FEATURE:
PHILANTHROPY

By **Peter Tucci**

How Illiquid Taxpayers Can Take Advantage of the New 60% Charitable Deduction

Your clients should consider cash donations

Lawyers, accountants and financial advisors routinely encourage their charitably inclined clients to donate appreciated property to charity. More often than not, that's sound advice: An individual who donates appreciated property to a public charity may receive a charitable deduction of up to 30% of her adjusted gross income (AGI) and avoid capital gains tax on the appreciation. But, the Tax Cuts and Jobs Act (TCJA),[1] enacted in December 2017, has shifted the tax landscape enough that some taxpayers—specifically, those who are in a high federal income tax bracket and plan to donate more than 180% of their expected average AGI over the next few years—should seriously consider ways to donate cash.

Internal Revenue Code Section 170(b)(1) limits charitable deductions to a set percentage of a taxpayer's AGI, depending on the nature of the property being donated, the organization receiving the donated property and whether the property is being donated "to" or "for the use of" the organization.[2] The TCJA increased the cap on deductions for cash donations to public charities from 50% of AGI to 60% of AGI. It also eliminated the so-called "Pease limitation" on itemized deductions. The Pease limitation pared back the value of taxpayers' itemized deductions, effectively reducing the spread between the more generous deduction for cash donations and the less generous deduction for donations of appreciated property.[3]

Charitable deductions are now capped at 30% of AGI for donations of appreciated property to public charities (unchanged from prior law), 50% of AGI when a taxpayer makes an election under IRC Section 170(b)(1)(C)(iii) (which limits the maximum value of the deduction to the taxpayer's basis in the property) (unchanged from prior law) and 60% of AGI for cash donations to public charities. In each case, taxpayers can carry over unused charitable deductions for up to five years following the year the gift is made,[4] which means that the 30% of AGI, 50% of AGI and 60% of AGI limitations begin to bite when a taxpayer's gift is equal to 180%, 250% and 360%, respectively, of the taxpayer's expected average AGI.

Individuals who want to make gifts that exceed 180% of their expected average AGI during the relevant tax years (the year of the donation and the five subsequent years) stand to reap substantial tax savings from the increased limitation on deductions for cash donations. This is true for individuals with highly liquid assets, who can simply transfer large sums of cash to charity. Surprisingly, perhaps, this is also true for individuals whose assets are illiquid and/or highly appreciated. In many cases, these individuals can come out ahead relative to the conventional approach of donating appreciated property by either: (1) selling appreciated property and donating the sale proceeds, or (2) borrowing against appreciated property and donating the loan proceeds.

Two Approaches

The most obvious way to turn a non-cash asset into cash is by selling it. Of course, selling property will trigger tax to the extent of any capital gains. But, the sale approach can pay off even if it means recognizing significant capital gains. In part, this is a reflection of the power of the

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new, higher limitation on charitable deductions for cash donations. This higher limitation allows taxpayers to deduct, over a 6-year period, as much as 180% of their average AGI on top of what they would have been able to deduct if they'd donated appreciated property to a public charity. The sale approach's attractiveness is also a reflection of the fact that, under IRC Section 1(h), charitable deductions offset ordinary income before offsetting capital gains.[5] As a result, the sale approach allows taxpayers whose income is largely ordinary in character to essentially swap out much of their ordinary income for capital gains, which is taxed at lower rates.

Alternatively, a taxpayer can borrow against appreciated property. This approach allows the taxpayer to take advantage of the higher AGI limitation for cash donations without realizing any capital gains or giving up control of the property itself. Moreover, if a taxpayer holds onto the property, its basis will be stepped up to fair market value (FMV) on the taxpayer's death.[6] The downside of borrowing, of course, is that by doing so, the taxpayer will incur interest costs that may exceed the tax savings from the larger charitable deduction.

Amanda the Corporate Executive

For example, imagine that Amanda is a corporate executive with an annual income of $1 million (entirely ordinary in character). Amanda wants to donate $6 million to her alma mater. She owns stock with a cost basis of 30% of its value. Her stock, which she's owned for many years, is worth well over $6 million. Amanda is a single filer subject to current federal income tax rates and claims no deductions aside from the charitable deduction and a $10,000 state and local tax deduction.[7]

If Amanda donates $6 million of stock to charity, she'll be able to claim a $300,000 charitable deduction each year for six years,[8] leaving her with $700,000 of ordinary income each year or $4.2 million of taxable income over the 6-year period beginning in the year of her donation. During that time, she'll incur about $1.35 million of federal income tax liability.

If Amanda immediately sells $6 million of stock and then donates the cash proceeds to charity, in Year 1 she'll recognize $4.2 million of capital gains along with $1 million of ordinary income. After claiming her 60% deduction, she'll be left with $2.08 million of taxable capital gains in Year 1 (as her ordinary income is fully offset), $400,000 of taxable ordinary income in each of the next four years and $520,000 of taxable ordinary income in the last year of the carryover period (as she finally exhausts her available charitable deduction from the $6 million donation five years earlier). Over the 6-year period, then, she'll incur about $1.10 million of federal income tax liability or $250,000 less than if she'd donated the property itself.[9]

Selling appreciated property is more attractive when a taxpayer's basis is a bit higher than 30% of FMV. In this example, Amanda's basis is low enough that she'll wind up in a similar place, taxwise, whether she donates

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the stock or sells it and donates the proceeds, assuming the full amount is donated or sold in Year 1. Here, the sale approach could yield some tax savings, but the conventional approach of donating the appreciated stock may make more sense after accounting for: (1) the time value of money (the upfront sale approach would increase Amanda's tax bill in Year 1, causing her to lose access to some of her money earlier than she otherwise would), and (2) the risk inherent in any approach that causes a large, certain increase in the taxpayer's taxable income in return for a potentially larger but uncertain decrease in the taxpayer's taxable income over the next several years.

The calculus changes if Amanda spreads out her gift over a period of years. If Amanda sells $6 million of stock over the course of six years, selling $1 million of stock each year, she'll have $680,000 of taxable income each year, entirely capital gains in character (as her ordinary income will be fully offset), leaving her with about $740,000 of tax liability over the 6-year period. If she instead donates $1 million of stock to charity each year for six years, she'll be able to claim the $300,000 charitable deduction each year for 11 years, resulting in a federal income tax liability of $1.35 million over the first six years and potentially

several hundred thousand dollars of tax savings over the five subsequent years. But, particularly given the time value of money and the possibility that Amanda's income could drop or she could die before the end of the 11-year period, she would be better off selling the stock.

Borrowing may be Amanda's best option. If she borrows $6 million and then donates the cash proceeds, she'll be able to claim the full 60% percent of AGI deduction each year for six years, leaving her with about $670,000 of federal income tax liability over that period. Her interest costs will depend on the interest rate and how quickly she's able to pay off the principal. But, if she's able to keep the aggregate interest payments under $680,000, she should come out ahead relative to the conventional approach of donating the stock. (She might consider borrowing from a trust to obtain a favorable interest rate and avoid bank fees and bank bureaucracy.) Meanwhile, Amanda's basis in the stock will be stepped up to FMV on her death, eliminating any capital gains liability. Note that Amanda can achieve the same tax result, while incurring less interest, by borrowing $3.6 million and donating the loan proceeds to charity (though, of course, in that case, her gift would be smaller).

Further Developments

The 60% charitable deduction remains very much in flux. It's set to expire at the end of 2025. If it isn't extended beyond 2025, taxpayers who make large cash gifts in 2021 or later could lose the ability to claim the full 60% deduction at some point during their carryover periods. At the same time, some groups are lobbying for the 60% deduction—which is currently only available (with limited exceptions) when a donor's gift consists entirely of cash and goes entirely to a public charity—to be expanded in ways that could affect the analysis in this article. For example, if the law is amended so that incremental cash gifts can be stacked on top of non-cash gifts, it may be possible for taxpayers like Amanda to take advantage of the 60% limitation by donating appreciated property, taking out a relatively small loan and then donating the loan proceeds to charity. If the law is amended so that the 60% of AGI limitation is available to taxpayers who elect under Section 170(b)(1)(C)(iii) to cap their maximum allowable charitable deduction at their basis in the donated property, donating high basis assets will become more attractive.

Think Twice

Advisors should think twice before advising clients to make very large gifts of appreciated property to charity. Some taxpayers, like Amanda, may be better off selling the property and donating the sale proceeds. Others may be better off borrowing against the property and donating the loan proceeds. Both approaches take advantage of the TCJA's 60% of AGI limitation on deductions for cash donations to public charities. Whether either approach makes sense for a particular taxpayer will hinge on the taxpayer's basis in the property, the size of the gift relative to her expected average AGI over the 6-year period during which she can claim deductions, the spread between capital gains and ordinary income tax rates, her risk tolerance and the character of her income, among other factors. Advisors ought to consider these approaches when a contemplated gift exceeds 180% of the taxpayer's expected average AGI over the six years beginning with the year the gift is to be made.

—The views expressed in this article do not necessarily reflect the views of Milbank LLP.

Endnotes

1. P.L. 115-97 (Dec. 27, 2017).
2. *See* Internal Revenue Code Section 170(b).
3. *See* IRC Section 68.
4. *See* IRC Section 170(b)(1)(C)(ii).
5. This is a function of how IRC Section 1(h) separates capital gains from ordinary income. Generally, under Section 1(h), net capital gain is subtracted from taxable income and taxed at capital gains rates while the remainder is taxed at ordinary income tax rates. Because IRC Section 63(a) defines "taxable income" as gross income minus deductions, this remainder will be equal to the taxpayer's ordinary income minus deductions.
6. *See* IRC Section 1014(a)(1).
7. In addition, states tax income at top marginal rates ranging from 0% in no income tax states like Texas to 13.3% in California. For the sake of simplicity, this article focuses on federal income tax liability.
8. In this example, Amanda's allowable charitable deduction would be the same regardless of whether she made an election under Section 170(b)(1)(C)(iii).
9. This sum includes Amanda's tax liability as a result of the 3.8% net investment income tax (also known as the "Medicare surtax") under IRC Section 1411.