

Charitable giving

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- For individuals who are charitably inclined, one of the most straightforward methods for giving is to donate cash or appreciated securities directly to a qualified charitable organization. Such gifts not only have the advantage of simplicity, but they can also be of immediate benefit to a charity.
- Generally, such donors can receive an itemized deduction on their personal U.S. income taxes (a “charitable deduction”).
- Changes to personal income tax rules in the American Taxpayer Relief Act of 2012 (ATRA), passed by the U.S. Congress on January 1, 2013, may not in fact reduce the value of many taxpayers’ charitable deductions; the new rules may actually increase the value of those deductions.
- This updated paper is intended to make potential donors aware of some issues and opportunities involved in the direct-donation method of gift-giving. In addition to direct gifts, indirect methods of charitable giving are available, including donations to charitable trusts, gift annuities, donor-advised funds, and private foundations.¹
- Vanguard recommends that you consult with your tax advisor to discuss your particular situation.²

Note: This updated paper was originally published as *Charitable Giving in 2013* (Hammer and Shin, 2013).

¹ See the Vanguard research paper *The Joy of Charitable Giving: Strategies and Opportunities* (Hammer and Shin, 2013).

² This paper is not intended to, nor does it, constitute legal or tax advice, and it cannot be used for the purpose of avoiding tax penalties that may be imposed under the U.S. Internal Revenue Code.

Generally, a gift to a qualified charitable organization is tax deductible to the donor as a charitable deduction.³ The amount of the charitable deduction is based on several factors. In general, the donor's taxable income is reduced by the value of the gift. Therefore, the income tax benefit of the gift is based on the individual's marginal income tax bracket. For example, if the investor is in the 28% income tax bracket both before and after the charitable deduction, a \$1,000 cash gift would reduce his or her income tax liability by the amount of the gift times 28%, or \$280.

Notably, if a donor makes a gift of appreciated assets directly to a qualified charitable organization, he or she also is not liable for the long-term capital gain on such assets.⁴ The capital gain on an asset is generally measured as the fair-market value of the investment minus its original cost basis. For example, a gift of stock purchased for \$300 several years ago but now worth \$1,000 would generate a charitable deduction of \$396 for a donor in the 39.6% tax bracket (39.6% x \$1,000). In addition, the donor would not have to pay capital gains taxes of \$140 (20% long-term capital gains tax rate for a donor in this tax bracket x \$700 long-term capital gain on the stock).⁵ For this reason, many donors find gifts of appreciated securities attractive.

Aside from publicly traded securities, many other types of assets can be donated, such as appreciated real estate or art. We advise prospective donors to consult their tax advisor if they are considering donating these types of assets. Assets can also be donated through other charitable entities or methods, such as charitable trusts, gift annuities, donor-advised funds, and private foundations (see **Figure 1**).⁶

The amount of a donor's charitable deduction is generally limited to 50% of his or her total adjusted gross income (AGI) and may be limited to 30% or 20% of AGI, depending on the type of contribution and the type of organization to which it is donated.⁷ Generally, a taxpayer may carry forward an unused charitable deduction for five years.⁸ Certain other requirements and limitations may apply. For example, to be eligible for the deduction, the gift must be made to a qualified charitable organization that meets certain requirements set forth in the federal tax code. In addition, the allowable tax deduction will be reduced by the amount of any substantial benefit conferred upon the donor as a result of the gift.

Figure 1. Types of assets for charitable giving

Type of asset	Description	Tax considerations
Cash	Cash, check, wire.	Generally, the income tax benefit is based on the donor's marginal income tax bracket.
Appreciated investments	Stocks, bonds, mutual funds, exchange-traded funds (ETFs).	In addition to receiving a charitable deduction, donors don't recognize a capital gain on such assets.
Other appreciated assets	Real estate, art, investments in hedge funds, partnership interests.	May require professional appraisal. Discussion with the charitable organization is recommended to ascertain its capacity to receive such assets.

Note: This list is not exhaustive.

Source: Vanguard.

Note about risk: All investing is subject to risk, including the possible loss of the money you invest.

³ See U.S. Internal Revenue Code §170.

⁴ Under the American Taxpayer Relief Act of 2012, the highest income tax bracket is 39.6%. The act raised the long-term capital gains tax rate from 15% to 20% for individuals in the highest income tax bracket.

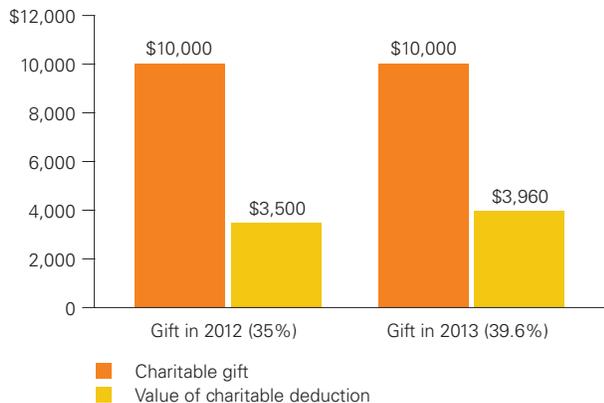
⁵ This example assumes a donor in the 39.6% income tax bracket, a 20% long-term capital gains tax rate, and no implications from the "Pease" limitation on itemized deductions (see also footnotes 9 and 10).

⁶ See Hammer and Shin (2013).

⁷ See U.S. Internal Revenue Service Publication 526 (2013), *Charitable Contributions*.

⁸ *Ibid.*

Figure 2. Value of a charitable gift for taxpayers in the highest tax bracket in 2013 versus 2012



Note: This example does not take into account any potential effects of the Pease limitation.
Sources: Vanugard, Internal Revenue Service.

Recent tax changes

The American Taxpayer Relief Act of 2012 (ATRA) reinstated a limit on itemized deductions for higher-income taxpayers, known as the “Pease” provision.⁹ Generally, the purpose of the Pease limitation is to raise revenue by limiting some itemized deductions popular among high-income earners. In considering the value of a potential charitable deduction, it is therefore important to consider the Pease limitation. In its reinstated form, the provision reduces the total amount of a taxpayer’s allowable itemized deductions by 3% of the amount by which the AGI exceeds certain thresholds: \$250,000 for single filers and \$300,000 for married couples filing jointly. Suppose, for example, a married couple have AGI of \$350,000, or \$50,000 above the threshold. The Pease limitation would reduce the total amount of itemized deductions by 3% of this \$50,000, or \$1,500 (3% x \$50,000). It is important to remember that the Pease limitation is applied based on the taxpayer’s *adjusted gross income*, although it may affect the amount of itemized deductions that a taxpayer may take.¹⁰

Figure 3. Pease limitation applies but has no effect on couple’s charitable deduction

a.	Adjusted gross income (AGI)	\$1 million
b.	Total itemized deductions to claim	\$100,000
c.	AGI above Pease threshold (a. – \$300,000)	\$700,000
d.	Pease limitation (3% x c.)	\$21,000
e.	Charitable contributions	\$50,000
f.	Noncharitable deductions (\$30,000 + \$10,000 + \$10,000)	\$50,000
g.	Claimed itemized deduction (b. – d.)	\$79,000

Source: Vanguard.

ATRA also created a higher-income tax bracket for taxpayers at the applicable income levels. For single filers with taxable income over \$400,000 (\$450,000 for married couples filing jointly), the applicable income tax rate was raised to 39.6%. Therefore, in 2013, one dollar in charitable deductions generally lowered the income tax of those in the highest tax bracket by 39.6 cents, before considering any potential effect of the Pease limitation. In 2012, the income tax benefit of charitable giving for those in the highest tax bracket was 35%, so each dollar of giving for those with \$400,000 in taxable income in 2012 generally lowered income tax by 35 cents (see **Figure 2**).

Effect of the Pease limitation: A few examples

In many cases, the Pease limitation does not affect the size of a taxpayer’s charitable deduction. Specifically, it does not affect those with AGI below the threshold amount of \$250,000 for single filers (\$300,000 for married filing jointly). Consider also a very high-income married couple with AGI of \$1 million (see **Figure 3**). The couple would like to claim \$100,000 in itemized deductions, consisting of \$30,000 in state and local taxes, \$10,000 in real estate taxes, \$10,000 in mortgage interest, and \$50,000 in charitable contributions. The Pease limitation reduces their itemized deductions by \$21,000, or 3% of

⁹ The Pease limitation was first incorporated into the Omnibus Budget Reconciliation Act of 1990; it is named after former Congressman Donald J. Pease.

¹⁰ Generally, the Pease limitation cannot reduce a taxpayer’s total deductions by more than 80%. It does not apply to deductions for medical expenses, investment interest, casualty and theft losses, or gambling losses.

Figure 4. Pease limitation affects couple's charitable deduction

a.	Adjusted gross income (AGI)	\$1 million
b.	Total itemized deductions to claim	\$70,000
c.	AGI above Pease threshold (a. – \$300,000)	\$700,000
d.	Pease limitation (3% x c.)	\$21,000
e.	Charitable contributions	\$50,000
f.	Noncharitable deductions (\$10,000 + \$10,000)	\$20,000
g.	Claimed itemized deduction (b. – d.)	\$49,000

Source: Vanguard.

the amount above the threshold of \$300,000 (\$1 million – \$300,000 = \$700,000 above the Pease threshold; 3% Pease limitation x \$700,000 = \$21,000 reduction). Thus, they will be able to claim \$79,000 in itemized deductions (\$100,000 in itemized deductions – \$21,000 Pease limitation = \$79,000). In this case, because of the amount of noncharitable itemized deductions (\$50,000 total), the charitable deduction reduces their taxable income by the same amount, even with the effects of the Pease limitation.

In some cases, the Pease limitation may affect the taxpayer's charitable deduction (see **Figure 4**). Consider a married couple with AGI of \$1 million and \$70,000 in itemized deductions, consisting of \$10,000 in real estate taxes, \$10,000 in mortgage interest, and \$50,000 in charitable contributions. The couple have no state or local taxes. Again, the Pease limitation reduces itemized deductions by 3% of the amount of AGI above the threshold of \$300,000, resulting in \$49,000 in itemized deductions (\$1 million AGI – \$300,000 threshold = \$700,000 above the threshold; 3% x \$700,000 = \$21,000 reduction in itemized deductions; \$70,000 total itemized deductions – \$21,000 Pease limitation = \$49,000 in itemized deductions after the Pease reduction). In this case, the Pease limitation is in excess of the other noncharitable itemized deductions and therefore directly reduces the taxpayer's \$50,000 charitable deduction.¹¹

Generally, if itemized noncharitable deductions are greater than the amount of the Pease limitation, then the full benefit of the charitable deduction will be enjoyed. Conversely, if itemized noncharitable deductions are less than the amount of the Pease limitation, then there is no benefit to the charitable deduction until the limitation is met.

It's important to keep in mind that the amount of the Pease limitation is driven by the taxpayer's AGI, not the amount of his or her itemized deductions. For example, consider a married couple with \$400,000 of AGI in 2013 who would like to claim a \$50,000 itemized deduction, 100% of which is state and local taxes. Pease reduces the couple's total itemized deductions by \$3,000 (3% x the amount of AGI over \$300,000, or 3% x \$100,000 = \$3,000). Thus, the total itemized deductions that can be taken are reduced from \$50,000 to \$47,000. Now suppose the same couple considers making a charitable contribution of \$10,000 at the end of 2013. The value of their charitable deduction is not reduced by the Pease limitation, because the Pease limitation is driven by the couple's AGI—not the amount of their itemized deductions. Therefore, they receive the full charitable deduction—39.6% under the higher 2013 ATRA income tax bracket—on the \$10,000 charitable gift.

A final point is that taxpayers who pay the alternative minimum tax (AMT) are not affected by the Pease limitation. They receive the full benefit of their charitable deduction based on the AMT rate. Again, individuals should consult with their tax advisor to consider the full impact of taxes on their charitable deduction and, conversely, the full impact of a charitable deduction on their taxes.¹² For example, a tax advisor could evaluate whether AGI could be lowered through contributions to retirement plans, assess the amount and timing of personal itemized deductions, and perform a multiyear analysis to evaluate the potential impact of charitable giving over a longer time period.

¹¹ In states with low or no income tax, the state and local income tax deduction may be reduced or unavailable.

¹² Taxpayers should be aware that a charitable deduction could also potentially affect whether they will pay the AMT. A charitable deduction may affect whether their AMT liability would be greater than their regular tax. Again, individuals should consult their tax advisor on this issue.

Conclusion

Individuals who are charitably inclined may receive an income tax deduction for their gift to a qualified charitable organization. One of the most straightforward methods for giving is to directly donate cash or appreciated securities to the charitable organization. Under ATRA, those in the highest income tax bracket may receive a higher deduction of 39.6%. In considering whether to make a charitable gift, potential donors should evaluate many factors, including the type of asset donated (cash, appreciated securities, or another type of asset), the method of giving, the maximum charitable deduction based on their AGI, the amount of the charitable deduction based on their tax bracket or AMT, and the potential implications of the reinstated Pease limitation. As always, prospective donors should consult with their tax advisor to evaluate how to best manage their charitable giving.

References

- American Taxpayer Relief Act of 2012, Public Law 112-240, H.R. 8, 126 Stat. 2313.
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