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Vanguard research | Financial planning perspectives September 2022

Charitable giving: Three elements of a successful plan

In 2020, charitably inclined investors donated a record-breaking estimated $471 billion to organizations across the United States.[1] Their reasons varied, but regardless of the purpose, a successful charitable giving plan involves three elements: determining *when* to give, *what* to give, and *how* to give. All three work together, and each affects the other. For example, what is donated can affect when and how the donation is made. An advisor can help balance the elements in a way that helps optimize the donor's overall gifting strategy. We examine some common charitable giving strategies, discuss the advantages and disadvantages of each, and present examples to illustrate the potential impact.

When to give

The timing of charitable gifts can have financial consequences for the donor, the donor's heirs, and the charity. The donor's cash flow needs, purpose for giving, desire to pass assets on to heirs, and estate and tax planning needs should all be considered.

What to give

The type of property donated can also have a big financial effect. Cash tends to be easiest. However, donations of appreciated securities or property may yield an equivalent benefit to the charity but carry much greater tax and estate planning advantages for the donor.

How to give

The many methods of giving include direct gifts, bequests, charitable trusts, and donor-advised funds. Each has its benefits and considerations and can serve very different goals. Selecting the right method is critical to the success of the donor's giving strategy, investment plan, and overall estate plan. Some methods can be very complex, and their appropriateness is not always apparent. Donors are strongly encouraged to consult with their financial planners before engaging in any charitable giving strategy.

Note: Throughout this paper, we discuss only the federal tax consequences of the strategies described. State laws vary widely and may differ from federal tax laws. Tax discussions are based on current rules and regulations in effect as of the writing of this paper and are subject to change at any time. Investors should consult with their tax advisor before engaging in any transaction that may have tax consequences.

1 See *Giving USA 2021: The Annual Report on Philanthropy for the Year 2020*. Available at givingusa.org. For the purposes of this paper, we assume the investor is charitably inclined. Although donations may offer income and estate tax advantages, the benefits will rarely, if ever, outweigh the cost of the gift.

When to give

A detailed examination of the donor's needs and goals is necessary to determine the optimal timing of the gift. The timing of the gift—whether a single donation or a series of gifts—can depend on the charity as well as the donor's intent and cash flow. For example, a donor who lacks the means to make a single large gift or has concerns about a charity's ability to manage such a gift may wish to make a smaller initial donation. He or she can then wait to see how the charity manages or uses it and make additional gifts in the future, if appropriate. The strategy may differ for a donor who wants to fund either an established charity with a high degree of sophistication in managing gifts or a specific project. In this case, he or she may wish to make a large one-time gift or a series of ongoing gifts to help fund the project or charity over a longer term.

Some tax benefits may depend on the type of charity receiving the gift. A financial advisor can provide insight into the different types of charities as well as their different treatment and requirements under the tax code.

The donor's tax planning and cash flow needs must also be assessed. Cash flow considerations can be both objective and subjective: Although a donor may objectively be able to afford to make a lifetime gift, for example, subjective concerns may make a bequest more appropriate. For purposes of tax planning, clients with more taxable income at present than they expect in the future may wish to accelerate their giving during the high-income years to maximize their charitable income tax deduction.

Most deductions for charitable gifts require taxpayers to itemize their deductions. Grouping or "bunching" charitable deductions in a single year rather than spreading out the gifts over several years may help maximize the tax benefits. This strategy can complement repositioning portfolio assets into a more tax-efficient setup. Working with a financial planner to help balance charitable goals, cash flow needs, tax planning, and other considerations can significantly increase the chances of a wealth plan's success.

What to give

From a tax and estate planning perspective, the type of property donated may make little difference to the charity but can have a large effect on the donor's taxes and portfolio.

Cash is king when it comes to simplicity

The simplest and easiest property to donate is cash. The donor has full control over the amount and timing of the donation and receives a tax deduction for the total amount, subject to IRS limitations.

Appreciated securities—one gift, multiple benefits

Donating appreciated securities in-kind can provide tax benefits beyond those of a cash donation.[2] As with cash, here donors can control the timing and amount of the gift and receive a tax deduction for the fair market value of the securities. Additionally, they do not have to recognize (or pay taxes on) the unrealized gains. This added benefit can be an excellent way to further the donor's charitable intent while simultaneously managing his or her tax bill.

Although any securities can be donated, gifting of appreciated securities will typically have the greatest tax advantages. Investors who are considering donating securities or other property at a loss may often be better off selling the asset, recognizing the loss, and donating the resulting proceeds. They should consult with their tax advisor, as the rules regarding how much they may deduct for donations of this type of property are complex. **Figure 1** shows the tax impact of donating cash versus appreciated stock.

Gifting appreciated securities or property may be more complex than gifting cash—but it could also provide potentially greater tax benefits and may save the donor time, effort, and expense associated with the sale of property.

FIGURE 1.

Tax impact of donating cash versus appreciated stock

Example: Bob and Jill are married and file a joint tax return; together, they have an adjusted gross income of $100,000 and decide to donate $10,000 to charity. They will fund this gift using 50 shares of stock purchased several years ago for $100 each that are now worth $200 each. By gifting the appreciated shares in-kind, Bob and Jill realize an additional tax benefit of $750. The tax impact of gifting the stock versus selling it and making a cash gift of $10,000 is as follows.

Key observations:

- Assumptions for charitable donation, taxable income, and tax on income are the same for both approaches.
- Gifting appreciated securities results in additional tax benefit of $750 from nonrecognition of gains.

	Cash	Appreciated securities
Income	$100,000	$100,000
Charity	– 10,000	– 10,000
Taxable income	$90,000	$90,000
Income tax	$13,234	$13,234
Capital gains tax	+ 750	+ —
Total taxes owed	$13,984	$13,234

Notes: Income tax is calculated using IRS 2022 tax tables and assumes a 15% long-term capital gains tax rate. Capital gains tax assumes $5,000 in capital gains.

Source: Vanguard.

2 Certain exceptions apply. See IRS Publication 526 for exceptions to limits for specific tax years and more information.

In order to avoid recognition of capital gains, donors must have held securities for at least one year and gift them in-kind. In-kind transfers require paperwork, making them more complicated than cash gifts, and the transfer can take from several days to several weeks. Because the value of the securities will likely fluctuate during this time, the donor has less control over the exact amount the charity ultimately receives. Also, because deduction limits on gifts of appreciated securities are different than those for cash gifts (see **Figure 2**), it's best to consult with a tax advisor when considering this strategy.

Beyond the tax consequences, gifting can also serve as a means to rebalance or readjust a charitably inclined individual's asset allocation.

FIGURE 2.

Effects on the donor of gifting assets, by asset type

Type of gifted asset	Income tax deduction*	Additional tax benefits	Additional non-tax benefits	Complexity of making gift
Cash	Amount of gift up to 60% of adjusted gross income (AGI)	—	—	Low
Appreciated securities held more than one year	Fair market value of securities up to 30% of AGI**	Nonrecognition of capital gains	No transaction costs (commissions, etc.)	Medium
Other appreciated property held more than one year	Fair market value of property up to 30% of AGI	Nonrecognition of capital gains	No transaction costs; charity responsible for sale of property	High

* Assumes charity is a 50% charity as defined by the IRS. Deductibility limitations for some organizations are lower.

** Donors may also choose to deduct their basis in the donated property at a limit of up to 50% of AGI.

Source: Vanguard.

Other appreciated property: more potential benefits, more uncertainty

Virtually any type of property may be donated, including real estate, automobiles, art, and collectibles.[3] As with appreciated securities, a gift of appreciated property held for more than one year generally allows the donor to take a deduction for the fair market value of the property on his or her income tax return while avoiding recognition of capital gains. Additionally, the charity takes on the responsibility of selling the property. This can result in significant savings of money, time, and effort for the donor, because commissions on the sale of property can be substantial and finding a buyer can be a lengthy process.

Considerations when donating appreciated property are similar to those involved in donating appreciated securities; however, their magnitude can be much greater. A gift of real estate, for example, can involve significantly more paperwork than a gift of securities, including deeds, tax records, and other documents. Also, it may take a long time for the charity to sell the property, during which its value could change greatly.[4] Finally, valuing property can be a difficult and imprecise process, rules on the deductibility of property gifts are complex, and not all charities will accept them.[5] Donors should check with their charity of choice and engage appropriate appraisal and tax professionals when contemplating this type of gift.

Consider strategies to maximize your charitable deduction by gifting a combination of cash, securities, and property. A financial advisor can help balance the different limits to secure the maximum allowable income tax deduction.

3 Donations of art or collectibles may be subject to additional "related use" requirements or be limited to a deduction of cost basis, if the cost basis is lower than the fair market value.

4 As with donated securities, the gift of property is valued as of the date of transfer for the purpose of determining the donor's income tax deduction. Only the value the charity receives upon sale may change.

5 Please note that certain charitable contributions were subject to 100% AGI in years 2018, 2019, and 2021; investors should consult a tax advisor for guidance specific to their situation. Advisors and consultants to less sophisticated or resource-limited nonprofit organizations may wish to advise them to draft a gift acceptance policy if they do not already have one. This can help prevent these clients from accepting illiquid or otherwise burdensome gifts.

How to give

As well as determining *what* to give and *when* to give it, investors will need to determine *how* to make their donation.

Immediate charitable gift

Using the simplest and most common method of giving, the donor gifts assets of cash or property that will not be needed during his or her lifetime. The donor receives a deduction for the full value of the gift in the year it is given (subject to IRS limitations; see Figure 2). The gift (along with its future growth) is removed from the donor's estate and does not count against his or her lifetime exemption.[6]

One common approach to making an immediate charitable gift is through a nondeductible gift from a qualified retirement account; this method is known as a qualified charitable distribution (QCD).[7]

A QCD is unique in that the gift counts toward the required minimum distribution (RMD) but is not recognized as income for tax purposes. Because many tax-related items—itemized deduction and exemption phase-outs, net investment income tax, taxability of Social Security, and Medicare Part B premiums, for example—are based on adjusted gross income (AGI), QCDs could be more attractive than taking the RMD and making deductible gifts (which do not reduce AGI) from either the RMD or other sources. **Figure 3** shows the tax impact of a deductible donation versus a QCD.

For a gift to qualify as a QCD, donors must be age 70½ or older, and the distribution must be made payable directly to the charity by the IRA custodian and cannot exceed $100,000 annually. Additionally, the recipient must be a "public charity" as defined by the IRS. Donations to private foundations, donor-advised funds, and certain other entities do not qualify for QCD treatment. Other restrictions exist as well, so donors should make sure they are familiar with the rules.

Donors over age 70½ may wish to consider a qualified charitable distribution.

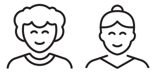
Funding a QCD strategy may also be leveraged for rebalancing or repositioning a portfolio in a tax-efficient manner. Working with a financial advisor can provide insight into how these strategies intersect.

6 For 2022, the federal gift and estate tax exemption is $12,060,000 per individual. This is the total amount, above the amounts gifted under the annual exclusion amounts, that an individual can pass free from gift and estate taxes. Lifetime gifts that use a portion or all of the exemption are deducted from the estate tax exemption amount when calculating the taxable estate. Any assets held by the estate in excess of the remaining exemption are taxed at a maximum rate of 40%. Barring additional legislation, however, this exemption amount is set to sunset on December 31, 2025. The amount at sunset is anticipated to be around $6,000,000.

7 Qualified retirement accounts for purposes of a QCD include traditional IRA accounts or inactive SEP or SIMPLE accounts. An inactive SEP or SIMPLE is one that has not received employer contributions during the year. Technically, QCDs may also be made from Roth IRAs, but because distributions from Roth IRAs are tax-free, this is of limited benefit.

FIGURE 3.

Tax impact of deductible donation versus QCD



Example: Chris and Dana, both 75 years old, are a married couple who file a joint return. This year, they had combined Social Security benefits of $20,000 and pension income of $20,000. They also have an IRA that, at the end of last year, had a balance of $1,000,000. Their calculated RMD is $40,650. Chris and Dana do not need the income from their IRA and want to donate that amount to charity. The income tax impact of a deductible donation versus a QCD is shown below.

Key observations:

- When Chris and Dana take an RMD (rather than making a QCD), their AGI rises, subjecting more of their Social Security income to tax.
- The QCD leads to tax savings of about $1,000.

		Deductible donation	QCD
Income and AGI	**Social Security benefits**	$20,000	$20,000
	Pension	$20,000	$20,000
	RMD	$40,650	$40,650
	QCD	—	$40,650
	AGI (Social Security benefits + pension + RMD – QCD)	$80,650	$40,000
	Resulting taxable percent of Social Security	85%	50%
Taxable income	**Taxable Social Security** (Social Security benefits x taxable percent of Social Security)	$17,000	$10,000
	Other taxable income (AGI – Social Security benefits)	$60,650	$20,000
	Charitable donation	$40,650	—
	Total taxable income (taxable Social Security + other taxable income – charitable deduction)	$37,000	$30,000
	Income tax due	$4,029	$3,189

Notes: 50% of Social Security benefits are taxable for married taxpayers filing jointly with a base income (1/2 of Social Security benefits + other taxable income) of $32,000 to $44,000 ($25,000 to $34,000 for single filers) and 85% for taxpayers with a base income above those amounts (see *IRS Publication 590B* for details). Income tax is calculated using IRS 2022 tax tables.

Source: Vanguard.

A gift intended to meet charitable and other financial goals

It may be possible for the same portfolio of assets to support both charitable and other financial planning goals such as a bequest to family members or income for the donor. "Split-interest" trusts, charitable gift annuities, and bequests are several of the ways to accomplish such multiple goals.

Properly constructed, a split-interest trust can provide a benefit to the donor, the charity, and the donor's beneficiaries. The most common types of split-interest trusts used in charitable giving plans are the charitable lead trust (CLT) and the charitable remainder trust (CRT).[8]

Charitable lead trust

In a CLT, the donor grants income from the trust to a designated charity for a fixed period of time. After that period, the remaining funds in the trust are passed on to noncharitable beneficiaries named by the grantor. The donor, the charity, and the donor's beneficiary all benefit (**Figure 4**).

The actuarial value of the gift passed to the beneficiaries (which is less than the value of the entire gift) will count against the donor's lifetime exemption or be subject to gift tax. Also, because of market fluctuations during the years income is paid to the charity, there is no way to determine in advance how much will be passed to the beneficiaries. Therefore, donors should take care when determining what portion of trust assets to give to a charity and how long the income stream should last.

When designing charitable trusts, there are a variety of solutions to customize the trust to meet the individual's needs and objectives.

FIGURE 4.
Benefits of a charitable lead trust

	Benefits
Donor	The donor may receive an income tax deduction equal to the present value of the income stream paid to the charity* at the time the trust is funded. The entire amount deposited to the trust and its subsequent growth is removed from the donor's estate. Unrealized capital gains on assets transferred to the trust are not immediately recognized.
Charity	The charity receives a predictable income stream.
Beneficiaries	Since gift tax valuation is assessed when the gift is transferred to the trust, any incremental growth transfers to the beneficiaries free from additional estate taxes.

* The donor must claim the income paid to the charity each year on his or her personal income tax return, even though the charity is receiving the income. If the donor elects to take an upfront deduction for the present value of the income stream, no deduction is permitted in future years.

Source: Vanguard.

8 We focus on annuity trusts (CLAT/CRAT) for the purposes of this discussion. Unitrusts (CLUT/CRUT) also exist, which have different income and remainder payout profiles.

Charitable remainder trust

In many ways, a CRT is the opposite of a CLT because the remainder and income portions are reversed. A noncharitable beneficiary, usually the grantor, receives the income from the trust for his or her lifetime or a period of years, and the charity receives the remaining assets. As with a CLT, the donor, the charity, and the beneficiary of the trust all benefit (**Figure 5**).

There is no way to determine in advance how much the charity will receive, and there may be gift tax consequences if the noncharitable-income beneficiary is someone other than the grantor. Therefore, as with a CLT, donors should give careful consideration to a CRT's design.

For philanthropic individuals, charitable trusts can be powerful tools to manage the timing of recognized income and capital gains. Financial advisors can provide more information on advanced planning strategies using charitable trusts.

FIGURE 5.

Benefits of a charitable remainder trust

	Benefits
Donor	The donor receives an income tax deduction equal to the present value of the remainder interest* of the trust in the year it is formed. The entire amount deposited to the trust and its subsequent growth is removed from the donor's estate. Unrealized capital gains on assets transferred to the trust are not immediately recognized.
Charity	The charity receives any assets remaining at the end of the trust period free from estate taxes.
Beneficiaries	The income beneficiary receives a predictable, taxable income stream.

* The charitable deduction for a CRT is equal to the present value of the expected remainder interest. This amount is complex to calculate and requires the assistance of a tax professional.

Source: Vanguard.

Charitable gift annuity

A charitable gift annuity (CGA) shares many of the features of a CRT. The donor gives the assets to a charity and receives an income stream in return, along with tax benefits—an immediate income tax deduction, nonrecognition of unrealized capital gains, and removal of the donation from the estate.[9] Unlike with a CRT, however, with a CGA the donated assets are not placed into a trust; instead, they immediately become the property of the charity, which then provides a guaranteed income stream. Charities frequently use a single premium immediate annuity (SPIA) to fund the guarantee; thus the beneficiary is unlikely to outlive the income stream, regardless of investment performance. Because it is funded with an SPIA, the payout rate for a CGA may be lower. CGAs also tend to be easier to set up than CRTs, since they are administered by the charity.

Figure 6 on page 11 highlights some of the differences and similarities in how a CRT, a CGA, and a CLT unfold over time.

Bequest

A bequest is a gift left to a charity after the donor's death. Donors can make bequests by means of a will, revocable trust, or beneficiary designations on accounts or insurance contracts. It is, in many ways, similar to an immediate gift, except that it occurs at a future date (the death of the donor). As a result, the donor has full use of the gift during his or her lifetime. The donor will not receive an income tax deduction at the time the bequest is documented. However, the estate can claim a deduction for the full amount of the bequest, once distributed, from the estate tax return.[10]

Gifting retirement plan and traditional IRA assets can be tricky from an income tax perspective. Naming a charity as a beneficiary on the accounts can transfer those assets efficiently without having to recognize the income.

9 The immediate tax deduction is similar to that for a CRT.

10 However, the estate cannot take a charitable deduction on its income tax return.

FIGURE 6.

Tax impacts of the charitable remainder trust, charitable gift annuity, and charitable lead trust

Charitable remainder trust

Donor gifts assets to a trust.

- Charitable deduction against income tax
- Capital gains on assets avoided
- Subject to gift tax or exemption

Trust sells assets.

- No immediate income tax generated

Trust provides income stream to non-charity beneficiary for a period of years.

- Income taxable to income recipient

After that period of years, remainder of assets transfer to charity with no additional tax consequence.

Charitable gift annuity

Donor gifts assets in kind to a charity.

- Charitable deduction against income tax
- Capital gains on assets avoided
- May have gift tax implications

Charity sells the assets.

- No capital gains recognized

Charity uses a portion of the proceeds to fund an income stream for the donor or a non-charity beneficiary.

- Income stream usually funded with a single premium immediate annuity (SPIA)

The rest of the proceeds are available for use by the charity.

Charitable lead trust

Donor gifts assets to a trust.

- Charitable deduction against income tax
- May have gift tax implications

Trust provides income stream to charity beneficiary for a period of years.

After the income period, remainder of assets transfer to noncharitable beneficiary or back to donor.

Source: Vanguard.

A gift today for distribution in the future

Some donors may be ready to make a gift—and potentially realize tax- and estate-planning benefits—but not yet ready to distribute the money to their selected charities. Below are two strategies they can use to make future gifts.

Donor-advised fund (DAF)

A DAF is a separate charitable account maintained and operated by a tax-exempt sponsoring organization. The donor makes one or more deposits to the account from which grants are funded and makes recommendations as to how the account should be invested, which charities should receive grants, and what the grant amounts should be.[11] Grants may be made over time, but because the sponsoring organization is a public charity, the donor receives an immediate tax deduction for the entire amount of the gift(s) in the year(s) made (subject to IRS limitations). The donor has no tax filing requirement and is not subject to minimum annual gifting rules (unlike a private foundation).[12] DAFs can be a good option for donors who want to fund a long-term giving strategy over a relatively short period of time without incurring the start-up and administrative costs or being subject to the rigorous Treasury regulations associated with private foundations.

Donor-advised funds can allow donors to fund a long-term giving strategy over a relatively short period of time.

Donors should keep in mind that sponsoring organizations charge a fee for their services. They may also restrict minimum deposits, grant sizes, the types of property or securities accepted, and the charitable organizations that qualify for grants.

Private foundation

A private foundation is a charitable organization created by the donor and administered by the donor or others hired to do so. Depending on its purpose, a foundation may make charitable gifts to individuals or organizations, with the foundation's board of directors deciding how large each grant should be. Generally, private foundations must distribute at least 5% of their assets annually. Donations are tax-deductible, but the limitations on deductibility are different (generally lower) than they are for gifts to public charities.

Private foundations are complex to form and strict IRS reporting requirements and regulations govern their operation. They can be very expensive to set up and administer and may not be appropriate for all donors.

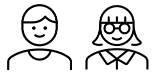
Figure 7 shows the tax impacts associated with DAFs, private foundations, and annual gifts.

11 The donor may also name another person or entity as advisor to the fund to manage these functions.

12 Although DAFs are not required to make a minimum gift each year as private foundations are, they are expected to make periodic distributions to qualifying organizations.

FIGURE 7.

Tax impacts of DAF, private foundation, and annual gift



Example: Tom and Joan want to donate $1,000,000 to charity, but they are not ready to commit the entire donation to a single charity. They are retiring this year and will be cashing out their stock options. As a result, their income this year will be $2,000,000, but they expect their income to be only $50,000 per year after that. They are considering a private foundation, a donor-advised fund (DAF), or a series of annual gifts of $50,000 a year for the next 20 years. The possible impacts on the couple are as follows:

Key observations:

- In each case, the charity receives about $1 million, either all at once or in smaller increments over time.
- A gift to a DAF produces the largest income tax deduction, taking full advantage of deductibility limits in a year of unusually high income. These limits are lower for a private foundation.
- Compared with a foundation and a DAF, annual gifts produce a smaller reduction in the donor's estate. Because of the time value of money, a $1 million gift over 20 years is worth less than $1 million given to a foundation or DAF today.

		Donor-advised fund	Private foundation	Annual gift of $50,000
Impact on donor	**Income tax deduction, first year**	$1,000,000	$600,000	$50,000
	Income tax deduction, years 2–20	—	—	$25,000
	Total income tax deduction over 20 years	$1,000,000	$600,000	$525,000
	Estate reduction	$3,207,135	$3,207,135	$1,839,280
	Required annual gift	—	$50,000	$50,000

Notes: Income tax deductions are based on cash deductibility limits of 50% of AGI for public charities and 30% for private foundations. Estate reduction is calculated as the future value of the gift(s) over 20 years at a 6% rate of return. Income tax deduction in years 2–20 for the annual gift is limited to $25,000 because of the 50% deductibility limit ($50,000 income x 50% = $25,000). This hypothetical illustration does not represent the return on any particular investment and the rate is not guaranteed.

Source: Vanguard.

Conclusion

Charitable giving is an important goal for many investors. Although any form can be beneficial, proper planning of the when, what, and how can help maximize the donor's philanthropic as well as overall wealth planning goals. The rules regarding some of these strategies are very specific and complex. Therefore, individuals should consult with tax and estate planning professionals before engaging in any charitable giving plan.

Reference

Giving USA 2021: The Annual Report on Philanthropy for the Year 2020, a publication of Giving USA Foundation, 2021. Researched and written by the Indiana University Lilly Family School of Philanthropy. Available online at givingusa.org.

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This is an updated version of a 2016 Vanguard paper, *Charitable Giving: Three Steps for a Successful Plan*, by Garret Harbron and Alisa Shin.

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ISGCGP 092022