Tax Bunching

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We Americans are a giving people. For 2016, $390 billion was donated to charity. Individuals (as opposed to foundations and corporations) donated $282 billion of the $390 billion (72%)[1].

Under the previous tax code, charitable giving was fairly straightforward. However, with the 2017 tax reform changes, taxpayers are looking for strategies to adapt to the new tax laws. Once strategy taxpayers should evaluate is called tax bunching.

A little background

This current set of tax law changes strives to broaden the overall tax base. Two significant changes were the limitation or repeal of many deductions and the expansion of the standard deduction. The deduction for state income and property taxes is now limited to $10,000 and miscellaneous deductions were repealed. In addition, the standard deduction increased from $12,700 to $24,000 for married filing jointly couples ($6,350 to $12,000 for single individuals).

The result is that the combined impact of fewer itemized deductions and an expanded standard deduction means a larger number of taxpayers will take the standard deduction going forward. And, by not itemizing, deductible expenses like charitable contributions will no longer provide any federal income tax benefit.

What to do?

Is there something taxpayers can do to maintain the same level of gifting while maximizing the tax benefit? The answer is to consider the strategy called tax bunching in which the taxpayer can accelerate or defer their deductible expenses (such as charitable contributions) so that more of them happen in one tax year, rather than spreading them over several years.

The math
Let’s consider a fictional couple in 2018 whose sum of state income taxes and property taxes is greater than $10,000 and is limited, therefore, to a maximum $10,000 deduction. They also have a mortgage for which they will have $5,000 interest and give $7,000 to charity each year. The total allowable deduction is $22,000.

Because of the tax law changes, instead of itemizing, they would take the larger $24,000 standard deduction for 2018. Thus, they would receive no federal tax value for their itemized expenses. With regards to their charity over the next four years, they would gift $28,000 with no tax benefit from the gifting.

Solution
What if our couple opts to defer their charitable gifting from 2018 to 2019? Instead of gifting $7,000 in 2018, they wait a year and gift $14,000 in 2019. Rinse and repeat for the next two years with no charitable contributions in 2020 and $14,000 in 2021. They would end up taking the standard deduction of $24,000 in 2018 and 2020 but would itemize deductions of $29,000 in 2019 and 2021. Their total deduction over four years would then be $106,000 or $10,000 more than had they continued to donate each year. See below.

	2018	**2019**	**2020**	**2021**	**4 Year Total**
Old Strategy	$24,000	$24,000	$24,000	$24,000	**$96,000**
Bunching	$24,000	**$29,000**	$24,000	**$29,000**	**$106,000**

If our fictional couple is in the 24% marginal income tax bracket, this $10,000 in additional deductions taken over four years would amount to a tax benefit of $2,400.

Consider a Donor-Advised Fund
A donor-advised fund can provide further opportunity to bunch deductions without immediately distributing assets to specific charities. This type of account is a simple tax-smart solution for charitable giving. Basically, it allows individuals to contribute either cash or securities in a given tax year and take an immediate charitable deduction. Individuals may receive greater tax benefit by contributing appreciated securities. By doing so, a deduction is received for the value of the shares given without having to pay the tax on the gain that would be realized from selling the shares and donating cash.

Once the donor-advised account is funded, the donor then has the opportunity to recommend a grant to a specific charity (or charities) at a future date.

Bottom line
The new tax law presents an opportunity for taxpayers to revisit their individual situations. There is no one right way for each taxpayer to approach these new laws. However, with some careful planning and attentive behavior, there might be some things taxpayers can do to maximize the tax value of those actions.

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[1] Giving USA https://givingusa.org/see-the-numbers-giving-usa-2017-infographic/