“FOUNDATION FOCUS” Presentation (4/20/2018)

Update on Tax Cuts & Jobs Act (TCJA)

- Legislation passed on Dec. 20, 2017
- Reference article in Spring 2018 issue of our *Connections* publication

Big takeaway relative to charitable giving: Increase in standard deduction

- Doubles from $12,000 to $24,000 in 2018 for married couples
- Single taxpayers: $12,000
- Persons age 65 and older will get an additional $1300, meaning that for a married couple both over age 65, Standard Deduction = $26,600

Concern: Possible decrease in overall charitable giving, since donors won’t be able to get to the $24,000 (or $26,600) threshold.

Point: You can only claim a tax deduction for charitable contributions if you itemize.

Note: Fewer than 10% of taxpayers are expected to itemize for 2018, down from 30%.

And so the jury is still out for several years on the potential impact of this.

The other side of the coin, so to speak (if there is a “silver lining”)—

With the ***increase*** in the standard deduction—coupled with lower income tax brackets—most taxpayers will likely see a net increase in their disposable income, and that will translate into ***increased*** charitable contributions.

What is the likely impact of the new tax law on MSU Development Foundation?

My sense is that it will not be all that significant.

We have just experienced our 3rd consecutive year of ***record giving to Foundation.*** This growth **has not** been driven by the federal income tax code, in my estimation, but instead it is more a function of *state* income tax policy, namely:

1) **ND State Tax Credit** for endowment/foundation funds (40% tax credit)
2) **ND Challenge Fund for Higher Education**, providing matching funds for gifts to qualified endowments.

Naturally, we are hopeful that donors will continue to support MSU because they believe in our mission and the work of the Foundation, and <u>not</u> strictly because they can receive an income tax deduction.

<u>IRA Charitable Rollovers</u>

One opportunity that takes on increasing importance under the new tax law is <u>IRA charitable rollovers</u>. And I might add that **virtually every article I read following the passage of the new tax legislation made specific reference to IRA charitable rollovers**, so I am far from the only one banging the drum on this particular strategy.

Now, if you are 15-20 years or more from having to take Required Minimum Distributions (RMDs), you can probably "tune out" this part of the presentation, and I will not be offended in the least. However, if you are at that point, that is to say, 70 ½ years of age (or older), and have not considered the IRA charitable rollover, or, if you are approaching that point in time, you may want to give this some consideration.

And before you say to yourself that this strategy does not apply to me because my retirement plan assets are in a 401(k) plan or 403(b) arrangement (or some other form of qualified retirement program), I would point out that there is a high probability—**maybe 95% or greater**--that <u>your assets will ultimately end up in an IRA</u>. And the reason is because when you do eventually retire or separate from service, an <u>IRA will almost always be your best distribution option</u>, for a number of reasons:

1) ***It preserves the tax-deferred status of the funds***
2) It <u>buys you time</u> until you can make a more informed decision as to your overall withdrawal strategy
3) It is likely to be a <u>more cost effective</u> alternative
4) It typically offers <u>superior investment choices,</u> and finally
5) Charitable rollovers can ***only*** come from IRAs (not 401(k)/403(b) plans)

What then, is an IRA charitable rollover?

- ➢ Available to IRA account holders age 70 ½ or older
- ➢ Enables them to transfer up to $100,000 ***each year*** from their IRAs to qualified charitable organizations.
- ➢ Distributions completely avoid federal income tax liability, and
- ➢ Can satisfy some or all of the taxpayer's RMD

So if you are part of that demographic (i.e. IRA accountholder, age 70 ½ or older, **and have charitable inclinations**), you really need to look at IRA rollovers as part of your giving strategy. Why?

1) You need to understand that under normal conditions:
    - Any distributions from a traditional IRA are taxed as ordinary income (reportable in year received via Form 1099-R)
    - Includes any amounts that are removed pursuant to RMDs
2) For most taxpayers who have reached 70 ½, their ability to itemize deductions has been greatly curtailed:
    - Home owners have likely retired their mortgages years ago, and so ***itemized deduction for mortgage interest is no longer available.***
    - With the doubling of the standard deduction, it will be difficult to get to that threshold (absent large unreimbursed medical expenses and/or fairly generous charitable contributions).

An **example** might be helpful:
Assume a donor must take a $5000 RMD. His intention is to make a $5000 contribution towards our Buy-a-Seat campaign, so upon receipt of the funds, he writes a $5000 check and delivers it to Jeremy Feller.

Outcome:
$5000 will be included in his taxable income for the year, but unless he has itemized deductions in *excess* of the $24,000 threshold, he will not receive the tax benefit.
Result: Donor will owe $600 in income taxes (assuming a 12% bracket) or $1100 (assuming a 22% bracket).

Better way to accomplish the objective:
By having the $5000 RMD transferred directly to the MSU Development Foundation (with the gift earmarked for the Buy-a-Seat campaign), he would completely "zero out' any federal income tax liability.

The tax-free transfer from the IRA lets him benefit from making the gift to the Foundation, even without itemizing. He can still take the standard deduction, but his charitable gift is not included in this Adjusted Gross Income (AGI), and therefore escapes taxation.

IRA rollovers are often referred to as **Qualified Charitable Distributions (QCDs)**

- Dollars never hit the taxpayer's Adjusted Gross Income (AGI)
- Because you would have otherwise paid income taxes on that distribution, the IRA charitable rollover strategy offers significant benefit to those who would have given that amount regardless.

NOTE: The IRA charitable rollover strategy does not have to be an all-or-nothing proposition with respect to Required Minimum Distributions.

Assume the same fact situation as the previous example (i.e. $5000 RMD), but the donor does not wish to give the full amount to MSU, but instead would opt for a $2500 gift. That's perfectly acceptable:

- Taxpayer still must remove the full $5000 as his RMD
- $2500 will be reported to him as taxable income (since that amount must go directly to him)
- 2500 will be paid directly to the Foundation, pursuant to the IRA rollover

Point: Donor is only taxed on the amount not rolled over to charitable organization. So in this example, his savings is $300 (assuming a 12% bracket), or $550 (assuming a 22% bracket).

I might mention that although I am still a few years removed from having to take RMDs, I know for a fact that the IRA rollover will be an important component in my charitable giving strategy. In fact, I firmly believe it will actually enable me to ***increase*** my overall level of support to the university. Example.

One final point regarding Required Minimum Distributions is a not so subtle reminder of the substantial penalty tax for failing to remove an RMD.

- Penalty = 50% of the amount required to be withdrawn
- Example: failure to remove a $5000 RMD would result in a $2500 penalty tax

Update on status of "stretch IRAs"

Something I touched on at our April 2017 meeting, when my topic was charitable estate planning for IRAs. Those of you who were at that meeting may recall that in addition to covering IRA rollovers as a strategy for outright gifts, I also talked about planned gifts (or end-of-life gifts) for IRAs, using a change of beneficiary form.

Stretch IRA is a made-up term; it does not exist within the Internal Revenue Code. Just exactly what is a stretch IRA?

- Essentially, it is a legacy vehicle that extends and preserves the tax-deferred status of IRAs for multiple generations
- Something you do not automatically qualify for or receive out of the goodness of Uncle Sam's heart; instead, it is a by-product of careful tax planning, involving the strategic use of IRA beneficiary designation forms.

Why do I mention this?

- Safe to say that the Service does not like the stretch IRA concept, and there have been ongoing efforts over the years to do away with it.
- Most recent proposal was contained in the **Retirement Income and Savings Enhancement (RISE)** Act, dating back to Sept. of 2016.
- That proposal would have basically killed the stretch IRA as we know it, as it basically would have required non-spouse beneficiaries to empty the account within 5 years following the account holder's demise (as opposed to payouts over a life expectancy).

  Concern: Accelerated payouts might force many beneficiaries into higher income tax brackets.

  Despite that concern, the stretch concept appeared to be all but dead, following a 26-0 vote of the Senate Finance Committee in the fall of 2016 to kill the stretch concept. And whenever you had a 26-0 vote, the legislation ***always*** became law the following year.

  So when I reported on this last year, I said we would keep our eye on that for you, and guess what? **The measure never made it to the Senate floor for a full vote,** and therefore was not included in the Tax Cuts & Jobs Act legislation**.** And so the "bottom line" is:

The stretch IRA defied the odds and is still alive and kicking!

> This is an important development, in my estimation, and presents additional opportunities for endowment and foundation funds to secure planned gifts from Individual Retirement Arrangements.

Charitable Lumping

A final strategy I will touch on very briefly—and one that relates back to the increase in the standard deduction (and the concern that most taxpayers will not be able to get to the new thresholds)—is something referred to as charitable "lumping" or "stacking."

Say for example a donor wants to give $10,000 each year for three years. Instead, he or she gives $30,000 in one year, which in turn exceeds the $24,000 threshold for itemized deductions, and therefore secures a tax benefit for the contribution.

The above strategy is similar to bunching deductions in one year, for example, and then alternatively, taking the standard deduction the following year (or every other year, as the case may be). So I think that the charitable giving community as a whole, will see more of these types of strategies going forward.

And just to be perfectly clear, the new tax law **does** **not** eliminate the deduction for charitable contributions. It's just that with the increase in the *standard deduction*, it will be harder for taxpayers' to get to the higher thresholds, to receive any benefit.

Elimination of Roth Re-characterizations

Finally, and just as a footnote to all of this, the only change to the IRA regs contained in the new tax legislation pertains to **Roth IRAs**.

As you know, a Roth IRA is essentially a "flip-flop" to a regular or traditional IRA, in that contributions are made on an *after-tax basis*, and as a result, qualifying distributions are completely income tax-free.

Qualified distributions:

1) Account must have been in place for at least 5 years, and
2) Account holder must be at least 59 ½ years of age

Tax Cuts & Jobs Act legislation eliminates Roth re-characterizations going forward.

"Re-characterization" is the two-bit term used for undoing a Roth conversion.

- Saw a fair amount of conversions in the aftermath of the "Great Recession"
- Many portfolios off 25%-30%

As seemingly disastrous as that was at the time, it presented a significant planning opportunity, as it permitted owners of traditional IRAs to:

- convert assets to a Roth IRA
- pay income tax on the value of the (deeply discounted) asset(s), and
- completely shelter any future appreciation from taxation, once the funds had been moved to the Roth IRA.

And so, for the most part, these conversions worked out fairly well for those who were able to take advantage of that planning opportunity, as the financial markets did eventually rebound, and in fact fairly rapidly.

Fast forward a few years, and even though conversions had tailed off quite a bit by then, there were nonetheless a number of account holders who were doing Roth conversions. <u>But what if, after transferring assets to a Roth, those assets went down in value</u>? In that eventuality, you would be paying too much tax, would you not?

Enter the re-characterization option. This device enabled taxpayers to:

- undo the conversion
- move the asset(s) from the Roth back into the traditional IRA, and
- unwind the income tax consequences of the original conversion

  In effect, re-characterizations gave taxpayers a second bite of the apple, so to speak, allowing them to have their cake and eat it too, if you will.

New tax law has now **closed** that loophole, <u>preventing the use of re-characterizations going forward</u>. Roth ***conversions*** are still permissible; it's just that once you do them, they are a "done deal," and there will be no ability to go back and undo them in the future.

That's probably more than you wanted to know about Roth re-characterizations, but I mention them to point out that there are a fair amount of complexities in dealing with both Roth and regular/traditional IRAs, and those complexities often present planning opportunities for those whose eyes are open to the possibilities.

One final caveat with respect to Roth IRAs, and this is a point I have made before: **You never want to leave Roth IRA assets to a charitable organization. If you do, it simply means that you paid unnecessary taxes.**

If you are considering that or have questions along those lines, I would strongly suggest that you contact the Development Office, and we will be happy to visit with you about a better solution. We **DO NOT** render tax advice, per se, but we will work with you in identifying win/win scenarios for donors and the university.