Memorandum

To: Emeriti Colleagues
From: Lee S. Friedman
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Re: The New U.S. Tax Law and Charitable Contributions
Date: April 4, 2018

The new U.S. tax law passed by Congress and signed by the President in 2017 has many provisions that are in effect now. Some of those provisions will have substantial effects on emeriti tax bills, and some emeriti may be very unpleasantly surprised—lose several thousand dollars—if they simply behave this year as they did last year. This will not be true for everyone, and some may end up pleasantly surprised. I'm writing now to try and take away the "surprise" part, and so that you have time to consider and to take actions suitable to your own situation. These actions primarily affect how we make charitable contributions. Let me emphasize that I am an academic economist, not a CPA or a tax attorney. My message is intended to be educational; it does not substitute for advice based upon your specific circumstances from a qualified financial professional.

In recognition that financial reasoning is not everyone's cup of tea, I provide the gist with the key takeaways up front followed by, for those interested, more nuanced explanation.

The Short Version

Takeaway #1: Many married emeriti tax-filers may find that they will no longer itemize deductions, but will take the new higher $24,000 standard deduction instead. This is most likely for those who no longer have substantial deductible mortgage interest payments.

If #1 is true, what happens to charitable deductions?

Takeaway #2: Many emeriti, including both married and single filers, will find that it is advantageous to make charitable donations (to your usual charities) by writing checks on an IRA account. This is most likely for retirees age 70.5 or older who are subject to Required Minimum Distributions (RMDs) on their tax-deferred accounts like IRAs and 403bs.

If you think #2 may be true for you, see the pros and cons in the next section and discuss the idea with your financial advisor. If it still seems like a good idea:

Takeaway #3: If you want to implement #2, act in the next few months to enable suitable check-writing in an IRA that you already have or will open. You can if you wish roll over funds from University retirement savings accounts to fund your checkwriting IRA at your desired level.

The rest of this message explains the reasoning that leads to these three takeaways and adds some detail.

The Longer Version

Two provisions of the new tax law have particular consequence for us. One is that the standard deduction, which affects the decision about whether to itemize deductions, is substantially higher. The higher it is, the less likely is itemization to be a good strategy. For a married couple under the new law, the standard deduction is now $24,000, up from $12,700. Second, the new law hits many Californians hard by limiting to $10,000 the amount of state and local taxes that may be deducted. Almost all of us pay much more than $10,000 in property and state income tax, so under the old law itemization was almost always the best choice for us.

Under the new law, single and married filers are affected differently. The new limit on local and state tax deductions is $10,000 regardless of your filing status. That is, there is a substantial "marriage penalty": two single filers who marry will find that they lose $10,000 in deductible state and local taxes. Because single filers have a new standard deduction of $12,000, our single filers will generally be able to itemize as usual except for this limit (i.e. they will deduct the $10,000 limit and usually will have at least $2000 in other deductions). But for married filers, the new question becomes whether or not they have at least $14,000 in other deductible expenses apart from property and state taxes paid. For some with recently purchased or refinanced owner-occupied homes, deductible annual mortgage interest may be large enough to get over the $24,000 minimum that makes itemization sensible. But there are also a number of married emeriti filers who are not paying high amounts of deductible mortgage interest. This group needs to rethink whether and how to itemize.

There are other deductible expenses besides state and local taxes and qualifying mortgage interest (note some interest payments are no longer deductible, such as interest on home equity loans). For example, some people may have substantial deductible medical expenses, although this is not that common for us because of our insurance and federal income limitations. The one category of other deductible expenses that many of us have, and over which we have much control, is charitable contributions. However, if you are in the group whose deductions apart from charity fall substantially below the standard amount ($24,000 married, $12,000 single), there may be a much better strategy for you than itemizing charitable contributions.

The alternative tax strategy is to make charitable contributions directly from an IRA account, especially if you have to take out funds from tax-deferred accounts anyway. It was legal to contribute this way in the past, but both unnecessary for most (because of the ease of itemization) and cumbersome in procedure. New administrative procedures make this as simple as writing a check.

You may be thinking "Whoa, my IRA is my safety net" and not available for charity. Some emeriti, particularly younger ones, will be correct about this. But our emeriti population near or past age 70 should consider this carefully. Tax-deferred accounts like IRAs or 403bs owned by retired persons are subject to Required Minimum Distributions (RMDs) that begin in the year in which you become 70 and ½ years old. These mandatory distributions count as additional income on your tax return, and will be taxed at your marginal (federal + state) tax rate. The marginal rate is lower under the new law, but still will be in the 33-41% range for most of us. There is one exception to this taxation of RMDs: to the extent that you make these distributions from an IRA directly to qualified charities (the same 501(c)(3) charities that qualify for itemization). These Qualified Charitable Distributions (QCDs) do count toward satisfying the RMD, but do not count as taxable income. You get at least the same tax benefit from making QCDs (in any amount up to your total RMD) as you would by itemizing over the standard deduction, and you can get this benefit without itemizing and thus taking full advantage of the new higher standard deduction.

If you need to include your charitable deductions to get you over the $24,000, you may not be receiving much of a tax benefit, if any. Suppose you have $14,000 in non-charitable deductions, $11,000 in charitable deductions, an RMD greater than $11,000, and that your marginal tax bracket is 35%. The total of $25,000 in deductions is enough to itemize, but you are only gaining 35% of $1000 or $350 by itemizing instead of taking the standard deduction. If instead you take the standard deduction and make your charitable contributions as QCDs out of your RMD, you reduce your taxes by 35% of $11,000 or $3850. Making the exact same charitable contributions by the QCD method rather than itemization saves you $3500 in this example.

Many IRA-providing firms have now simplified the process of taking a QCD from your IRA. For example, Schwab and Fidelity allow checkwriting of any amount (no minimum) directly from an IRA, and other IRA providers may have the same or similar options. To take a QCD, all you have to do is write a check drawn upon your IRA account to any charity (requesting a mailed acknowledgment of the donation from the charity, just as you would do when itemizing). The brokerage will include and report these amounts as “normal distributions” to the IRS, and when you fill out your tax form, there is a line to report the sum of your QCDs and subtract it from the sum of your reported “IRA normal distributions” to get your taxable distribution. Note that if you have more than one type of tax-deferred account (e.g. one or more 403bs and one or more IRAs), each account will have an RMD. Your requirement generally is to take out the sum of the RMDs from each type separately (e.g. one RMD for all 403b accounts, another RMD from all IRA-type accounts). Thus you may want to have enough assets in your IRA-type accounts so that the RMD from them is at least equal to your desired QCD amount ($11,000 in the above example).

For those that do not have IRAs, but do have University retirement savings accounts, note that you can roll over any amount from one or more of the University accounts to fund an IRA of your choosing. You should be careful to make sure that you can hold suitable alternative investments to those you were holding in the University account. While it only takes a few days to open a new IRA with checkwriting privileges, it may take a number of weeks before you actually receive the checks. You will also want to make your donations well before December 31 of each year, to allow time for the charity to receive your check and to acknowledge it with a receipt.

Depending upon each individual’s circumstances, the QCD method may have some additional financial advantages. It can lower the taxable portion of social security benefits, it can reduce Medicare premiums, and it can reduce the bite of the Alternative Minimum Tax (itself reduced under the new tax law). Thus it may be advantageous even to filers who itemize other deductions (like some of the single filers amongst us).

Of course any advantages must be weighed against any disadvantages, which are largely in the form of some inconvenience. For example, you can make an itemized charitable donation by credit card over the internet and wait until the last days of the year, but you cannot do that with the QCD method (the charity could accept a check online, although as of now most are not set up for that). Also, you must make sure that your IRA holdings include enough “cash” (withdrawable funds) to cover each QCD check that you write when you write it. Some people who already use the QCD method report that they generally do so only for donations over a certain amount, continuing to make small donations in the most convenient way. There may be some charities that are not set up to receive and acknowledge checks, although all major ones that I know about welcome checks and provide receipts.

Another limitation of the QCD method is that it cannot be used to fund another strategy for charitable giving called the Donor Advised Fund or DAF. A DAF is generally used by individuals who wish to donate appreciated assets like stocks or mutual funds directly to charities. The individuals avoid capital gains taxes, get an itemized deduction equal to the value of the assets placed into the DAF, and then at their leisure direct the firm to give the assets to their chosen charities. A typical arrangement would be to open a DAF with the same firm that handles your taxable financial assets, easing the transfer of the assets to be donated into the DAF. The new tax law, with its higher standard deduction and limit on state and local tax deductions, also reduces the tax savings from itemizing a DAF contribution for the reasons discussed and illustrated above. Individuals who have these assets to donate still may find a DAF advantageous. Rather than donating annually to the DAF, they may donate larger amounts but less frequently (to minimize the amount used simply to reach the level of the standard deduction). Still, DAF contributors typically will make some cash contributions to charity as well, and nothing prevents the use of both DAFs and QCDs.

Summary

The new tax law will cause significant changes in our tax bills, and for many of us it may no longer be worthwhile to itemize rather than to take the standard deduction. The largest deductible expense that is at our discretion each year is charitable deductions. If you itemize them in order to better the standard deduction, you may save some money but it can be quite a bit less than what you saved under the old tax law. Those subject to RMDs from their retirement savings accounts, however, may have a much better strategy and find that they can further reduce their tax bill substantially--if they make charitable cash donations as QCDs from IRAs with check-writing privileges. To do this for the current 2018 tax year, the IRAs should be set up in the next few months for this purpose and funded so that the RMD from all of your IRA-type accounts is at least your desired QCD amount. The QCD method is somewhat less convenient than donating online by credit card, but the tax savings can be considerable. Both IRA providers and charities may soon realize that many U.S. retirees are in similar positions, and thus they may work to further simplify QCD procedures.