How to Donate More Tax-Efficiently

Donating cash is straight-forward but is usually not the most tax-efficient way to give. A little bit of planning could maximize your tax deductions and/or minimize income taxes on your investment income.

If you have appreciated investments that you owned more than one year and you donate the investments to a charity, you can count the fair market value in your itemized deductions. Even if you take the standard deduction and do not itemize, you avoid paying capital gains tax on your unrealized gain. Because charities are tax-exempt, the untaxed appreciation disappears, and no one pays capital gains tax.

Donor advised funds (DAFs) have grown in popularity for several reasons. Rather than donating investments directly to operating charities, donors can contribute their appreciated investments to a DAF. As with the above, donating appreciated long-term assets creates an itemized deduction at fair market value. The donor then can request that the DAF make grants to the charities the donor prefers. This strategy can be very beneficial if the donor wants to "bunch" their deductions by pre-funding a few years of donations in a single year and claiming the standard deduction in other years. Administratively, DAFs also allow donors to make several smaller gifts more easily and book a deduction before the eventual charitable recipients have been decided. DAFs are offered by many of the larger financial institutions.

If you are over age 70 ½, you may consider transferring up to $100,000 of your IRA directly to a charity each year as a qualified charitable distribution (QCD). This transfer satisfies any required minimum distribution for the same amount. The taxpayer is not taxed on the distribution and cannot deduct the donation. It would seem this would cancel out and not matter, but it can often yield large tax benefits. If a taxpayer is affected by phase-outs or phase-ins, possibly less of their Social Security benefits would be taxable, more of their medical deductions would count, or they would owe less for their Medicare premium surcharges. Please bring any QCDs to your tax preparer's attention as the tax forms will look the same whether you keep the distributions or make a QCD. QCDs cannot be made to donor advised funds, supporting organizations, or private foundations.

As you consider your estate planning, it may make sense to leave tax-free assets to individual heirs (such as items that are stepped up in basis or life insurance) and leave assets that create taxable income like retirement accounts to charities.

December 2020

Sue Speer, CPA, Chair of IWCF Investment Committee
Molly Guenther, CFA, CFP®