Charitable Giving With an Eye on Tax Time

Doing well by doing good: Various ways to aid your favorite causes.

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While changes to tax law over the past few years have reduced or eliminated many deductions in favor of a higher standard deduction, those who have the ability to give back still have an opportunity to do good and reduce their tax bill at the same time.

Two-thirds of American households donate to charity annually, according to the Philanthropy Roundtable, a network of charitable donors based in Washington, D.C. These charitable contributions can provide meaningful tax savings, but it is important to understand the rules and the strategies available to you to maximize the tax benefits related to your gifts.

THE STANDARD DEDUCTION VERSUS ITEMIZED DEDUCTIONS

For 2023, the standard deduction was increased to $13,850 for single taxpayers and $27,700 for married couples filing joint. With the state and local tax deduction limited to $10,000, you may need significant charitable contributions to get above the $27,700 standard deduction. Even if you will be below the standard deduction threshold, there are still strategies that you can employ to maximize tax savings from your charitable contributions. One is through a qualified charitable distribution (QCD) from your individual retirement account (IRA). The second is lumping several years' worth of donations into one tax year. We discuss each below, but first we review the tax implications for the various ways you can give.

GIVING CASH

The easiest way to give is to write checks to the charities of your choice. If you're still a taxpayer who is able to itemize deductions, the contribution amounts are subtracted from your taxable income, up to a maximum of 60% of your adjusted gross income. Thus, if you're in the 22% federal tax bracket*, for a donation of $10,000, you save $2,200 in federal taxes so that your actual out-of-pocket cost is $7,800. In addition, if you live in a state with income tax, the out-of-pocket cost is less, since you save state income tax as well. Although the easiest, this method is in fact the least tax-efficient way to make a charitable gift.

** In 2023, the 22% tax bracket is adjusted gross income above $89,450 if married or $44,725 if single.*

GIVING SHARES OF STOCK OR MUTUAL FUNDS

From a tax-efficiency standpoint, gifting appreciated securities is far more advantageous. Again, we'll assume you are in the 22% tax bracket. Several years ago, you invested $2,000 in a stock and it's now worth $10,000. If you sell it, you'd owe the 15% federal capital gains tax ($1,200) netting $8,800 after tax. You could then give the $8,800 to charity and receive a $1,936 deduction for a net savings of $736.

Instead, if you give the shares directly to charity, you'll receive a $10,000 tax deduction, which will save you $2,200 in federal income tax. In addition, you avoid the $1,200 in capital gains tax because you gifted the shares directly to the charity rather than sold them. The charity gets $10,000 instead of $8,800 and you save $1,464 more in taxes by giving shares rather than cash.

It's important to note the maximum deduction for giving appreciated securities is 30% of your AGI versus 60% for cash in any one year. If your gift of stock exceeds this limitation, the excess amount can be carried forward for up to five more years.

If giving appreciated shares, it's important to identify the shares with the lowest cost basis so that you're removing the maximum in capital gains from your portfolio. Brokerages don't do this by default, so we recommend you instruct them to do this in writing, as they may not even have a place on their forms for it.

Also, the shares you give must be held for more than one year or you get credit only for your cost basis of the security rather than for the appreciated amount.

QUALIFIED CHARITABLE DISTRIBUTIONS (QCDS)

A qualified charitable distribution is created when you request that your required minimum distribution (RMD) from your IRA account go directly to a charity. This allows you to meet your distribution requirement and not recognize this income as taxable, since it's a direct donation to charity. Be aware that there are some limits on how to implement a QCD.

The contribution must be made by an individual, over age 70-1/2, and individuals are limited to $100,000 in qualified charitable distributions per year, although obviously you can give less.

Rather than receiving the distribution as income and itemizing the contribution as a deduction, the QCD goes straight to the charity and is not included in your gross income. Thus, QCDs are more effective than simply writing a check because the QCD allows you to lower your adjusted gross income, rather than simply offsetting AGI with a matching deduction. QCDs will likely become more popular going forward, as they enable you to reduce your income with a contribution, even in the case where you do not itemize deductions.

CHARITABLE 'LUMPING'

While QCDs can create significant tax benefits, in many circumstances a gift of appreciated shares still presents the largest potential tax savings. But with the standard deduction now $13,850 per person, it may take a significant charitable gift in order to get above the standard deduction hurdle and realize any tax benefit from the gift.

In order to clear the standard deduction hurdle, taxpayers can try and "lump" deductions into one year in order to increase tax saving.

You can't pay multiple years' worth of state taxes, real estate taxes or mortgage interest in one year. But you can lump multiple years' worth of charitable gifts into one year to maximize your deductions. Often gifts are made in the form of a multi-year pledge. In its simplest form, lumping those donations would mean accelerating the pledge and writing a check or gifting securities to donate the full amount in the current year.

For example, take the case of a married couple with state and local tax deductions of $10,000 and mortgage interest of $6,000. In addition, they have pledged a donation of $30,000 to their alma mater, spread out over five years ($6,000 per year). In this base case, the $5,000 donation would bring their total itemized deductions to $21,000. They would simply file using the $27,700 standard deduction and realize no tax benefit from the charitable donation.

Under a lumping strategy, they could accelerate their pledge, gifting $15,000 this year and $15,000 next year. Their itemized deductions would now be the $16,000 in taxes and interest plus the $15,000 deduction, for a total of $31,000. They would then itemize on their return and receive a tax benefit for a portion of their donation. Donating the full $30,000 in the current year would further increase the tax benefit.

DONOR-ADVISED FUNDS

However, you may not be comfortable donating your full pledge in the current year. And you may not have a single charity or pledge large enough to lump in this fashion to maximize the deduction. In many cases, our clients make smaller, regular donations to a handful of organizations each year.

Or what if you have an appreciated stock that you know you want to donate in the future, but don't want to decide which charities to give to at this time?

You can donate your stock to a donor-advised fund (DAF), which qualifies as an intermediary charity. You'll receive a full market value deduction in the year that you give the stock to the DAF. The DAF establishes a fund in your name. Thereafter, the DAF makes gifts to charities from your fund. Legally, you can't control these distributions, since you gave the stock permanently and irrevocably to the charity. But you retain the right to make "grant suggestions" as to who receives the distributions.

The DAF is entitled to accept or reject those suggestions, but in practice they are rarely rejected, provided the charities are public 501(c)(3) nonprofit organizations. As always, investigate and compare before selecting a donor-advised fund. Generally, DAFs are established with gifts of $5,000 and more. Charitable assets in DAFs jumped to $34 billion in 2021, as the strategy has become increasingly popular under the current tax regime. We will explore them in detail in our next column.

If giving appreciated shares, it's important to identify the shares with the lowest cost basis so that you're removing the maximum in capital gains from your portfolio.

CONCLUSION

A 2008 study by Harvard Business School found that giving money to someone else lifted participants' happiness more than spending it on themselves. These good feelings are reflected in our biology.

In a 2006 study, the National Institutes of Health found that when people give to charities, it activates regions of the brain associated with pleasure, social connection and trust, creating a "warm glow" effect. Scientists also believe that altruistic behavior releases endorphins in the brain, producing the positive feeling known as the "helper's high."

It can often feel difficult to find real world situations where "everybody wins." When taken together, the personal, social and monetary (tax) benefits make supporting causes you believe in a true benefit for all.

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