Charitable Planning and Taxes

Charitable planning is made complex by the large number of factors to be taken into account. Among these are the current and expected income of the donor, the variety and urgency of the needs in the community, the current and future wealth of the donor, the marital and family status of the donor both now and in the future, and, last, but certainly not least, the current and future tax law.

The topic of this report is how to plan rationally in the face of the complexity of, and uncertainty about, the tax law. As we write this, the question seems particularly acute because the tax law is prominent in the news.

Economists have long known that taxes harm the economy by destroying wealth and reducing incentives to produce wealth.¹ And the effects are not small, although for some reason they are hardly ever talked about. For example, Martin Feldstein, a Harvard economist and president emeritus of the National Bureau of Economic Research, has estimated that each dollar of additional income tax may cost the economy two dollars.² In other words, when Washington says they are going to raise income taxes by a trillion dollars, if they were honest would disclose that they are going to

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¹ For an undergraduate-level explanation, complete with graphs and examples, of how taxes create deadweight losses, see, for example, Harvard economist Greg Mankiw’s book, *Principles of Economics*. There is no need to buy the current edition, which is very expensive. Earlier editions are available used for as little as one cent, plus shipping, on Amazon.

² See, for example, Feldstein’s NBER working paper 5055. The abstract says, in part, “A marginal increase in tax revenue achieved by a proportional rise in all personal income tax rates involves a deadweight loss of nearly two dollars per incremental dollar of revenue.” NBER working papers are available online. See www.nber.org/papers/w5055.pdf.
destroy an additional two trillion dollars in potential wealth.

Just as they know that high taxes are harmful, economists have also long known that the damage can be minimized by low, fair, reasonable, and predictable taxes.

Unfortunately for the United States and its taxpayers today, none of these four desiderata apply to current U.S. tax law. Taxes are not low. Most people would say they are not low, not fair, not reasonable, and certainly not very predictable.

In fact, the federal tax laws change virtually every year. Some years are more dramatic than others. Furthermore, even many things that do not actually change are implemented only one year at a time.

Some changes are relatively minor, such as the exact dollar amount allowed for a dependent deduction, while others, such as the statutory rate on income, are extremely important. And changes in the statutory tax rate are not rare. Since the implementation of the income tax in 1913, the top statutory rate has changed no fewer than 37 times! That’s an average of more than once every three years.

How should a rational person plan charitable giving in the face of such a constantly changing and unpredictable environment?

While we do not have any absolute answers to offer, we have developed some rules of thumb. Our hope is that if you understand how to think about tax planning, you will be able to make more informed, if not actually better, decisions.

**Giving Approach**

There are perhaps as many approaches to charitable giving as there are donors. However, most approaches fall into one of sev-
eral categories. We will examine each category and develop rules that apply to each.

**Fixed-Dollar Amount**

One simple approach to charitable giving is to give a certain, fixed amount each year. While this might seem like a very nonoptimal approach, it is quite common. Examples include giving patterns such as multiyear commitments to give a certain amount a year to a charity, such as a church or a school; membership dues to charitable organizations such as museums or synagogues; and hundreds of other instances in which people choose to support an organization at a specified number of dollars per year.

Consider an example in which a hypothetical donor gives a fixed $20,000 a year, in total, to charity. Is there any tax-related optimization available?

At first, it would seem the answer is no. You give $20,000, and you get to deduct it. End of story.

But actually that is not the end of the story. We have to look at the donor’s income level and what else is going on in his tax return to determine whether there is a better way to do it.

For example, suppose the donor has total income of $300,000 a year, and lives in a state such as Texas or Florida that has no income tax. To keep things relatively simple, assume that the donor is married and has two dependents.

Under the current law as this is written, this donor, giving $20,000 on December 31, 2011, and $20,000 on December 31, 2012, would pay a total, over the two years, of $157,386.

The same donor, with the same income, and doing everything else the same, except that he waits one day and makes his first contribution on January 1, 2012, would pay a total federal tax, over the
two years, of $152,513. In this case, waiting a day saves him $4,783. If this situation in any way fits you, you’ve just made a fantastically high rate of return on the cost of this book.

If this donor’s situation, and the tax laws, held still, we could say with confidence that the donor should take this approach every year.

But in the real world, things rarely hold still for that long. Our hypothetical donor’s financial life is so simple that it is unlike the situations of many real people. For example, most people with an income of $300,000, spouse, and two dependents will also have a mortgage. Let us assume that they have a $400,000 mortgage. With this simple change, he now gains no benefit from bunching the payments into one year.

However, if his income were $400,000, and his mortgage $300,000, it again makes sense to bunch the deductions into one year.

So even with no uncertainty about the tax laws, with any complexity at all to the situation it is not possible to make a blanket statement about what is best.

**Fixed-Percentage Gifting**

Just as some people give a fixed-dollar amount each year, others give a fixed percentage. There is a very long and illustrious tradition of doing exactly that. Many people read the Bible as prescribing that 10 percent should be given to charity each year. (Others view the tithe prescribed to go to the priests as the equivalent of a tax. Still others view the Bible as specifying a 10 percent income tax, and 10 percent for charity.) The Talmud specifies that people must give a minimum of 10 percent and a maximum of 20 percent. The maximum so as not to impoverish themselves, and also perhaps to make sure that there are members of society who are able to accumulate the capital that is so essential to economic progress.
As of this writing, the Internal Revenue Code (IRC) sets various percentage limits on the maximum amounts that can be deducted for income tax purposes. The rules are somewhat involved, but basically the maximum that can be deducted in any one year is 50 percent of adjusted gross income (AGI). For gifts of noncash assets to public charities, and gifts of cash to private foundations, the limit is 30 percent of adjusted gross income (AGI). For gifts of appreciated publicly traded stock to private foundations, the limit is 20 percent of AGI.

We can now classify fixed-percentage donors into three groups: those giving less than 20 percent of their AGI to charity each year, those giving between 20 percent and 50 percent each year, and those giving more than 50 percent each year.

As you might expect, the first group, less than 20 percent, is by far the most common. However, you may be surprised at how many are in the second group—20 to 50 percent. In our careers, we have known a few supremely charitable souls who persistently gave more than 50 percent of their income to charity. In fact, based on our observations, we might conclude that the rabbis of the Talmud were right that it is indeed possible for overly generous people to give away so much that they themselves become the recipients of charity. As we write this, we are thinking of a particular person who at one time was worth $50 million dollars, and gave it all away, to the point that he has now borrowed against his future income, against his house, and against his IRA, and goes looking for charitable contributions. This is a highly respectable and upstanding citizen.

Donors who give more than 20 percent a year are likely to find their deductions limited if they attempt to bunch them, so this is not likely to be a useful strategy for them.

But the fixed-percentage donor who contributes less than 20 percent of this annual income should carefully consider whether
gift-bunching makes sense. Sometimes it will make her better off, sometimes worse off, and sometimes it won’t make much difference. We strongly urge people in this situation to consult with their tax advisors. It may be quite worthwhile to work up a detailed model of various potential scenarios.

For example, consider a donor with an AGI of $200,000, who gives the biblical 10 percent each year. Suppose this donor is married, and a resident of a state with a 5 percent state income tax, like Utah. This donor’s default position would be to pay his $10,000 in state taxes each year as they are due, and make his $20,000 charitable contributions each year. Under this scenario (based on current law, and simple assumptions), each year he will pay a two-year total of $82,616 in federal income taxes, and $20,000 in state income taxes.

However, this donor could also consider (and review with his tax advisor) bunching his charitable contributions into the second year. The model will show that this will actually increase his two-year total of federal taxes by $8. But it will reduce his two-year total of state income taxes by almost $600.

Also of interest here is the possibility of bunching three years’ contributions into one year. The donor would do this, for example, by making his contribution “for” 2011 on January 1, 2012, his contribution for 2012 in June, and his contribution for 2013 on December 31, 2012. This three-year bunching will drive his three-year total federal tax up by $404, but he will save almost $1,800 in state taxes over the same period.

However, these rules cannot be applied blindly. For example, suppose we have the same taxpayer/donor. Everything is the same, except that he has the opportunity to take a one-time long-term capital gain of $100,000. Does it matter when he takes it? And does this affect the decision of whether or not to bunch the charitable contributions?
The answers are yes—and no. He should still bunch his deductions into the middle year. But he should not put the $100,000 into this same year. He should take it either before or after the bunching year. The difference is about $2,500 in tax.

**Tax Planning Complexity**

As you can see, even when there is no uncertainty about tax rates, and no uncertainty about income numbers, the problem of determining the optimum is not simple. And as anyone who’s filled out a tax return knows, the scenario is almost never as simple as our examples. Furthermore, even a taxpayer/donor living in a no-tax state like Nevada still has to worry about two tax systems: the regular federal income tax and the alternative minimum tax.

In theory, if you could specify the tax laws, the uncertainty in the laws, and the uncertainty in your income, you could set up a type of optimization problem known as a stochastic programming problem. Don’t worry if you don’t know what those words mean, because the chances are slim to none that you’ll ever need to consider it.

When we started our careers, the complexity of the problems was similar, but many of the problems were unsolvable in a reasonable amount of time given the available computing power. Today, computing power is not the constraint. Unfortunately, the expertise necessary to (a) fully understand the problem and (b) solve it once it is understood are rare and costly.

You’ve probably heard of the Black-Scholes model for calculating the theoretical price of certain option contracts. Myron Scholes, a former professor of ours at Stanford, won the Nobel Prize in economics largely on the strength of this work. Fischer Black did not win the prize only because of his untimely death from throat cancer two years before the Nobel was awarded to Scholes.
Black was a supremely gifted financial economist, and an analytical wizard. In 1984, he was hired by Goldman Sachs. But Black had very little experience in the areas that Goldman traditionally operated in. He reputedly was paid a very large amount of money. But why was he there?

Most of the people at Goldman Sachs didn’t understand and didn’t see how Black could be adding much value, because there were no trading coups or corporate transactions with his name on them. Black was never part of the firm’s culture in many other ways. He interacted with several hundred people, but only to the extent that their interests overlapped with his and he was learning from them. Without Rubin’s [Robert Rubin, former Treasury Secretary in the Clinton administration, and before that a senior partner at Goldman] sponsorship and guidance, he would no more have become part of the firm than oil mixes with water. A loner, he never could join in the intense collaboration that was so central to Goldman Sachs’s operation. He was certainly not a team manager and he had no selling skills and no interest in developing client relationships, particularly outside normal business hours. Worse, using Black with clients could backfire on a salesman because Black always spoke as he thought at a particular moment; he was not predictable.

So what was Black doing there? It seems quite likely that he was working on tax planning. The development of optimal tax planning strategy is probably in most cases an even harder problem than was developing the theoretical value for an option.

In 2009, Goldman Sachs reported a $6.4 billion tax expense. We saw from our extremely simple hypothetical taxpayer that opti-

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mization, even in a very simple setting, might reduce a tax bill by several percent. Let us just suppose for the sake of discussion that in Goldman’s case (we have no information on the matter beyond what is in their publicly reported numbers) optimal planning reduced that tax bill by 1 percent. That would mean that without optimization, the tax bill would have been $6.509 billion, for a difference of about $65 million. For comparison, Goldman’s chairman was paid a bonus of $9 million. So if, as seems likely, Goldman has some smart people working on tax optimization, they are probably earning their fees.

You and we can’t afford to pay someone like Fischer Black (as if there were any other people like Fischer Black) to spend most of their time worrying about your tax bill. On the other hand, chances are good that your situation is not as complex as that of Goldman Sachs.

**Guidelines for Analytical Expenditure: Or Is Analysis Worth It?**

All our experience with tax planning suggests that there is no substitute for close, detailed analysis of your particular situation. However, experience also suggests that it may be possible to offer some useful guidelines about when it is likely to be worthwhile investing time and money in careful tax planning.

The biggest and most important variable will be your income. As we’ve seen, the kind of tweaking around the edges that you can find by carefully looking is likely to amount, at most, to a few percent. But the cost of that analysis is not zero. If you do it yourself, it will require a certain amount of expertise, and very probably software. You’ll need to learn the software and then spend the time looking at different scenarios.

You could also have a professional, such as your accountant, do it. There are two caveats here. One, not all accountants are equally
good at it. Remember, people who are very good at this kind of analysis can save large taxpayers millions of dollars. So just as you’re not likely to find a Jack Nicklaus or Tiger Woods to join your foursome at the club, you’re not likely to find a Fischer Black to work on your taxes.

The second point follows from the first. The better the professional, and the more value she can add, the higher will tend to be her price. If your taxes are in the millions, that cost is likely to be worthwhile. If your taxes are lower, it might not pay to hire the most expensive professional.

With these points in mind, we can draw some rough rules of thumb. Let’s assume that good planning, as opposed to average planning, can reduce your tax bill by 2 to 4 percent a year. So for every $10,000 of taxes, perhaps good planning can save you $300. If you do the planning yourself, you only have to cover your time, and perhaps the cost of some software. Consumer software varies widely in quality and price. Many tax professionals use professional quality software programs such as BNA Income Tax Planner. A single user license currently sells for about $650.

With income tax rates as high as they are, even someone earning relatively modest amounts of income can find himself with a tax bill of $100,000. And many professionals and businessmen will find themselves paying far in excess of that.

So at fairly modest levels of income, say around $200,000, it will probably pay the average taxpayer to invest a little time and effort into tax planning.

**What to Do When Tax Rates Are Uncertain**

While tax rates change seemingly constantly (on average about every three years), the changes are not random. Between the inception of the income tax in 1913 and 2010, the top tax bracket
changed in 37 of those years. Of those 37 changes, 17 were up, and 20 were down. Although there were more drops by count, the increases have been much bigger than the cuts. The actual top tax rate is now five times the original top rate.

But there is another pattern that you would probably guess at if you thought about it. Changes in tax rates are not independent of each other over time. At first, you might think that a tax increase is more likely to be followed by a tax decrease. But in fact exactly the opposite is the truth. Looking at the record of income tax rates in the United States over the last century, if the last change in tax rates was an increase, the next one has a much better than even chance of also being an increase. The same goes with decreases. Economists say that rate changes are serially correlated. Roughly, speaking purely statistically, the next rate change has about a 60 percent probability of being in the same direction as the last change.

Of course, this is just a statistical observation. It takes no account of the size of the changes, nor of the absolute level of marginal tax rates. In the last century, there have been only two periods of steeply declining income tax rates. Those periods happen to match up quite closely, although not entirely, with the presidencies of just two men: Calvin Coolidge and Ronald Reagan.

It is not a coincidence that both Coolidge and Reagan were philosophically committed to smaller government, free markets, individual liberty, and low(er) taxes.

Unless you are a careful student of history, you might be under the impression that Coolidge’s Republican successor, Herbert Hoover, and Reagan’s Republican successor, George H.W. Bush, were free-market advocates like their predecessors. But if you look at Hoover’s and Bush’s tax policies, you will see how wrong this view is.
Hoover pushed for and got the largest increase in the top income tax bracket in the history of this country. Hoover increased the top bracket from 25 percent (it’s never been that low since) to a shocking 63 percent. He was then followed by Franklin Roosevelt who got congress to raise the top bracket four times, up to 94 percent.

But even that wasn’t enough for Roosevelt. In fact, Roosevelt issued an Executive Order, Number 9520 on October 3, 1942, which contained in its fine print an income tax of 100 percent on salaries over $25,000! You probably never read this in any history book in school. But it is true. Congress soon repealed it.

After Reagan left office, his immediate successors of both parties raised income tax rates, with George “Read-my-lips” Bush boosting the top rate from 28 percent to 31 percent, and then Bill Clinton raising it to 39.6 percent.

Even the much ballyhooed/maligned (depending on point of view) income tax cuts during the first administration of George W. Bush left the top tax bracket a full 25 percent higher than it had been at the end of the Reagan administration (35 percent vs. 28 percent).

As long as there is no Reagan or Coolidge, or a successor to that philosophy, in the White House, the bias of tax rates is strongly up. As we write, Congress continues to wrangle over the future direction of tax rates. The tax law adopted at the 11th hour in the waning days of 2010 in many ways intensified the uncertainty because it is effective for only two years.

**Timing of Gain Realization**

Occasionally, a donor will have a one-time gain realization event,

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such as the sale of a business. In the great majority of cases, the timing of such decisions will be driven by business considerations and not taxes. Nevertheless, there may be some tweaking around the edges.

In stable tax rate times, the usual consideration is to attempt to push the gain realization event into the next year, if possible, so that the taxpayer will gain the use of the tax money owed for an additional year. Of course, if taxes are expected to rise, then he will want to do the opposite.

**Charitable Remainder Trusts and Deferral**

One charitable technique that deserves serious consideration every time a large gain is to be realized is the Charitable Remainder Trust (CRT). In addition to being a charitable vehicle, a CRT is also a tax-deferral vehicle.

When rates are flat or falling, deferring taxes from the present into the future is usually a good idea for the taxpayer. However, when taxes are rising or expected to rise, deferring taxes may be a very costly venture.

**Conclusion**

As Ben Franklin said, taxes are one of the two certainties of life. You cannot avoid taxes. But with good planning, you can minimize them. Unfortunately, the tax system is so complex that tax planning must be highly individualized. For taxpayers earning even modest amounts, this usually means obtaining the advice of experts.

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