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# Bunching Tax Deductions to Maximize Their Benefit

## An old technique has new value after the Tax Reform bill

Bunching expenses, particularly charitable gifts, in one year rather than over multiple can provide added tax benefits, especially after the latest tax law changes. And combining that plan with a donor-advised fund can compound the tax savings.

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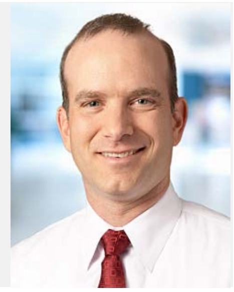

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The latest round of tax reform resulted in the limitation, or even outright repeal, of many of the itemized deductions previously claimed by individual taxpayers. In addition, the standard deduction, the base deduction amount that is available to all taxpayers, was nearly doubled. As a result, the number of taxpayers who will simply use the standard deduction rather than itemizing is expected to grow from about 70% to over 90%. While this will certainly simplify the tax filing process for many, it also means that certain expenses are less likely to provide a tax benefit going forward.

However, for taxpayers who have the ability to control the timing of these expenses, there may still be a way to maximize their tax benefit through a technique known as "bunching." And while the concept of bunching deductions into a tax year when they provide the most benefit has been around as long as there have been income tax deductions, it's taken on new significance as a result of the tax law changes.

### ITEMIZED DEDUCTIONS VS. THE STANDARD DEDUCTION

Taxpayers are able to reduce the amount of their income subject to tax through the use of deductions. The tax code offers all taxpayers two methods for doing this – using the standard deduction or itemizing your deductions. The standard deduction is a flat amount based on your filing status, and under the tax reform bill this amount was increased dramatically, as shown below:

| Filing Status | 2017 Standard Deduction | 2018 Standard Deduction |
|---|---|---|
| **Married Filing Joint** | $12,700 | $24,000 |
| **Single, Married Filing Separate** | $6,350 | $12,000 |
| **Head of Household** | $9,350 | $18,000 |

Rather than using the standard deduction, taxpayers can instead itemize if it results in a larger total deduction. This means deducting specific expenses incurred during the year in order to reduce taxable income. Among the many types of expenses considered deductible are state income taxes (or sales taxes if they are more), property taxes, mortgage interest, charitable contributions, medical expenses, investment expenses, tax preparation fees, unreimbursed business expenses and casualty losses. Beginning in 2018, however, the treatment of many of those expenses has changed, as shown in the table below:

| Expense Type | Treatment After Tax Reform |
|---|---|
| **Medical Expenses** | Medical expenses exceeding 7.5% of income are deductible in 2018, but that will rise to 10% in 2019. |
| **State Income or Sales Tax, Property Taxes** | These taxes went from fully deductible to a maximum deduction of $10,000 for all taxes combined |
| **Mortgage Interest** | For mortgage in place prior to December 15, 2017, interest on up to $1 million in debt was deductible. For loans entered into after that date, the limit is $750,000 |
| **Home Equity Interest** | If a home equity loan was used for anything other to buy, build or substantially improve the home, the interest is no longer deductible |
| **Charitable Contributions** | The deduction for cash gifts to charity was expanded slightly; all other forms of charitable giving remain the same. |
| **Casualty Losses** | Only deductible for Presidentially declared disaster areas |
| **Investment Expenses, Tax Preparation Fees, Unreimbursed Business Expenses and Other Miscellaneous Deductions** | No longer deductible |

The combination of fewer expenses that qualify as itemized deductions plus a larger standard deduction means many fewer taxpayers will itemize their deductions going forward. As a result, the tax benefit of those previously deductible expenses will go away, effectively making those items more expensive.

For example, assume a married couple who in 2017 paid $15,000 of state income taxes, another $9,000 of property tax, $8,000 of mortgage interest and gave $5,000 to charity. As the table below shows, this couple's itemized deductions exceeded their standard deduction for 2017. In 2018, however, their income and property tax deduction is limited to just $10,000, while the standard deduction is much higher. As a result, they claim the standard deduction for 2018

| Expense Amount | 2017 Deductions | 2018 Deduction |
|---|---|---|
| **State Income Tax** | $15,000 | $10,000 |
| **Property Tax** | $9,000 | |
| **Mortgage Interest** | $8,000 | $8,000 |
| **Charitable Gifts** | $5,000 | $5,000 |
| **Total Itemized Deductions** | $37,000 | $23,000 |
| **Standard Deduction** | $12,700 | $24,000 |
| **Greater of Itemized or Standard** | $37,000 | $24,000 |

This taxpayer would see this situation and realize they no longer receive a tax benefit for their itemized deductions. And while they can't stop paying their income and property taxes or the interest on their mortgage loan, they may be inclined to reduce or even stop their charitable giving knowing there is no longer a tax benefit for those gifts.

## RESTORING THE BENEFIT OF ITEMIZED DEDUCTIONS

All may not be lost when it comes to maximizing the benefit of these expenses, in particular charitable contributions. Through a technique known as bunching, a taxpayer can keep their total expenses the same, but increase their total tax deductions over multiple years. Under bunching a taxpayer delays a year's worth of charitable giving from one year to the next, but then gives double the amount to charity in that second year. The total giving stays the same, but the total tax deductions claimed are increased. This is illustrated in the following tables, where instead of this taxpayer giving $5,000 to charity every year, they give $10,000 to charity every other year:

| Without Bunching | 2018 | 2019 | 2020 | 2021 | |
|---|---|---|---|---|---|
| **State Income & Property Taxes** | $10,000 | $10,000 | $10,000 | $10,000 | |
| **Mortgage Interest** | $8,000 | $8,000 | $8,000 | $8,000 | |
| **Charitable Gifts** | $5,000 | $5,000 | $5,000 | $5,000 | |
| **Total Itemized Deductions** | $23,000 | $23,000 | $23,000 | $23,000 | |
| **Standard Deduction** | $24,000 | $24,000 | $24,000 | $24,000 | |
| **Greater of Itemized or Standard** | $24,000 | $24,000 | $24,000 | $24,000 | |
| | | **Total Deductions without Bunching** | | | **$96,000** |

| With Bunching | 2018 | 2019 | 2020 | 2021 | |
|---|---|---|---|---|---|
| **State Income & Property Taxes** | $10,000 | $10,000 | $10,000 | $10,000 | |
| **Mortgage Interest** | $8,000 | $8,000 | $8,000 | $8,000 | |
| **Charitable Gifts** | $0 | $10,000 | $0 | $10,000 | |
| **Total Itemized Deductions** | $18,000 | $28,000 | $18,000 | $28,000 | |
| **Standard Deduction** | $24,000 | $24,000 | $24,000 | $24,000 | |
| **Greater of Itemized or Standard** | $24,000 | $28,000 | $24,000 | $28,000 | |
| | | **Total Deductions with Bunching** | | | **$104,000** |

In this simple example, this taxpayer increased their total tax deductions from $96,000 to $104,000 over four years, without increasing their cash outlay.

This plan can also work for taxpayers who are over the standard deduction every year, but have the flexibility to fall below it some years. In this example, a couple has paid off their mortgage but gives $15,000 to charity each year. These taxpayers exceed the standard deduction every year, but by making their charitable gifts in alternating years, are able to take advantage of the new larger standard deduction.

| Without Bunching | 2018 | 2019 | 2020 | 2021 | |
|---|---|---|---|---|---|
| **State Income & Property Taxes** | $10,000 | $10,000 | $10,000 | $10,000 | |
| **Charitable Gifts** | $15,000 | $15,000 | $15,000 | $15,000 | |
| **Total Itemized Deductions** | $25,000 | $25,000 | $25,000 | $25,000 | |
| **Standard Deduction** | $24,000 | $24,000 | $24,000 | $24,000 | |
| **Greater of Itemized or Standard** | $25,000 | $25,000 | $25,000 | $25,000 | |
| | | **Total Deductions without Bunching** | | | **$100,000** |

| With Bunching | 2018 | 2019 | 2020 | 2021 | |
|---|---|---|---|---|---|
| **State Income & Property Taxes** | $10,000 | $10,000 | $10,000 | $10,000 | |
| **Charitable Gifts** | $0 | $30,000 | $0 | $30,000 | |
| **Total Itemized Deductions** | $10,000 | $40,000 | $10,000 | $40,000 | |
| **Standard Deduction** | $24,000 | $24,000 | $24,000 | $24,000 | |
| **Greater of Itemized or Standard** | $24,000 | $40,000 | $24,000 | $40,000 | |
| | | | | **Total Deductions with Bunching** | **$128,000** |

As a result of giving $30,000 to charity every other year, rather than $15,000 every year, these taxpayers increased their total tax deductions by $28,000 over a four-year period.

One problem with deferring deductions from one year to the next is that it leaves charities short on funding in those off-years. To help the charities with their budgeting, perhaps consider the opposite approach – rather than deferring the gifts from year 1 into year 2, instead accelerate them from year 2 into year 1. In the example above, that would mean giving $30,000 to charity in 2018 and 2020, and nothing in 2019 or 2021. The tax benefit would be the same over the four years, although it would mean giving up control of the cash that much sooner.

## DONOR-ADVISED FUNDS

A partial solution to that issue is to consider gifting to a donor-advised fund (DAF). A DAF is a charitable entity, equivalent to a private foundation, but without the setup expense or ongoing tax filing responsibilities. Contributions to the fund are tax-deductible in the year of the gift, but the funds remain in the account until the donor decides to make distributions to a recognized charity. Donors can spread their grant-making over many years if they so wish, although the donation to the DAF is a completed gift and the funds can't ever be reclaimed by the donor.

A DAF can be ideal in cases where a taxpayer front-loads multiple years of charitable giving into one tax year but isn't interested in immediately transferring the funds to the charitable organizations. While the funds remain in the DAF, they can be invested to grow over time, providing even more funds to transfer to charity in the future. DAFs are becoming a common tool for managing larger charitable gifts, but there are many things to consider before opening an account (such as investment options, expenses related to the fund and rules for making donations). Your Financial Advisor can provide more information on the donor-advised fund options available through Baird.

The recent tax reform bill has changed much of what taxpayers have been accustomed to in our federal tax system. And while it may seem that many of the planning strategies used in the past have been eliminated, the tax code still leaves room for taxpayers to manage their tax liability through the use of careful planning and a combination of old and new techniques.