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Bunching Tax Deductions to Maximize Their Benefit

Taxpayers can make the most of their charitable giving as well as the standard deduction

Bunching expenses, particularly charitable gifts, in one year rather than paying them over multiple years can provide enhanced tax benefits. And combining that plan with a donor-advised fund can compound the tax savings.

Financial & Estate Planning Department
Baird Private Wealth Management

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Recent tax reforms have 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 has grown from about 70% to nearly 90%. While this certainly simplifies the tax filing process for many, it also means that certain expenses provide little to no 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, the strategy has taken on increased significance.

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 is adjusted annually for inflation, as shown below:

Filing Status	2020	2021	2022
Married Filing Joint	$24,800	$25,100	$25,900
Single, Married Filing Separate	$12,400	$12,550	$12,950
Head of Household	$18,650	$18,800	$19,400

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 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 and casualty losses, each of which are subject to different rules in order to be deductible.

Expense Type	Treatment After Tax Reform
Medical Expenses	Only medical expenses exceeding 7.5% of adjusted gross income are deductible.
State Income or Sales Tax, Property Taxes	The total deduction for all state and local taxes (SALT) is limited to a maximum of $10,000 ($5,000 for married filing separate).
Mortgage Interest	For mortgages in place prior to December 15, 2017, interest on up to $1 million in debt is deductible. For loans entered into after that date, the limit is $750,000 ($375,000 for married filing separate).
Home Equity Interest	Only deductible to the extent the home equity loan was used to buy, build or substantially improve the home. HELOCs are included in the debt limitations shown above.
Charitable Contributions	The deduction for charitable contributions is limited to a percentage of adjusted gross income, based on what was given and to what type of charitable organization.
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 limitations on expenses that qualify as itemized deductions plus a larger standard deduction means fewer taxpayers will itemize their deductions going forward. As a result, the tax benefit of those previously deductible expenses will be reduced, or even go away, effectively making those items more expensive. For example:

- A prospective homeowner may be less likely to purchase a home without the mortgage interest deduction, although it could incent those with existing loans to pay them off sooner.
- Taxpayers in states with high income taxes may consider relocating to states with lower, or even zero, state income tax.
- Individuals may be less likely to make a charitable contribution without a tax benefit to help offset the cost.

Perhaps relocating to another state or paying off an existing mortgage may not be realistic for most individuals. However, these limitations on deductions can have a direct effect on charitable giving plans as donors 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 the bunching approach, 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 deduction claimed is increased. This is illustrated in the following tables, where instead of this taxpayer giving $6,000 to charity every year, they give $12,000 to charity every other year:

Without Bunching	2022	2023	2024	2025	
State Income & Property Taxes	$10,000	$10,000	$10,000	$10,000	
Mortgage Interest	$8,000	$8,000	$8,000	$8,000	
Charitable Gifts	$6,000	$6,000	$6,000	$6,000	
Total Itemized Deductions	$24,000	$24,000	$24,000	$24,000	
Standard Deduction	$25,900	$25,900	$25,900	$25,900	
Greater of Itemized or Standard	$25,900	$25,900	$25,900	$25,900	
		Total Deductions without Bunching			$103,600

With Bunching	2022	2023	2024	2025	
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	$12,000	$0	$12,000	
Total Itemized Deductions	$18,000	$30,000	$18,000	$30,000	
Standard Deduction	$25,900	$25,900	$25,900	$25,900	
Greater of Itemized or Standard	$24,000	$30,000	$24,000	$30,000	
		Total Deductions with Bunching			$111,800

In this simple example, this taxpayer increased their total tax deductions from $103,600 to $111,800 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 $20,000 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 larger standard deduction.

Without Bunching	2018	2019	2020	2021	
State Income & Property Taxes	$10,000	$10,000	$10,000	$10,000	
Charitable Gifts	$20,000	$20,000	$20,000	$20,000	
Total Itemized Deductions	$30,000	$30,000	$30,000	$30,000	
Standard Deduction	$25,900	$25,900	$25,900	$25,900	
Greater of Itemized or Standard	$30,000	$30,000	$30,000	$30,000	
		Total Deductions without Bunching			$120,000

With Bunching	2018	2019	2020	2021	
State Income & Property Taxes	$10,000	$10,000	$10,000	$10,000	
Charitable Gifts	$0	$40,000	$0	$40,000	
Total Itemized Deductions	$10,000	$50,000	$10,000	$50,000	
Standard Deduction	$25,900	$25,900	$25,900	$25,900	
Greater of Itemized or Standard	$25,900	$50,000	$25,900	$50,000	
		Total Deductions with Bunching			$151,800

As a result of giving $40,000 to charity every other year, rather than $20,000 every year, these taxpayers increased their total tax deductions by $31,800 over a four-year period.

One problem with deferring charitable gifts 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 $40,000 to charity in 2022 and 2024, and nothing in 2023 or 2025. 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 the charity's lack of funding 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 willing to immediately transfer 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 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.