To Give Or Not To Give: Tax Deductions For Charitable Donations

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If you have had a successful year (and we hope that you have!) and are feeling particularly generous this holiday season, then you may be wondering what is the most tax efficient way to make a gift to your favorite charity.

As many of you know, the Internal Revenue Code allows you to take a deduction on your income tax return for gifts to qualified charities. Most contributions to schools, hospitals and religious organizations qualify for the charitable deduction. There are also many other organizations that can receive charitable deductible gifts. If you are uncertain whether or not the organization is a qualified charity for tax deductible gifts, you can search the IRS's website at http://apps.irs.gov/app/eos/.

What is the Best Way to Make a Contribution?

In most cases, the easiest way to make a contribution is to simply write a check. However, for the "best bang for your buck," you may wish to make a contribution of something other than cash to the charity. At Einhorn Barbarito, we often counsel clients to consider making a gift of appreciated stock to the charity of their choice. Making a gift of appreciated stock that has been held for more than one year allows you to get a deduction equal to the fair market value of the shares on the date of the gift. The reason that this is such an efficient way to make a gift is that if you were to sell the stock, you would have to pay capital gains tax on the sale and you would never net the full value of the proceeds.

For example, let's assume that you have decided to make a gift of $10,000 to Rutgers University. You could write a check for $10,000 or you can give the university 100 shares of stock in XYZ Company that you bought two years ago for $10 a share but which is now trading at $100 a share. Either way, you will get a charitable deduction on your tax return of $10,000.

But the truth is that the stock was really not worth $10,000 to you. To turn the stock into cash, you would need to sell it. While that would give you proceeds of $10,000, you would have to pay capital gains tax on the $9,000 of capital gain (the $10,000 in proceeds less the $1,000 ($10 x 100 shares) you paid for the stock). You would likely net closer to $7,000 after you pay capital gains tax. If you then gave away the net proceeds, the charity would only get $7,000 and you would only get a $7,000 charitable deduction. Instead, if you gave away the stock to the university, the school could sell the stock and, since it is a charitable entity, it would not pay any tax on the capital gain. In other words, they receive $10,000 and you would get a charitable deduction for the full $10,000. Both you and the charity benefit! Be sure to check with your favorite charity to see if they accept stock donations.

Another great way to make a contribution to a charity is to utilize IRA distributions. If you are over 70 ½, you are required to take a distribution from your IRA each year, which is known as a "required minimum distribution." Even if you do not need the entire distribution, you are required to take it. You must keep in mind that these distributions are subject to income taxes. If you are planning on making a charitable gift anyway, you are probably better off directing the IRS custodian (the bank) to make the distribution directly to the charity. Since charitable organizations don't pay taxes, the charity gets the entire gross amount, and you have satisfied your required distribution obligation. This provision of the Internal Revenue Code seems to come and go at the whim of the Congress, and it is scheduled to disappear after 2013, so this is a great year to take advantage of this opportunity.

This brings us to our favorite charitable giving suggestion. We constantly have clients that come to our office to have a Last Will and Testament prepared. In most cases, our clients have estates of over $675,000, the amount where the New Jersey estate tax begins to apply. Sometimes the client will want to benefit a charity as well as their family. So let's say that a client has a $2,000,000 estate consisting of cash and securities worth $1,800,000 and an IRA worth $200,000. Let's say that the client tells us to provide in his Will for a charitable bequest to the Make a Wish Foundation of $200,000 and to leave the balance of the estate to his children. He is also going to name his children as the beneficiaries of his IRA. This will result in a New Jersey estate tax of $89,520 as New Jersey will impose an estate tax on the entire estate over $675,000 including the value of the IRA.

But, as you may know or may have experienced, the children will never receive $200,000 from the IRA because they will be required to pay income taxes on each distribution they receive. Charities, however, do not pay taxes on IRA distributions – they get the whole amount tax-free. So wouldn't the client be better off leaving the IRA to the charity and the balance of his estate to the children? Yes, because the estate tax will still be the same, and the charity gets the same $200,000, but instead of the children having to pay income taxes on the IRA distributions, the children would receive the client's other assets, which will not be subject to income taxes, and the charity will receive the IRA, on which it does not have to pay income taxes. It is a win-win situation for the children and the charity. The only loser is the IRS and the State of New Jersey who will collect a smaller tax.

There are several other efficient ways to "do well by doing good." Charitable giving is a noble thing, but if you can save some taxes by thinking before giving, then it is really a fantastic result.

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