Kiplinger

RETIREES, GET AN UPFRONT TAX BREAK FOR DELAYED CHARITABLE GIVING

A donor-advised fund allows you to deduct your contributions on your tax return today while postponing the actual charitable donations until later.

By: David Rodeck - October 28, 2021

Americans are a generous people, donating many billions of dollars to charity each year, nearly $450 billion in 2019 alone. Although the U.S. government rewards donations with a tax break, the Tax Cuts and Jobs Act of 2017 made it harder to qualify by increasing the size of the standard deduction. To get any tax benefit from your donations in 2021, your total itemized deductions for the year, including charitable gifts, must exceed $12,550 for individuals and $25,100 for married filers.

These new rules make it more tax-effective to give a single, large donation rather than spread it out over time, but "people might not want the charity receiving everything at once," says Neel Shah, an estate-planning attorney and a certified financial planner at Shah Total Planning in Monroe Township, N.J. "People's intentions and charitable goals can also change over time, or they might not know which charity to give to."

If you're in this situation, a donor-advised fund might be the answer. These accounts let you deduct your contributions today while postponing the actual charitable donations until later. The money can be doled out gradually to one or more qualifying charities of your choice. "On its most basic level, a donor-advised fund is like a philanthropic, flexible spending account," says Christine Donovan, vice president of Northern Trust's foundation and institutional advisers practice. Because you fund the account with an irrevocable gift, you cannot get the money back, but you still retain control of when to donate, how much and where, although some fund providers may restrict which qualifying charities you can give to.

Donor-Advised Funds Can Mean a Juicy Tax Break

Cash is the most common way to fund these accounts. Rather than giving $10,000 a year to charity and falling short of the standard deduction limit, you could transfer $100,000 into a donor-advised fund, receive up to a six-figure immediate tax break, and then distribute $10,000 a year from the account. Shah recommends scouring your brokerage portfolio for any appreciated securities to donate because you will get "the full deduction and completely avoid taxes on your capital gains."

The amount you can deduct in any given year, however, is limited to 60% of your adjusted gross income for a cash gift and 30% of AGI for capital assets like appreciated stock. Any unused deduction can be carried over and used to offset your taxes for up to five years. If you donate an investment held for less than a year, you can only deduct your original cost basis for buying the asset, not your gains.

Although you can donate other assets like real estate or shares of a business, financial experts caution against doing so. "Once the gift has been made, you're giving up any enjoyment of it," says Shah. "With these other assets, there's more potential for missteps and abuse." For example, if you give real estate, you can't stay at the property anymore for free, and if you donate a private business, you can only collect a fair-market salary if you continue working there after relinquishing ownership to the donor-advised fund.

If you make a mistake and break these rules, it will cost you. The IRS could retroactively disallow your donation. Not only would you lose the deduction and owe back taxes, but the IRS could also charge you interest and penalties for underpayment because you claimed an invalid deduction. For assets like cars, real estate and private businesses, you're better off selling the property first and then using cash from the sale for your donation.

Not all organizations are candidates for donations. Only IRS-qualified public charities and some private foundations are eligible. Churches, schools and municipal governments in the U.S. also qualify. When in doubt about the organization's status with the IRS, Shah warns, don't use the donor-advised fund to give to the charity. Always double check that what you want to support qualifies by asking the firm operating the donor-advised fund, your financial adviser or the charitable organization itself.

There Are Other Perks of Donor-Advised Funds

Donor-advised funds have other advantages besides tax breaks. Automatic donations to charities can be scheduled and even made anonymously. The money in the account can be kept in cash or invested in mutual funds, exchange-traded funds, hedge funds or other options from the account provider. If you don't want to manage the investments, you can hire an adviser to do it for you. Any investment gains in the donor-advised fund are tax-free, potentially generating even more money to give away in the future. Of course, if your investments lose value, you'll have less to give.

Compared to charitable trusts or a private foundation, the funds are also simple and cost-effective. "Donor- advised funds do not require the staffing associated with private foundations, as the donor has no need for recordkeeping, submitting a 990 filing, or board meetings," says Donovan. You also avoid the extra tax-reporting requirements, paperwork and maintenance costs of running a trust.

You could even delay giving the money away until after you die. While you're alive, you establish how and when you want to donate the funds, and then let your hand-picked successor for managing the account follow through once you pass away.

The Costs for a Donor-Advised Fund

Brokerage firms, especially if you already invest there, are the most affordable and convenient way to open a donor-advised fund. Three of the biggest brokerages -- Fidelity, Schwab and Vanguard -- "do all the heavy lifting in terms of setting the account up for you," says Brian Stivers, owner of Stivers Financial Services in Knoxville, Tenn.

A donor-advised fund typically costs nothing to set up, but there is usually an annual maintenance fee for keeping the account open. The annual fees at Schwab, Vanguard and Fidelity are on a sliding scale; all start at 0.6% and decline as accounts get larger. Annual fees for other providers can be 1% or more, particularly for smaller balances. Minimum deposits also vary. Fidelity and Schwab don't have one, but Vanguard requires at least $25,000 to open a donor-advised fund.

If you invest the balance, you'll have standard brokerage investment fees based on the funds you pick and, if you hire an adviser, a management fee -- the same one you would pay if you hired the person for your retirement or brokerage account.

Other fund providers include philanthropic service companies, such as the American Endowment Foundation and National Philanthropic Trust. Nonbrokerage providers, however, often have higher administrative fees of 0.7% to 0.85% and outsource the investing. Some providers may specialize in a certain type of charity or those in a particular location, like the Silicon Valley Community Foundation, the National Christian Foundation or a university-run fund.

Smaller, cause-specific funds are more likely to restrict the charities you can donate to. For instance, a university-run fund may require a percentage of your donations to go to the school, or a religious fund may only approve of charities that meet certain moral guidelines. Larger programs will usually approve grants to virtually any IRS-approved organization.

Is a Donor-Advised Fund Right for You?

Stivers says donor-advised funds make the most sense for people with a net worth between $500,000 and $5 million, as they are probably already giving away the ideal amount to reap the tax benefits. Someone with a higher net worth might find the extra work and cost of a trust or private foundation justifiable for donating larger sums. Anyone making smaller donations, like $1,000 a year, can certainly open a donor-advised fund, but it may not be worth the effort, Shah says.

Stivers points out that these charitable-giving tools often work best for donors without immediate family members to inherit. "For those with no children or grandchildren, a lot of them like the idea of deciding while they're alive where the money will go after they're gone."

If you do have heirs, donor-advised funds offer a great opportunity to teach the importance of charitable giving to a younger generation. It's a nice way to leave a legacy, Stivers says.

Neel Shah, managing attorney of the law firm of Shah & Associates is an attorney, financial advisor and author who provides insightful analysis and actionable strategies for Business Owners, Entrepreneurs, and Investors.

To contact Neel, call 609-277-3887 or visit www.beaconwealth.us.

Reprint created by M&O Marketing