Council of Michigan Foundations

What Happens When A Great Stock Market Meets Tax Reform?

2017 Planning Tips with Charitable Contributions

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2017 has been an extremely unusual year in the markets, and it isn't even over yet. Let's see, hurricanes, market goes up. North Korean hydrogen bombs, market goes up. Chaos in DC, market goes up. It defies reason, and leads me to wonder, 'what next?' Couple that with a pending significant tax law change, and we have an opportunity--to save some tax dollars and do something charitable.

Why Tax Change Matters

The tax changes will have several effects on charitable giving. Some of the main features of individual tax law changes proposed on November 2nd are:

- Lower brackets
- Doubling of the standard deduction
- Elimination of personal exemptions
- Retention of deduction of mortgage interest (but with lower limits) and charitable contributions
- Effective in 2018

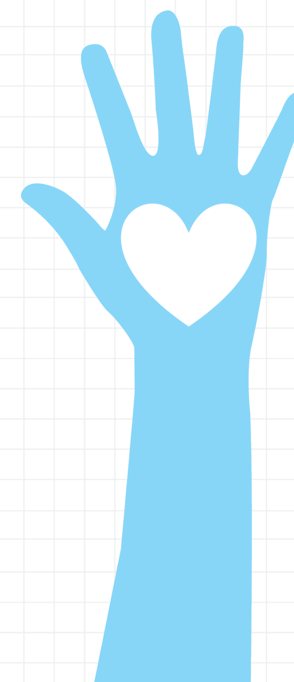
Under this scenario we can see that:

a) we may be in a lower bracket in the future (or may not); and
b) deductions that may be lost need to be taken now.

Here's an example: Suppose you are married with no kids, currently own a house and pay about $6,000 in mortgage interest. You pay an additional $6,000 in state income taxes and property taxes and plan to give $5,000 to charity.

The law says that you can deduct the greater of your itemized deductions or the standard deductions. In this case, you have $17,000 in deductions. For 2017, the standard deduction for married people is $12,700. So, if you itemize, you get to deduct an additional $4,300.

Under the proposed tax law the standard deduction goes up to $24,000, in my example, you would take the standard deduction and would get no tax benefit for your charitable contributions or your mortgage interest. What does this mean? It means for people who make charitable contributions and deduct them, making a larger contribution in 2017 may save taxes. You could double your contributions, get the write-off this year, and take the standard deduction next year.



Market's Up And It Helps

Here's another aspect of getting the write-off. If you donate appreciated property like stocks or mutual funds, you can, within limits, deduct the fair market value and you don't pay capital gains tax. Look at the example below for a person in the 25% tax bracket, who can itemize and fully take a charitable deduction of $10,000:

	Cash	Stock	Difference
Donation (value)	$10,000	$10,000	
Cost Basis	$10,000	$5,000	-$5,000
Gain	0	$5,000	+$5,000
Capital gains tax	0	$750	
State tax saving (4.25% for MI res)		$212	
Federal tax saving (25%)	$2,500	$2,500	0
Total tax savings	$2,500	$3,462	$962

In this case, giving appreciated property saved an additional $962. It was 38% more efficient than a cash contribution.

Here are some logical questions you might have:

Q: Does it matter how long I hold the stock?

A: Yes, you must hold it one year or more to get special treatment.

Q: This works for stocks with gains, what about the dogs that lost money?

A: The advantage is only for gainers. For losers, you are better off selling them and deducting the loss.

For example, suppose you own stock in Orange and Colonel Electric. You originally invested $10,000 in each. Orange, which is up about 50%, is worth $15,000 and CE, which is down 33%, is worth $6,600. If you sell both, you net the gain against the losses, so you pay capital gains taxes on about $1,600, or $240 in federal taxes (if you are in the 15% bracket) and state taxes of $68 (if you are in a 4.25% state income tax state like Michigan). Netting all this out would total about $21,292. If you then gave $15,000 to your favorite charity, you'd have $6,292 in your pocket, and you'd save 25% (presuming you are in the 25% bracket and have sufficient other itemized deductions). That saves you $3,750, so you have $10,042.

Let's look at Plan B: You give the Orange stock to your charity, resulting in tax savings of the same $3,750. You sell the CE stock and deduct $3,000 of the loss (you can deduct a net of $3,000 of loses a year, and carryover the reminder, in this case $400). You save another $750 in federal taxes and $128 in state taxes. The end result is that you have $11,228, $1,186 more than if you sold the stocks and donated the cash proceeds. Conclusion: Donate winners and harvest/sell the losers.

Q: Can I do this in an IRA?

A: No, you don't recognize gains and losses in an IRA on your income tax return. However, there is a very valuable rule for people over age 70½ who have IRAs, called the Qualified Charitable Distribution (QCD). I'll cover that, because an IRA can be even better than appreciated property as the source for a charitable gift.

Q: What are the deduction limits on charitable contributions?

A: You can make contributions any size, but in general, you may only deduct up to 50% of your Adjusted Gross Income in any given year. The unused portion is carried forward for up to 5 years. The limits are based on both the type of charity and the type of asset donated. For appreciated stock held more than one year and given to a 'normal' charity, the limits are generally 30% of AGI and carryover of unused amounts for 5 years.

Tax-Bracketology and Roth Offsets

Playing with charitable contributions and your 2017 tax bill before year-end can provide some serious tax benefits. If you itemize, you can move your taxable income down with charitable contributions. If you have a traditional IRA, you can move your income up with Roth IRA conversions. A Roth IRA is a wonderful tool that allows tax-free growth. Roths can be created and funded by contributing, which is logically called a contributory Roth (and is subject to certain earnings limits), or by converting a traditional IRA to a Roth in a conversion by paying the taxes. Qualified Roth withdrawals are not subject to income taxes, nor do they have to be taken starting at age 70½, like conventional IRAs. You can leave a Roth IRA to your spouse as their Roth, or to other heirs, who would then be able to withdraw tax-free over a period no longer than their life expectancy. All in all, Roth IRAs are a fine planning tool. A Roth offset is using a Roth conversion to use up a charitable contribution.

Here's how a Roth offset might work: Millie has $50,000 of Orange stock she wants to donate to her favorite charity. Her basis is $20,000, so she has a $30,000 gain. If she takes the full deduction, it will push her into the 15% bracket, plus she hits some of the limits on income. Millie has a traditional IRA that has some rollover funds form her previous employer. She's under 70½, so she's not taking her Required Minimum Distributions (RMD) yet. When she does hit age 70½, those distributions will push her into a higher income tax bracket. Millie can sit down with her CPA and determine the amount of Roth conversion that will keep her in the 25% bracket and thereby save her tax dollars later, since Roth IRAs do not require distributions at age 70½ (or at any point in the owner's life, for that matter). Millie could even leave the

Roth conversion to her kids or grandkids. This can provide a substantial savings in taxes over time, since the beneficiaries of conventional IRAs would pay ordinary taxes (as would Millie), but would not pay taxes on a Roth distribution.

Q: How do I do a Roth conversion?

A: It pretty simple: you tell the custodian of your IRA you want to convert a certain dollar amount to a Roth. You can even designate which assets you want to go to the Roth (which would usually be the ones with the highest appreciation potential). Recognize this important fact: You want to pay the taxes on the conversion from money outside of the Roth. In this regard, get a pro to help you.

Q: Can I donate my Roth to charity?

A: You can, but you don't want to. Roth IRAs are tax-free, and charities are tax-exempt. You could name a charity as a Roth beneficiary, but you are wasting the tax-free status. Give the Roth to a person and give appreciated property to charity.

Q: Can you 'undo' a Roth conversion?

A: Yes, and that's cool. You can 'undo' a Roth conversion with a 'recharacterization', which allows you to treat a Roth conversion as if it never took place. You have until the extended due date of your 2017 return, which is October 15, 2018, to take a 'Mulligan' on your conversion, or recast it as if it never happened. A provision in the proposed new tax law eliminates the ability to recharacterize (or take a 'Mulligan' on) a ROTH conversion taking place after 2017. This makes Roth conversions in 2017 even more valuable.

Mom and Grandma Can Play Tax-Bracketology As Well

This is a play on an idea from our book '50 Good IRA Ideas'. I did this with my Mom. She had an IRA left over from my Dad. She didn't need the RMD (it wasn't much anyway), and she was in a low tax bracket. We converted her IRA to a Roth, paid the tax, and let it grow tax-free. My sister and I will get the Roth, although Mom may leave it to the grandkids. The proceeds will be tax-free, and can be paid over the life expectancy of the beneficiary. Spin this a bit more and Mom can donate some appreciated stock to her favorite charity and convert some of her IRA to a Roth to offset the deduction. By the way, we did this about 6 years ago, and it's worked out for my sister, me and for my mom. The end result: Mom, no RMD, and Sis and I, tax-free Roth, eventually (which is hopefully a long way off).

Q: How do I convert my Mother's IRA to a Roth and how much should I convert?

A: You contact the custodian of the current IRA and inform them you want to make a conversion. You can transfer assets directly to the Roth. Generally, you want to convert enough to keep your parent(s) in their current tax bracket, but go to the upper level of the bracket (our tax-bracketology) argument. This would be after any potential deductible charitable contribution.

Q: Can I 'undo' the conversion?

A: Yes. Roth conversions can be recharacterized up to the due date of the tax returns, including extensions. That means that if you do a 'Mom' Roth conversion in 2017, you can un-convert it any time until October 15, 2018. A provision in the proposed new tax law eliminates the ability to recharacterize (or take a 'Mulligan' on) a ROTH conversion taking place after 2017, making Roth conversions in 2017 even more valuable.

Q: What are the advantages to Mom of the Roth conversion?

A: Mom avoids future Required Minimum Distributions on any portion of her regular IRA that she converts. Roth IRAs do not require distribution at age 70½, or any age, for that matter. Roth earnings are tax-free. And Roth IRAs can be passed to beneficiaries' tax free.

Q: Who can be the beneficiary and what are the rules?

A: You can name anyone as a beneficiary. Normally a parent names kids or grand-kids. When someone other than a spouse receives a Roth IRA, they must take Required Minimum Distributions over their life expectancy. Those distributions will remain tax-free. So if Theresa is 65 and has $50,000 in an IRA that she

can convert and stay in her tax bracket (because of a charitable donation), she can convert that $50,000 into a Roth. She has a son who is 42, and twin granddaughters who are 12. Suppose she lives to age 85, and makes 7%. Her Roth will be worth, at that point, $193,484. If she leaves it to her son who is now age 62, he can withdraw from the Roth tax-free over 23.5 years (IRS table I). If he continues to make 7%, and also lives to 85, he'd get cumulative tax-free distributions of $390,000, and leave his daughters about $168,000, totaling about $558,000. On the other hand, if Theresa leaves the Roth to the girls, who would be 32 at her death, they withdraw over 51.4 years. They would take, assuming they make 7% and live to 85, about **$1.7 Million** in tax-free distributions and leave about $577,000 to their heirs. We like to call this a Dynasty Roth. And what did this cost Theresa? If she made an offsetting charitable contribution during the tax year she also did the Roth conversion, maybe nothing out of pocket except the contribution.

Q: **Can I leave the Roth to charity?**

A: You can, but you don't want to. Roth's are tax-free and charities are tax-free. Leave your regular IRA to a charity and the Roth to a person.

Business owners may have a big opportunity if they own a pass-through entity. For Subchapter S and LLC organizations (taxed as a Sub –S or partnership), the 'pass-though' income is at 25% for 2018. For 2017, this is taxed at the owner's normal rate. If a business owner is in the higher brackets (for Married, to be above 25%, you need to have taxable income above $153,100, or $91,900 for single), you may want to consider charitable gifts if you are so inclined. For example, a business owner making $500,000 in taxable income will be in the highest bracket. They can save about 40% on all charitable contributions in 2017, versus '18. In addition, if appreciated stock is donated, there is the saving on capital gain taxes (23.8% for 2017 2018, plus 4.25% of state taxes (for a Michigan resident)). So a business owner making over $470,700 in taxable income who gives $50,000 to charity in 2017, saves about $20,000 in taxes by contributing in 2017, versus possibly $12,500 in 2018.

Q: **So can all pass-through income be taxed at the lower rate?**

A: No, or everyone who had high income would do it. There are certain limitations on the types of income eligible for the pass-through. However, if someone owned a manufacturing business in a pass-through entity, they could shift some of the income from the highest individual bracket to pass-through at a lower rate.

King and Kong: Charitable Trusts

Some huge dollars can be donated though the use of charitable trusts. This may work especially well in 2017. In general, you can divide the ownership of an asset into two pieces: that which you own during your lifetime (called a life estate) and what's left after you die (called a remainder interest). You can give either to a charity: you can keep the income from an asset and give what's left when you die to the charity, (a reminder trust), or you can give the income to the charity and leave the remainder to some other entity, like heirs, (called a lead trust). In either event, you get the deduction for the value of the donation. The value is determined based on what the life or reminder interest is worth at a certain rate. In a lead trust, you get the value of what the income stream is worth at a certain rate.

Example of a Charitable Remainder Trust. Suppose I am a business owner who is 62 (gosh, what a coincidence!). I want to donate $1,000,000 of appreciated property to my favorite charity, or to a Community Foundation to distribute to my favorite charity. On the other hand, I want some income for my lifetime, so I want 5% of my million (or whatever it becomes) to come to me for my lifetime. That starts at $50,000 a year. [Note: this type of charitable trust is called a Charitable Remainder Unitrust, and its main feature is that it pays a percentage of the value of the trust every year.] If I made the gift on 10/31/17, the IRS discount rate is 2.6%, so the deductible gift is $408,360. I will get $50,000 next year and 5% of the $1,000,000 (minus the $50,000 withdrawal) for my life and my charity gets the balance at my death. If I am in the top bracket for 2017, this saves me prospectively over $161,700 of income taxes (if I meet the rules). If the law changes to allow me a pass-through income, I may have permanently saved 14.6% of the contribution. In addition, I took the whole contribution out of my estate, which saves my heirs about 40% if I have a taxable estate. I win, charity wins, US Treasury loses.

A Charitable Lead Trust is similar, except you give the income to the charity and gift the remainder to heirs. Using the case above, I'd gift $1,000,000 to a Charitable Lead Trust which would give 5% of the Trust to my charity every year, and then give the remainder to my kids or grandkids. Using the above numbers, if I gave my charity $50,000 a year of the $1,000,000 for 20 years, and at that time had it distributed to my grandchildren, I'd get a deduction of $786,870 today. I use up $213,130 to make a gift (20 years from now) to the grandkids. I'd get $1,000,000 out of my estate (offset by the gift tax I used up on the remainder). Over 20 years, the charity would get $1,000,000. If the trust made anything over 5%, say 6%, the grandkids would get about $1,360,000 in 20 years. I'd get a $786,870 tax deduction (if I meet the rules), and the family would save estate taxes.

A word about interest rates and charitable trusts. If we think a great market and tax reform are a perfect storm, low interest rates add another dimension. The rate used to calculate the charitable interest is very low (2.6% as of 10/31/17). The lower the rate, the higher the deduction. Think of it like a mortgage: If I take out a 20 year mortgage at 2.6% with an annual payment of $50,000, it comes out to a 'mortgage' of about $772,000, which is my deductible portion of the gift under the charitable lead trust. If the rate rises by 1% to 3.6%, my deduction does down by about $70,000. Likewise, on the charitable remainders, a gift of $1,000,000 20 years from now is worth about $598,000 at 2.6% and $493,000 at 3.6%. $105,000 reduction in the charitable deductions by a one percent movement in interest rates. Rates go up, deductions go down.

Q: **So if I set up a charitable trust, do I lose control of the money?**

A: You can only get either the income stream or the residual. You can also control the investments. You usually can't change the provisions of the trust itself, unless something happens to the charity.

Q: **If I get income from a charitable trust, do I pay taxes on that?**

A: Yes, income from a charitable trust is taxable.

Q: **How hard is it to set up?**

A: Charitable trusts require a competent estate planning attorney and do take some time to set up. In our office, we generally can turn them around in a few weeks.

Qualified Charitable Distributions (QCDs)

This is a good one, which has been on-again and off-again by the year-end whims of Congress (but was made permanent a few years ago). If you are over age 70½ and taking Required Minimum Distributions (RMDs) from your IRA, you can give some or all of your RMD directly to a qualified charity (up to $100,000 per person). This is great from a tax standpoint because you don't include any portion of the QCD in your income. This may keep your Social Security benefits less taxable (because the taxability of your Social Security benefit is based on your Modified Adjusted Gross Income (MAGI) and the QCD is not included in MAGI[i]). It may also lower other income characteristics, like the phase-out of personal exemptions and itemized deductions. Medicare premiums may also be lowered if AGI stays below certain thresholds. It reduces gross income for federal and almost every state income tax. Charitable contributions made from an RMD must be payable directly to the charity(ies)[ii]: You may not donate to a Donor Advised Fund or charitable trust with a QCD. You will want to make a QCD before year-end.

Q: **Do I have to be 70½ or older to do this, or can I use my IRA if I am younger?**

A: You have to be age 70½ or older.

Q: **Can I do this with an inherited IRA?**

A: No, only your own IRA, or an IRA you inherit from your spouse as a spousal rollover (which is technically yours) can do a QCD.

[i] I.R.C. §86(a)(2)
[ii] I.R.C. §§408(d)(8)(A), 408(d)(8)(B)

Can't Decide Who Or When?

The problem we're facing in this short timeline is that sometimes we can't decide before year–end which charities we may want to benefit. We even may want to reserve monies for future gifts. There are two good solutions: the Donor Advised Fund (DAF) and the Community Foundation. Donor Advised Funds let you make a deductible contribution now and designate the charity(ies) later. You can even earn an investment return on the money while it is not donated. Community Foundations can perform a similar function and move money for you and manage according to your wishes. We've used this for specific scholarship ideas and to make property donations to schools. Community Foundations can act like a private foundation without the hassle, restrictions and cost.

Q: **How easy is it to set up a Donor Advised Fund?**

A: Super easy. We typically use one of the big discount broker houses, like Fidelity, Schwab, TD Ameritrade or Vanguard. You set up an account and fund it. If you already have an account at the custodian, super simple and at most a few days.

Q: **Can I invest the money?**

A: Yes, depending on how much you donate. The Fidelity Charitable Fund has a minimum opening donation of $5,000 and has administrative fees and certain investment fees for a specific Fidelity mutual fund pool the account is invested in. If the account has more than $250,000, you can manage the account outside of the pools.

Q: **Can I name a successor if I die before the money is distributed?**

A: Yes and you should. For example, you could name one or more of your children or grandchildren to be the successors to suggest donations after you are gone. This is a great way to create a legacy and to get your family involved in charitable activities.

Q: **Can I donate appreciated securities or mutual funds?**

A: Absolutely, and it's part of the whole idea of this paper. You can also give privately held stock, real estate, Bitcoin and partnership interests. Some of these get complex in their valuations. Oh yeah, and you can use cash.

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