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A Philanthropist's Guide to Federal Taxes 2019

The Most Flexible Tax-Saving Tool: The Charitable Deduction

A distinguishing characteristic of American society has been the voluntary association of individuals to address needs. This was the characteristic of the young country that impressed Alexis de Tocqueville of France when he toured the United States in the early 1830s. In his report *Democracy in America*, which he published in 1835, he observed that when Americans see a problem they do not wait for government alone to solve it for them, but they immediately form an association to deal with it.

For more than 100 years the United States government has provided tax incentives to encourage individuals to contribute to the charitable organizations whose missions they want to support. Those tax incentives have encouraged gifts both during and at the end of life. The major incentive, of course, is the charitable deduction. A person who makes a gift during life is entitled to income- and gift-tax deductions, and the estate of a person who leaves a bequest to charity is entitled to an estate-tax charitable deduction. **Note:** According to an article in *Strategic Wealth Planning* about the history of the tax deduction, the War Revenue Act of 1917 authorized the first individual income-tax deduction for charitable deductions.

The tax savings resulting from the charitable deduction remain quite substantial. The income-tax deduction in particular is a powerful tool because it offers taxpayers incredible flexibility regarding the amount, timing, and type of gift. Generally speaking, taxpayers tend to have much less control over other types of deductions—such as those for state and local taxes and mortgage interest.

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Tax Savings Tied to Income-Tax Rates

The actual financial benefit of a charitable tax deduction is primarily a function of a taxpayer's marginal income-tax rate: The higher your marginal tax rate, the more savings you will realize from your charitable deductions.

2019 Tax Rates & Brackets

Tax Rate	Single	Married Filing Jointly	Head of Household
	TAXABLE INCOME		
10%	$0–$9,700	$0–$19,400	$0–$13,850
12%	$9,701–$39,475	$19,401–$78,950	$13,851–$52,850
22%	$39,476–$84,200	$78,951–$168,400	$52,851–$84,200
24%	$84,201–$160,725	$168,401–$321,450	$84,201–$160,700
32%	$160,726–$204,100	$321,451–$408,200	$160,701–$204,100
35%	$204,101–$510,300	$408,201–$612,350	$204,101–$510,300
37%	Over $510,301	Over $612,351	Over $510,301

Cash gifts are deductible up to 60% of your contribution base. The contribution base is typically equal to your adjusted gross income (AGI). Any unused deduction can be carried forward for up to five additional years. That means your out-of-pocket cost for a charitable gift is reduced by the same percentage as your marginal tax bracket.

Example: John, a single taxpayer, would have taxable income of $225,000 this year if he did not make any charitable gifts. He decides to make a cash gift of $20,000 to support our work. Because his income places him in the 35% marginal tax bracket, John's gift will reduce by $7,000 (35% x $20,000) the amount of tax he would have otherwise owed. Thus the net cost of his $20,000 gift is $13,000.

Charitable-planning pointer: In certain states a gift may also generate state income-tax savings. The examples and explanations herein refer to the federal tax.

Even Better: A Gift of Long-Term Capital-Gain Property

If you own assets that have gone up in value—such as stocks, bonds, and real estate—your savings may be even greater if you use them to make charitable gifts. The reason is that gifts of most long-term capital-gain property are deductible at their full fair-market value, and you are not taxed on the capital gain.

The capital-gain tax rate depends on the type of property you contribute, how long you have owned the property, and your marginal tax rate. The following charts show the capital-gain tax rates for sales of securities or nondepreciated real estate that has been owned for more than one year.

Single Taxpayer	
Taxable Income	**Tax Rate on Long-Term Capital Gain and Qualified Dividends**
Not more than $39,375	0%
$39,376-434,550	15%
Over $434,550	20%
Head of Household	
Taxable Income	**Tax Rate on Long-Term Capital Gain and Qualified Dividends**
Not more than $52,750	0%
$52,751-461,700	15%
Over $461,700	20%
Married, Filing Jointly	
Taxable Income	**Tax Rate on Long-Term Capital Gain and Qualified Dividends**
Not more than $78,750	0%
$78,751-488,850	15%
Over $488,850	20%

In addition to the tax on capital gain at the applicable rate, the Affordable Care Act levies a surtax of 3.8% on the investment income (capital gain, dividends, interest, and rents) on taxpayers whose adjusted gross income exceeds certain thresholds—$200,000 for single individuals and $250,000 for couples filing jointly. Thus the maximum effective capital-gain tax

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rate on securities and nondepreciated real estate could be 18.8% or 23.8%.

It should be noted that a higher tax on capital gain applies to tangible personal property and to the gain attributable to the depreciation in depreciated real estate. Those rates are 28% and 25% respectively, not including the surtax.

Example: Years ago Gloria bought shares of XYZ stock for $20,000; today they are worth $50,000. She knows that if she sells the stock, she will owe tax on the $30,000 of long-term capital gain.

Gloria is planning to make a $50,000 gift to us this year, so she decides to give XYZ stock instead of cash. She is able to deduct its full $50,000 value—a $17,500 savings in federal income tax given her 35% bracket. She also avoids paying the 18.8% ($5,640) tax on her $30,000 paper profit. (Because of her income level, the 3.8% surtax is added to her 15% capital-gain tax rate.) This plan results in total tax savings of $23,140 ($17,500 income-tax savings + $5,640 capital-gain tax savings).

A gift of stock can be a particularly good way to close out a position in the market without negative consequences. Those who held their positions following the 2008 market decline may have significant gain in their portfolios.

While market uncertainty has left many looking to protect the gain in stocks they still hold, capturing it the traditional way—by selling—will result in a tax on the capital gain. By giving such stock instead of cash, you can escape this locked-in position and preserve your charitable deduction. If you like the stock as an investment, you can repurchase it after making the gift.

Deduct your gifts of appreciated property, up to 30% of AGI. Unlike gifts of cash, gifts of long-term appreciated property are deductible to the extent of 30% of your AGI. **Note:** Just as with gifts of cash, any unused deduction can be carried forward for up to five additional years.

Rules for tangible personal property: While gifts of long-term appreciated securities and (most) real estate are usually deductible at fair-market value, there are special rules that apply to certain kinds of property. Gifts of tangible personal property—such as art, jewelry, and coin collections—are deductible at full fair-market value if we can put the property to a use related to our exempt purposes. Otherwise, your deduction is equal to the lower of the fair-market value or your basis in the property.

Please speak with a member of our staff and your advisors if you are planning a gift of any appreciated property.

Note: In certain states that tax capital gain, a gift of appreciated property may result in additional tax savings that would further reduce the cost of the gift.

What Is a "Marginal" Tax Bracket?

You may have heard people express concern that additional income will actually cost them money by pushing them into a higher tax bracket. This is a common misconception.

When your taxable income crosses over into a higher bracket, it does not mean that all of your income will be taxed at that higher rate. Each portion of your income is taxed at the rate of each successive bracket.

Example: A single person with $100,000 of taxable income is in the 24% marginal tax bracket and pays a total tax of $18,174. Each successive portion of that person's income is taxed as follows:

Income Bracket	Amount Taxable	Tax Rate	Tax
First $9,700	$9,700	10%	$970
$9,701 – $39,475	$29,775	12%	$3,573
$39,476 – $84,200	$44,725	22%	$9,839
$84,201 – $100,000	$15,800	24%	$3,792
			TOTAL $18,174

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Suppose this person contributed $20,000 of cash. The exact tax savings would be the sum of:

- $15,799 (the portion that would have been taxed at 24%) x 24% = $3,792.
- $4,201 (the portion that would have been taxed at 22%) x 22% = $924 for a total of $4,716.

In the examples we approximate the tax savings by multiplying the deduction by the tax rate that would have applied to most of the amount deducted.

Special Rates for Dividend Income

Just as with long-term capital gain, most dividend income receives special tax treatment. As noted previously, the rate is 15% or 20% depending on the amount of taxable income. The Affordable Care Act surtax of 3.8% applies to investment income, which includes dividend income, so certain higher-income taxpayers will pay a rate of 23.8% on dividends.

Note: Although most ordinary dividend income qualifies for these low rates, check carefully with your advisors when reporting it. Some payments that are labeled "dividends" may actually be taxed as interest.

Strategies if You Don't Itemize

As a result of the Tax Cuts and Jobs Act, fewer people will itemize deductions than before. One reason is that the standard deduction has been increased to:

- $12,200 for single individuals and married persons filing separately.
- $18,350 for heads of households.
- $24,400 for married couples filing jointly.

The other reason is that the deductions for a number of expenses have either been eliminated or limited under the new Tax Act. For example, the total amount that can now be deducted for any combination of state and local income tax, property tax, and sales tax is $10,000. (This is commonly referred to as the SALT deduction limitation.)

Many people will now take the standard deduction rather than itemizing because the total of all expenses they are able to itemize is less than the standard deduction.

How nonitemizers might save taxes with charitable gifts. If you find your itemized deductions are just below the amount of the standard deduction this year, you might want to "double up" your charitable contributions. That is, you would contribute before the end of this year twice the normal amount and then not contribute the following year. This year you would itemize, realizing tax savings from your charitable gifts, and the following year you would take the standard deduction.

Life-Income Gift Options

There are a number of ways you can make a current charitable gift, benefit from significant tax savings, and continue to receive annual income based on the value of your gift. You can even add another beneficiary—such as a spouse or a child—or designate another person or persons to receive the payments.

Charitable Remainder Trusts

One of the most popular types of life-income gifts is the charitable remainder trust, of which there are two basic types: the charitable remainder annuity trust (CRAT), which generates fixed payments based on a percentage of the original contribution to the trust; and the charitable remainder unitrust (CRUT), which provides variable payments based on a fixed percentage of the trust's value as it changes from year to year. In both cases, the trust funds remaining at the death of the last income beneficiary pass to the charity or charities you designate.

How they work: If you contribute $100,000 to establish a CRAT and retain a 5% income interest for

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yourself, you will receive $5,000 each year for life. With a 5% CRUT you will receive $5,000 the first year, but future payments will be based on the trust's value each year thereafter. In both cases, you will be entitled to a current charitable tax deduction equal to the present value of the charity's right to receive the remainder of the trust at your death. (See charts in next column.)

A CRAT enables you to lock in a fixed payment. It is particularly appealing to older individuals who want the security of predictable income unaffected by financial markets.

A CRUT allows you to incorporate special provisions to make it serve a variety of planning purposes. For example, you can limit annual income paid out to the lower of either the stated payout rate or the actual income of the trust. This can be a terrific retirement-planning tool if managed to primarily produce appreciation of capital instead of income—such as interest and dividends—until you are ready to start receiving payments. This allows the trust to grow faster, eventually producing even more income when you will need it. It is even possible to create a trust that starts out as an "income-only" trust, then "flips" to a CRUT that pays a fixed percentage at some point in the future.

Both CRUTs and CRATs are excellent vehicles to escape "locked in" positions in stock holdings—and can be extremely valuable for planning in volatile markets.

Example: Don, 70, has watched his stock portfolio grow over the last few years but is concerned about the future direction of the market. Now that he is retired, he would like to get a higher return from his investments—most of which are stocks paying small dividends—but he is reluctant to sell and incur significant tax on the capital gain.

Don decides to use growth stock currently worth $200,000, purchased years ago for $40,000, to create a CRUT that will pay him 6% of its annual value. This will produce a $93,652 charitable deduction, saving him $32,778 assuming a 35% tax bracket. Better still, he will not have to pay tax on the gain when he transfers the stock to the trust—a savings of $30,080 because he is subject to the 3.8% surtax on capital gain. The first year Don will receive payment of $12,000—an $8,000 net increase in cash flow because the stock he used to create the trust paid a dividend of only $4,000.

Charitable Deductions

$100,000 CRUT Payout Rates
One Beneficiary

Age	5%	5.5%	6%
60	38,314	35,226	32,431
65	45,131	42,032	39,206
70	52,550	49,578	46,826
75	60,347	57,621	55,059
80	67,952	65,559	63,282
85	74,946	72,939	71,007

Two Beneficiaries

Ages	5%	5.5%	6%
60-60	27,679	24,479	21,673
65-65	34,019	30,685	27,703
70-70	41,336	37,983	34,928
75-75	49,454	46,225	43,231
80-80	57,902	54,935	52,141
85-85	66,167	63,574	61,098

$100,000 CRAT Payout Rates
One Beneficiary

Age	5%	5.5%	6%
75	56,254	51,900	47,664
80	65,317	61,849	58,396
85	73,356	70,692	68,028

Two Beneficiaries

Ages	5%	5.5%	6%
75-75	43,362	37,740	*
80-80	53,838	49,223	44,637
85-85	63,633	59,996	56,359

*No charitable deduction is allowed because there is a greater than 5% probability that the trust corpus will be exhausted.

These calculations are based on a representative federal discount rate. This rate changes monthly, and you may use the rate in effect for the month of the gift or for either of the two preceding months to determine the deduction. A higher discount rate only slightly increases the charitable deduction for a CRUT but significantly increases it for a CRAT.

Because of the currently low federal discount rate, CRATs for younger ages may not qualify for a charitable deduction. CRATs for the above ages and payout rates would qualify provided certain provisions are in the trust agreement. Usually, only older individuals establish CRATs because they are at the stage of life when the security of fixed income is more important than the potential for growth. The CRUT is suitable for any age and especially for those who want the possibility of income growth to keep pace with inflation.

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The Charitable Gift Annuity

Another type of gift arrangement that generates a fixed life income is the charitable gift annuity. Payments can be made to either one or two beneficiaries, and the annuity rate is based on the age(s) of the beneficiary(ies).

One of the most attractive features of the gift annuity is that a substantial portion of the annual payout is a tax-free return of principal for the remainder of the life expectancy of the recipient(s).

Meet your charitable goals. Individuals wanting to make charitable gifts may find a gift annuity to be an excellent way to meet philanthropic goals while increasing their current cash flow.

Example: Phyllis, 75, has a $100,000 CD maturing soon. She needs to continue to receive the income it produces but does not find the 2.25% renewal rate very attractive.

She decides instead to cash in the CD and use the proceeds to fund a major charitable gift she has been planning. She contributes $100,000 for a charitable gift annuity that will pay her $6,200 annually in quarterly installment payments for as long as she lives.

What's more, $4,377 of her yearly payments will be tax-free for the remainder of her life expectancy. Phyllis also gets an income-tax deduction of $45,754, saving income tax and reducing the out-of-pocket cost of her gift.

We can provide you with a personalized illustration showing the amount of your payments, how they would be taxed, and the charitable deduction based on the amount you wish to contribute.

Taxable Equivalent of Tax-Free Yield

To realize the same after-tax return from an investment, you would need the following fully taxable return.

If your marginal tax bracket is	You would need to earn a fully taxable yield of			
10%	3.33%	4.44%	5.56%	6.67%
12%	3.75%	4.55%	5.68%	6.82%
22%	3.84%	5.13%	6.41%	7.69%
24%	3.95%	5.26%	6.58%	7.89%
32%	4.41%	5.88%	7.35%	8.82%
35%	4.62%	6.15%	7.69%	9.23%
37%	4.76%	6.35%	7.94%	9.52%
	To equal a tax-free yield of			
	3%	4%	5%	6%

Increased Exemption for Federal Estate and Gift Tax

The recently enacted Tax Cuts and Jobs Act preserves the federal estate tax but doubles the exemption. For 2019 the exemption is $11.4 million, and the combined exemptions for a married couple are $22.8 million. If lifetime taxable gifts plus end-of-life gifts to individuals exceed these exemptions, the excess will be taxed at a 40% rate. Since very few estates exceed these amounts, the number of estates subject to the federal tax is small.

However, if you live in one of the states that has a state estate tax, your estate could be subject to the state tax—even if not to the federal tax. That is because the state exemption amount in those states is generally lower than the federal exemption.

Here are possible scenarios:

- Your estate is below $11.4 million, and you either live in a state with no estate tax or you live in a state with an estate tax, but your estate size is below the state exemption amount: there will be no estate tax.
- You live in a state with a state estate tax, and your estate is below $11.4 million but above the state exemption: there will be state estate tax but no federal estate tax.
- Your estate is above $11.4 million, and you live in a state with a state estate tax: there will be a federal and

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state estate tax. The state estate tax can be deducted when calculating the amount of the federal tax.

Bequests to charity can be deducted on the federal estate-tax return and generally on any state estate return as well. Consequently, a charitable bequest can reduce the amount of tax owed on the estates of high-net-worth individuals.

Example: Margaret, whose estate is valued at $14 million, lives in a state with no state estate tax. She leaves a bequest of $1 million to our organization and the balance, after taxes, to family members. The taxes payable by her estate are reduced by $400,000. Without the charitable bequest, the federal estate tax would have been 40% x ($14,000,000 - 11,400,000) = $1,040,000. With the charitable bequest, the federal estate tax is 40% x ($14,000,000 - 11,400,000 - 1,000,000) = $640,000.

The Charitable Lead Trust

High-net-worth individuals who would like to transfer significant wealth to children or grandchildren while minimizing gift and estate tax should consider a charitable lead trust.

Here's how it works: You put assets into a trust that makes annual gifts to charity for a designated period of time, after which the balance of the trust is distributed to your designated beneficiary or beneficiaries. During the trust term you do not pay any tax on the trust's income. The present value of the charitable interest is subtracted from the total you contribute to the trust; only the balance—if any—is subject to the transfer tax, regardless of how much the trust assets grow in value.

It is possible to design a lead trust where the trust principal is returned to you rather than being distributed to others. This is called a **grantor** charitable lead trust. You receive an income-tax charitable deduction, but you are taxed on the trust income even though you do not receive it. The more common type is the one described above, which distributes the principal to heirs. It is called a **nongrantor** charitable lead trust.

Suppose that Margaret in the previous example, instead of making a $1 million outright bequest to our organization, created a charitable lead annuity trust that would pay us $60,000 per year for 15 years and then pass the remaining principal to her grandson—who is now 10 years old. The gift would result in an estate-tax charitable deduction of $695,990, resulting in estate savings of $278,396 ($695,990 x 40%). Margaret not only saves taxes but also delays the gift to her grandson until he is more mature.

The following chart illustrates various possibilities when you contribute $1 million for a charitable lead trust.

$1,000,000 Nongrantor Charitable Lead Annuity Trust Portion Subject to Transfer Tax			
Annual Payment to Charity from Trust	**Term of Years**		
	10	15	20
$50,000	$582,070	$420,010	$282,910
$60,000	$498,480	$304,010	$139,490
$70,000	$414,890	$188,020	-0-
$80,000	$331,310	$72,020	-0-

We Want to Help

We hope this guide proves helpful to you as you make your charitable plans. Of course, we have touched on just a few of the many creative charitable options available to you. If we can assist in any way in your planning process, please feel free to call on us.

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