Use Your Business to Maximize Charitable Donations

Giving to your church, school, or other 501(c)(3) charity is a noble act no matter how you choose to give.

But for the purposes of tax savings, some forms of giving are much more beneficial to you than are others. As a business owner, you can use some business strategies to get the money to these institutions as business expenses.

While this does not change anything from the institution's perspective, it hugely increases your tax savings. The Tax Cuts and Jobs Act (TCJA) makes it harder to benefit from your personal donations.

Let's say you donate $10,000 to a church, school, or other 501(c)(3) charity:

1. Will you get a tax deduction—in other words, will you itemize?
2. Will you benefit from the entire $10,000 as an itemized deduction? In other words, did the $10,000 simply put you over the hump that beat the standard deduction?
3. Say you can deduct all $10,000 as an itemized deduction. Would making it a business deduction increase the tax benefit value to you?

The TCJA made two big changes that make it less likely that you will itemize. First, the TCJA set a $10,000 limit on your state and local income and property tax deductions. Second, it increased the 2020 standard deductions (adjusted for inflation) to

- $12,400 for individuals, and
- $24,800 for married couples filing jointly.

Even if you make a big donation, think about the problem this creates—suppose you are married and donate $17,000 to charity. If this is your only itemized deduction, your donation does you no good because it's less than $24,800. Fortunately, there's a much more tax-savvy way to give.

As a business owner, you can make a few modifications and convert your church, school, and other 501(c)(3) donations to a different type of deduction—an ordinary business expense—which increases the tax savings that land in your pocket year after year.

To turn a charitable donation into a business expense, the donation has to be involved in some way in promoting your business. In one way or another, you need to prove that your strategy has as its purpose attracting customers and revenue for your business.

The tax law rule is that your donation must

- have a direct relationship to your business, and
- create a reasonable expectation for a commensurate economic return.

Here are four examples of successful business practices that benefit charities and create business deductions:

1. In the *Marcell* case, the owner of a trucking company contributed cash to a hospital because he wanted to impress the chairman of the charity drive, who was a potential customer. The court found that Philip Marcell had a reasonable expectation for a commensurate return on his donation and treated the contribution as a business expense.

2. ABC Company attaches rebate slips to some of its products that it sells to customers. The customers can then present the rebate slips to the charity, at which point ABC Company pays the charity the amount listed on the slip.

3. In Revenue Ruling 72-314, the IRS ruled that the stockbroker corporation that paid 6 percent of its brokerage commissions to the neighborhood charity could deduct the payments as business expenses because there was a reasonable expectation that the arrangement with the charity would direct new business to the brokerage and help retain existing business.

4. Sarah Marquis, a sole-proprietor travel agent, made payments to charities on the basis of business they did with her. She had 30 charities as clients, and those 30 charities accounted for 57 percent of her business.

Eight Things to Know About the SECURE Act

The Setting Every Community Up for Retirement Enhancement (SECURE) Act changed the landscape for retirement and savings planning.

Here are eight important reminders about this new law:

1. You can't use contributions made in 2020 but applied to 2019 for any SECURE Act provisions that apply to contributions made after December 31, 2019.

2. If you inherit an IRA, you now have to empty it within 10 years. But there are many exceptions to this rule, including one for the surviving spouse.

3. You determine whether your inherited IRA qualifies for the old stretch IRA rules on the date of death of the original owner.

4. The "qualified birth and adoption" distribution exception to the 10 percent penalty is $5,000 per child per parent, based on our reading of the law.

5. Your inherited IRA distributions don't count toward your RMDs for your other retirement accounts.

6. Minors who inherit an IRA get the old stretch rules, but once they reach the age of majority, they have 10 years from that date to deplete the account.

7. The new $10,000 Section 529 allowable distribution for payments of principal and interest on student loans is a lifetime limit on the beneficiary, but you (the account holder) can apply excess distributions to the beneficiary's sibling, and those distributions count toward the sibling's $10,000 lifetime limit.

8. The ability to retroactively create a stock bonus, pension, profit-sharing, or annuity plan does not allow plan participants to make retroactive elective deferrals. The retroactively created plan allows business contributions only. Remember, the retroactive ability applies in 2021. You hurt your plan participants by waiting. Don't wait. Put your 2020 plan in place now.

Avoid the Gift Tax—Use the Tuition and Medical Strategy

If you or a well-off relative are facing the gift and estate tax, here's a planning opportunity often overlooked: pay tuition and medical expenses for loved ones. Such payments, structured correctly, do not represent gifts.

The monies spent by you on the qualified medical and tuition payments reduce your net worth and taxable estate, but they do no harm to your income, gift, or estate taxes. Further, the loved one who benefits from your help does not incur any tax issues.

As unusual as this sounds, with the tuition and medical payments, you operate in a tax-free zone.

Gift and Estate Tax Exclusion

If you die in 2020, your heirs won't pay any estate or gift taxes if your estate and taxable gifts total less than $11.58 million.

If you are married and have done some planning, you and your spouse can avoid estate and gift taxes on up to $23.16 million.

Lawmakers set the current rates with the TCJA and also set them to drop by 50 percent in 2026. Gifts made now continue as excludable should they exceed the upcoming 50 percent drop.

Beating the Gift Tax with Tuition

The tuition exception to the normal gift tax rules involves direct payment of tuition (money for enrollment) made to an educational organization on behalf of another individual.

You may not two-step this. For example, you can't write a check to granddaughter Amy for $50,000 that she in turn uses for her tuition. Here, you made a $50,000 gift.

But if you write the $50,000 check directly to the educational organization to pay for Amy's tuition, you are in the tax-free zone. The $50,000 does not bite into your gift and estate tax exemptions, because it's for tuition.

The unlimited benefit here applies only to tuition for full-time and part-time students. You can't use it for items such as dorm fees and books. You can't pay the money to a trust and then require the trust to pay a grandchild's future tuition costs (this fails the test for direct payment to the institution).

Qualifying Educational Organization

Tax code Section 170(b)(1)(A)(ii) defines "educational organization" as "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."

The regs elaborate by explaining that the term "educational institution" includes primary, secondary, preparatory, or high schools, and colleges and universities.

Example. You have four children, ages 7, 8, 9, and 10, at a private school where the tuition is $17,000 per year per student. Grandma Grace pays directly to the school the tuition for each of the children. Grandma Grace has no gift tax or other tax issues. Her payments are in the tax-free zone.

You can also pay the tuition to a foreign university. That tuition payment is in the tax-free zone just as if you had paid it to the University of Chicago.

Irrevocable prepaid tuition meets the rules and offers planning opportunities. Grampa Zeke has four grandchildren, all in the first and second grades of private schools. He sets up and funds an irrevocable plan with each of the private schools to pay the tuition at their respective schools. The plans qualify for tax-free zone treatment.

Planning note. Prepaid tuition can be a great death-bed strategy.

Beating the Gift Tax with Medical

The tax-free zone treatment of medical expenses requires that you pay the money directly to the medical care provider or insurance company (when paying for health insurance).

Under this plan, you avoid gift taxes when you pay directly to the provider any medical expense that would qualify as an itemized deduction on your Form 1040. Here are the basics:

- Qualifying medical expenses are limited to those expenses defined in Section 213(d) and include expenses incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. (See IRS Pub. 502, Medical and Dental Expenses for an easy-to-understand list of itemized medical deductions—note this link produces a PDF of the publication.)

- In addition, the unlimited exclusion from the gift tax includes amounts paid directly to the insurance company for medical insurance on behalf of any individual.

- The unlimited exclusion from the gift tax does not apply to amounts paid for medical care that are reimbursed by the donee's insurance. Thus, if payment for a medical expense is reimbursed by the donee's insurance company, the donor's payment for that expense, to the extent of the reimbursed amount, is not eligible for the unlimited exclusion from the gift tax, and the gift is treated as having been made on the date the reimbursement is received by the donee.

Example. Sam, your buddy, takes a big fall while climbing Mount Everest. You pay $67,000 of his medical bills directly to the medical providers. You are in the tax-free zone and face no gift tax.

Say that the insurance company reimburses Sam for $31,000 of the medical bills that you paid, and Sam keeps the money. Now, you have the following tax situation:

- You have $36,000 of medical bills that you paid directly to the provider that are in the tax-free zone and not subject to gift taxes ($67,000 - $31,000).

- You can avoid $15,000 of gift taxes because of the 2020 annual exclusion. Thus, of the $31,000 reimbursed to Sam by the insurance company, you pay gift taxes on $16,000 and avoid taxes on the remaining $15,000 because of the annual exclusion.

Final Thoughts

The primary rule to remember when using the tuition and medical gift tax-free strategy is that you must make the payments directly to the institutions and providers. Imbed this rule in your brain as rule one for this strategy. Don't violate it.

If you have a loved one who needs tuition or medical help from you, use the tax-free zone method. For example, you have an estate tax problem and Uncle Jimmy needs help with his medical bills. Don't make a monetary gift to Jimmy to help him. Instead, make your checks payable to the medical providers who are billing Uncle Jimmy.

Even if you don't have a gift tax problem today, use the tax-free method because, who knows, you could win the lottery tomorrow.

And don't forget this strategy. Sure, you have an $11.58 million estate and gift tax exemption this year. In 2026, that's scheduled to drop by 50 percent (adjusted for inflation). But the current deficit issues could trigger a drop to, say, the 2008 exemption amount of $2 million, or lower.