset by the elimination of the itemized deduction phase-out. So for high income donors who make substantial gifts to charity, the tax benefits are better than ever.

And the Act is not limited to income tax deductions. The charitable contribution deduction for gift, estate, and generation-skipping transfer taxes remains in place. The Act nearly doubled the gift, estate, and generation-skipping transfer tax exemptions to $11,180,000, as indexed for inflation. So for very wealthy donors, there is still a tax incentive for charitable giving to reduce wealth transfer taxes.

The new non-itemizers

The big question under the new law for donors who make less substantial gifts is whether they will still itemize deductions, in light of the significant changes overall to deductions. Most importantly, the standard deduction was nearly doubled, from $6,350 to $12,000 for single taxpayers and from $12,700 to $24,000 for married taxpayers filing jointly, both indexed for inflation. With the new higher standard deduction, many taxpayers who used to itemize deductions will find that their potential deductions are less than the new standard deduction. This is even more likely for taxpayers who live in high tax states, as the state and local income and property tax deduction is now limited to $10,000. One change likely to impact many donors is the reduction of the home mortgage interest deduction for new mortgages used to purchase a new residence after 2017 to $750,000 of mortgage indebtedness. The current $1,000,000 limitation for existing mortgages and refinancings of the existing acquisition debt of those mortgages is grandfathered. The elimination of the deduction for home equity loan interest not used to purchase or improve a home has also been eliminated, along with many other deductions.

It has been estimated that the number of taxpayers who will be able to itemize deductions will drop by over 50% from approximately 26% of taxpayers before 2018 to only 11% of taxpayers. The Tax Policy Center has estimated that the number of donors who claim a charitable contribution deduction will drop from an estimated 21% of taxpayers to 9% of taxpayers[3]. Take the case of a married couple, with $300,000 of income, $5,000 in home equity loan interest borrowed to buy a car, and state and local taxes of $20,000, who made charitable gifts in cash of $10,000. In 2017, their itemized deductions of $35,000 vastly exceeded the standard deduction of $12,700, with the result that their charitable gifts provided them tax savings. But in 2018, their deductions will amount to only $20,000, less than the $24,000 standard deduction. Put differently, without further planning, they will receive no federal tax savings from their charitable gifts, and likely no state tax savings either.

Ways to mitigate the loss of deduction

Fortunately, for many donors there are some good ways to fully or partially offset the loss of the deduction.

Make your charitable gifts out of your IRA.
IRA assets are heavily tax-burdened and can be very attractive for gifts to charity, rather than family. For a donor who is not able to itemize, taking advantage of

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the IRA "charitable rollover" rules can be essentially the same economically as taking a tax deduction. The IRA charitable rollover provision permits individuals aged 70 ½ or older to transfer up to $100,000 directly from an IRA to a "qualified" charity without recognizing income or taking a charitable contribution deduction. The amount transferred to charity also counts to satisfy all or part of the required minimum distribution. Note that a qualified charity does not include a private foundation or a donor advised fund.

In addition to being helpful to donors who can no longer itemize, the IRA charitable rollover can be very helpful to taxpayers who:

- have already maximized their permitted charitable contribution deductions (see Figure 2)
- wish to minimize their AGI so as to stay below the threshold for the 3.8% surtax on net investment income (AGI of $200,000 single, $250,000 married filing jointly)
- live in a state that does not permit charitable deductions from state income tax
- can otherwise benefit from a lower amount of AGI

An added advantage of giving IRA assets to charity is that they are less attractive assets to leave to your heirs. If your estate will be taxable (i.e., exceeding the current $11,180,000 exemption for 2018), the IRA will be subject to federal estate tax. (Note that state estate tax also applies in some states, and the exemption amounts vary.) Furthermore, the heirs of an IRA must pay income tax on the IRA distributions to them. So distributing IRA assets during life not only saves income taxes, making up for the loss of itemized deductions, but frees up more attractive assets to go to your heirs in the future. If you leave non-IRA assets to your heirs, generally the basis in those assets will be "stepped up" to fair market value at death, and the heirs will have capital gains only on future appreciation.

"Bunch" your deductions. Of course many donors who will be unable to itemize are under age 70 ½ or do not have IRA assets available for distribution. For donors with sufficient liquidity, a simple approach is to "bunch" deductions, making charitable gifts in a single year equivalent to what you would typically give over two to three years, and then not giving directly to charity for the next few years. As a result of the increase from bunching, the charitable gift should be large enough to itemize the deduction. For example, a married couple who typically gave $10,000 a year, and paid $20,000 of state and local taxes, would have had fully deductible gifts before 2018, as their total deductions of $30,000 would easily have exceeded the standard deduction of $12,700. But in 2018, with the limited deductibility of state and local tax, and the higher standard deduction, their permitted deductions of $20,000 would be less than the standard deduction of $24,000. By giving two years' worth of gifts in 2018, they increase their deductions to $30,000 total, allowing them to itemize their deductions and get tax savings from their charitable giving.

Of course, giving is first and foremost about helping charity, and making large gifts in some years while skipping giving in other years could have an adverse effect on the charities relying on gifts. In that case, it may be helpful to have a discussion with the charity, particularly if it is a small charity, to make clear that it should not rely on a similar sized gift every year, and that the next gift will not be made for several years.

There are however, several simple approaches to address this problem. Probably the simplest and most effective is to establish a donor advised fund (DAF) with the deductible bunched gift and then use the DAF

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to support the charities in the years before the next charitable contribution. In this way, you can keep a fairly steady level of charitable support during the years when you will be taking the standard deduction. A DAF is a fund established at a sponsoring charity such as a local community foundation. By law, donors may only recommend charities to receive distributions of donated funds, but in most cases sponsoring organizations follow those recommendations. DAFs can be a good option for smaller donations as they are simpler and less expensive to establish than private foundations. Because a DAF is maintained by a public charity, the deduction limitations and operational restrictions that apply to private foundations generally do not apply to them. And, you can contribute appreciated property, such as closely held stock, to a DAF and still receive a full fair market value deduction.

Contribute appreciated property. For donors who cannot take advantage of distributing from an IRA or who don't have the liquidity to increase their charitable gifts through bunching deductions, a gift of appreciated securities can still save taxes, even when the donor does not itemize. For both donors who itemize and those who don't, a gift of long-term, appreciated publicly held stock is often a more tax-efficient gift than cash. When you give publicly traded securities held for more than a year to charity, you are generally allowed a full fair market value deduction for the donated securities, up to 30% of AGI if donated to a public charity; 20% if donated to a private foundation. And, you avoid the tax that would have been due on any future sale. But remember that the stock must be held for more than one year, or the deduction will be limited to basis, generally the initial purchase price. And, not all gifts of property are the same. They must be looked at asset by asset, and the charitable recipient can matter too. For example, the deduction for a gift of closely held stock to a private foundation will be limited to the cost basis of the stock. A gift of a painting that has appreciated in value can be a great asset to give to an art museum, as you will avoid the tax on collectibles, imposed at a 28% rate. If you plan to make a gift of stock or other property, be sure to allow enough time to make the transfer. Some smaller charities may even need to create a process for accepting such gifts and to establish a broker relationship. And some gifts of property will take negotiation and possibly a gift agreement.

The future of charitable giving: A great social experiment?

Donors at all income and wealth levels are increasingly interested in philanthropy. Under the new tax law, many donors will still be able to make fully deductible charitable gifts, either because their charitable giving is large enough to exceed the standard deduction, or because they have sufficient other deductions to exceed the standard deduction. With the elimination of the phase-out of itemized deductions, donors who itemize can take advantage of the full amount of their charitable gifts, subject of course to the AGI limits. For donors who can no longer itemize, there are several good strategies to mitigate the loss of the deduction, including the use of IRAs, donor advised funds, and gifts of appreciated property.

We might think of these changes in deductibility as a great social experiment. Will people continue to give, even if there is no tax savings from the deduction? Will they change their giving patterns to continue to be able to make deductible gifts? Some commentators have suggested that donations to charity will drop; others are more optimistic and believe that charitable giving is first and foremost a gift motivated by passion for a cause[4]. This article can't answer the question to the great social experiment; for that we will need the passage of time. Meanwhile, donors who are motivated both by charity and taxes have many ways to continue to be tax-effective in their giving.

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SOURCES

[1] *Giving USA 2018 Highlights,* An Overview of Giving in 2017, June 2018.

[2] *Tax Policy Center*, Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis, William G Hale, Hilary Gelfond, Aaron Krupkin, Mark J.Mazur, and Eric Toder, June 13, 2018, pp. 17, 21, and 37.

[3] *Tax Policy Center*, Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis, William G Hale, Hilary Gelfond, Aaron Krupkin, Mark J. Mazur, and Eric Toder, June 13, 2018, pp. 21, and 37.

[4] *Tax Policy Center*, Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis, William G Hale, Hilary Gelfond, Aaron Krupkin, Mark J. Mazur, and Eric Toder, June 13, 2018, pp. 22; Tax Reform: Who Really Benefits from Charitable Giving? Robert Sharpe, Trusts & Estates magazine, March 2018.

Carol G. Kroch
National Director of Philanthropic Planning
Wilmington Trust Company

302.651.8928
ckroch@wilmingtontrust.com

Carol is responsible for philanthropic planning for Wealth Management. She has extensive experience working with individuals and nonprofit organizations in estate, trust, and charitable gift planning and in advising nonprofit corporations and trusts, including private foundations and public charities. Carol was named by Private Asset Management magazine in 2015 and 2016 as one of the 50 most influential women in private wealth. She holds a JD from Boston College Law School and a bachelor's degree from Wellesley College. She is a Fellow of the American College of Trusts and Estates Counsel and is a member of the National Conference of Lawyers and Corporate Fiduciaries.

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