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2015 Charitable Tax Planning

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With the start of the New Year, it is an excellent time for gift planners, advisors and donors to consider tax planning opportunities for 2015. There now have been two full tax years under the increased levies of the American Taxpayer Relief Act of 2012 (ATRA). Upper-income taxpayers realize that they were targets of ATRA. With two years of substantially higher taxes, and modest itemized deductions other than charitable gifts, taxpayers recognize an urgent need to reduce taxes through prudent charitable planning.

I. Income Taxes

Single persons with incomes over $413,200 or married couples with incomes over $457,600 are subject to the top 39.6% tax bracket. If they have passive income, the 3.8% net investment income tax (also known as the Medicare tax) is applicable and their top federal bracket could be 43.4%.

Based upon IRS reports for tax year 2012, the top 1% of taxpayers had at least $434,682 in income and paid 30% of the total personal income tax. The top 5% of taxpayers had $175,817 or more in income and paid 59% of the total income tax. With billions in additional tax paid under ATRA, upper-income taxpayers now have a strong interest in charitable planning.

II. Capital Gains Tax

Capital gains tax rates are 0% for low-income taxpayers, 15% for mid-level taxpayers and 20% for top-bracket taxpayers. In addition, the 3.8% Medicare tax is applicable to the gain, so the top capital gains rate is 23.8%. Upper-income taxpayers who have any significant capital gain are likely to be in both the top income and capital gains tax brackets. A charitable planning option that permits bypass of capital gain is a powerful incentive to take action in 2015.

III. State Taxes

State income and capital gains rates vary. While nine states do not have state income taxes, the majority of the states have tax rates from 4% to 13.3%.

While the state taxes are deductible on the federal return, the effective state rate is frequently from 6% to 7%. For donors who live in a state with income and capital gains taxes, the top rates could approach 50% for income tax and 30% for capital gains tax.

IV. Appreciated Properties

Faced with capital gains rates that may exceed 30%, taxpayers who own appreciated stocks or land are in a potential “locked-in” position. Because they are reluctant to pay 23.8% (or even 30%) capital gains tax, they are hesitant to sell appreciated property.

With the Dow Jones average cresting 18,000 and home values increasing by over 11% in one year, traditional appreciated properties now have significantly increased in value and sales may lead to a large capital gains tax.

The Federal Reserve reported that household net worth peaked at $64 trillion in 2007, declined to $51 trillion in 2008 and now has regained the lost value. The Federal Reserve reported that in December of 2014, net worth of households had increased to a record $80.7 trillion. This increased net worth is substantially the result of appreciation of stock, homes and land that is held by upper-income persons. Therefore, these individuals have strong motivation to consider charitable planning options.

V. Charitable Deductions

For tax planning purposes, there are two principle rules on gifts to public charities. First, the deduction limit for cash deductions is 50% of the contribution base, normally the donor's adjusted gross income (AGI). If the gift is an appreciated property transfer to a public charity, then the applicable limit is 30% of AGI. In both cases, there is a five year carryforward. Current-year gifts are deducted first, with the carryforwards deducted up to the applicable limit for that year.

The 50% limit applies to cash gifts or for cumulative giving. If a donor has $100,000 of adjusted gross income and makes a gift of $30,000 of appreciated stock to a public charity, then he or she may also give up to $20,000 of cash. The total $50,000 of cash and stock gifts may be deducted in one year under the 50% limit. Because the gift of appreciated stock or land also bypasses gain, it is quite attractive to make the combined gifts up to the 50% limit.

VI. IRA Charitable Rollover

The option for IRA owners age 70½ or older to give up to $100,000 through an IRA-custodian-to-charity transfer has existed since 2006. It has been extended each year, most recently until December 31, 2014.

However, in December of 2014, Congress came close to passing the Supporting Americas Charity Act (H.R. 5806). This act would have made permanent the IRA charitable rollover, expanded limits for conservation gifts and enhanced deductions for gifts of apparently wholesome food. While the bill did not reach the two-thirds vote in the House required under the quick passage rules, Sen. John Thune (R-SD) indicated he planned to introduce the bill again in the Senate in 2015. Because there is strong bipartisan support in both the House and Senate for this bill, it is quite possible that there will be permanent passage of the charitable IRA rollover in 2015. With solid bipartisan support in both the House and Senate, it is nearly certain that there will be either IRA rollover permanent passage or an extension again in 2015.

Many upper-income persons have a substantial IRA or other defined contribution plan that could be rolled over into an IRA. If they are over 70½ and required to take a minimum distribution, then the IRA rollover is an excellent tax planning strategy.

VII. Income Tax Strategies in 2015

The optimum income tax reduction for 2015 occurs when three basic strategies are used. First, an upper-income person should maximize his or her IRA charitable rollover. If $100,000 is transferred directly from the IRA custodian to the charity, it is not included in taxable income. While there is no additional deduction, this is a substantial tax-saver. The upper-income person will frequently be subject to alternative minimum tax, even if there are large gifts to charity. High adjusted gross income will result in a phasing-out of the AMT exemption. Therefore, it is very important for upper income persons to use the charitable IRA rollover to fulfill their required minimum distribution and avoid taking the IRA payout into taxable income. Reducing adjusted gross income will save substantial alternative minimum tax for these persons.

Second, because an appreciated gift of land or stock bypasses capital gain and produces a fair market value charitable deduction, these are "favored" gifts. The next strategy for upper-income persons is to make appreciated property gifts up to the 30% limit each year. Some donors will invest in stock or land for the purpose of making appreciated property gifts in the future.

Third, there typically will be additional cash gifts. If up to 30% of AGI is given through stock or land gifts, then another 20% for cash gifts is available under the 50% total deduction limit. The combination of reducing AGI through the IRA rollover, appreciated property gifts to 30% of AGI and cash gifts for 20% of AGI will maximize income tax savings. The appreciated property and cash gifts may be made outright or through life income plans.

VIII. Life Income Planning in 2015

There are at least four specific life income plans that will produce either 50% or 30%-type deductions. These can be used quite effectively to maximize the tax savings through charitable planning.

Example One – Appreciated Stock

John and Mary Smith bought stock in a technology company several years ago. It has appreciated from $200,000 to $1 million in value. They are in the top 39.6% income tax bracket. If they were to sell the stock, there would be federal capital gains tax of $190,400.

By contributing the stock to a 5% charitable remainder unitrust, they bypass or avoid the $190,400 capital gains tax. In addition, they receive an income deduction of $394,860. With deductions spread over three years under the 30% AGI limit, they will write off this amount and save $156,365.

The unitrust is invested in a stock-bond portfolio. The annual $50,000 of income is approximately 60% capital gain and dividends and 40% ordinary income. The tax-favored payouts of the capital gains and dividends also provide significant tax savings over their two lifetimes.

Example Two – Cash Plus Trust

Bill and Helen Green purchased development land for $400,000. It has grown in value to $2 million. If they were to sell the property, they could pay over $350,000 in capital gains tax.

Bill would like to receive cash sufficient to make another similar investment, but hopes to reach this goal with no capital gains tax payment. The chosen solution is a sale and unitrust. With their financial advisor as trustee, they transfer 80% of the value into a 5% charitable remainder unitrust and 20% to a revocable trust. Because the trustee has title to 100% of the property, there are more favorable characteristics for both charitable tax deductions and sale of the property.

Costs for sale of the land are estimated to be $160,000, which are allocated pro rata between the two trusts. The net cash received will be $368,000 and the unitrust funding will be $1,472,000.

The capital gain is bypassed on the unitrust. With allocation of 20% of the basis to the revocable trust, potential gain on the cash portion is more than offset by the tax savings on the $631,776 unitrust charitable deduction. With their net tax savings over five years under the 30% guideline, Bill and Helen enjoy a total cash benefit of $549,639.

The sale and unitrust achieved all objectives. Bill has the cash necessary to make another investment and they receive generous income for two lifetimes from the trust. They reduced the net tax to zero and benefitted from additional tax savings.

Example Three – Tax Free Payouts

Susan White is age 80 and has a large income and substantial estate. As a result, she is in the top 39.6% federal bracket. On her passive income from corporate bonds, she is in the 43.4% bracket. Susan has always been open to supporting her favorite charity and transfers $1 million in cash to fund a 6.8% gift annuity. This is the standard rate based on her age of

80. The $1 million in cash had previously been invested in short-term corporate bonds with a 2% to 3% payout. In addition to subjecting her to a 43.4% tax rate on the income, the return was relatively low.

Upon funding the charitable gift annuity, she has an income tax deduction of $490,809. Over three years, this may save approximately $194,360. The charity that created the gift annuity ran the illustration with the lowest possible AFR of 2.0%. This slightly reduced the charitable deduction, but it maximized the tax-free payout. Susan was pleased because this tax-free payout was her number one objective.

Each year, the charity makes quarterly payments that total $68,000. The tax-free amount of $54,196 is 79.7% of the total payout. The balance of the payout is ordinary income. With her high tax bracket and the combination of income tax savings and tax free payout, the 6.8% annuity has an effective annual rate of 12.9%. Susan considers this in effect a 6.8% payout with two tax benefits that dramatically increases her effective rate.

Example Four – Municipal Bonds
Herb and Clara Brown are retired and have a substantial portfolio of municipal bonds. Herb (age 85) and Clara (age 84) enjoy the tax-free income from their bonds. They have no intention of ever transferring the municipal bonds.

However, a cordial gift planner explains to Herb and Clara how they could benefit substantially from their bond portfolio if they were able to combine a charitable deduction with retention of the tax-free income. Because Herb and Clara have substantial ordinary income from rental properties and a corporate pension, they are in the top federal and state tax brackets. Herb and Clara are in the 45% federal and state income tax bracket and would be very interested in reducing their tax.

Herb and Clara transfer $2 million in municipal bonds into a 5% charitable remainder annuity trust. The income tax deduction of $1,206,305 will reduce their income tax over five to six years by $554,900. John is delighted with over $100,000 in annual tax savings each year.

Each year the annuity trust pays out $100,000. The 4% in municipal income plus 1% of principal equals the 5% total payment. Over their estimated 10 year life expectancy, they will receive over $1 million in tax free payments from the trust. When they pass away, the $1.7 million remaining in the trust is transferred to charity.

This plan permits Herb and Clara to continue to receive tax-free income for their lifetimes. However, the very substantial charitable deduction will offset over half a million dollars in income tax on their other ordinary income.

Conclusion

With the combination of substantially increased tax brackets and appreciated property, upper-income Americans will be very interested in creative 2015 tax strategies. Because most of these individuals will not have substantial mortgage interest or medical expense deductions, their primary tax-saving opportunities will be charitable. For those who have “charitable receptivity,” the IRA charitable rollover, maximizing deductions and creative use of the life income charitable plans will create a great benefit for both the donors and their favorite charities.

MUSC’s Office of Gift Planning
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