

# Strategic Philanthropy: Gift Splitting in the Year of a Transaction

For founders and equity holders, a liquidity event typically triggers the desire to fund a donor-advised fund (DAF) or make a gift to a public charity to mitigate immediate tax liability. While the instinct is to maximize the charitable deduction in the year of the sale, this “lump sum” approach often results in tax inefficiencies.

By misunderstanding or overlooking the IRS rules for applying deductions against different income types, high-net-worth taxpayers risk wasting valuable deductions by using them to offset lower-taxed long-term capital gains (20%) instead of saving them to offset higher-taxed future ordinary income (37%).

For families anticipating significant ordinary income in the year following a sale (e.g., via consulting agreements, salaries, or non-qualified deferred compensation), a “split-year” contribution strategy allows for tax rate arbitrage—maximizing the economic value of every charitable dollar.

## The Technical Framework: IRC Ordering Rules

To understand the arbitrage opportunity, one must understand how the IRS applies charitable deductions under Internal Revenue Code Section 170. Deductions are not applied pro rata; they follow a strict hierarchy:

### **Tier 1: Ordinary Income**

Deductions are first applied against income taxed at the highest marginal rates, currently 37%.

### **Tier 2: Long-Term Capital Gains**

Only after ordinary income is reduced to zero does the remaining deduction spill over to offset long-term capital gains, which are taxed at the preferential 20% rate.

In a transaction year, a founder often has disproportionately high capital gains and relatively low ordinary income. A massive charitable gift in that year will quickly exhaust the ordinary income tier and be forced to offset capital gains. In effect, the taxpayer receives a 20-cent benefit for a dollar that could be worth 37 cents in the subsequent tax year.

# Case Study: The \$20 Million Liquidity Event

## The Scenario

You are closing a sale for \$20,000,000 in capital gains.

- **Year 1 (transaction year):** You take a \$250,000 salary (AGI: ~\$20,250,000)
- **Year 2:** You expect \$500,000 in ordinary income from consulting fees
- **The Gift:** You intend to donate \$1,000,000 in cash to a donor-advised fund (DAF)

## The Constraints

To maximize value, we must navigate two specific IRS rules:

- **Ordering Rules:** Deductions must wipe out ordinary income (37%) before they touch capital gains (20%)
- **AGI Cap:** In Year 2, cash deductions are limited to 60% of AGI. With \$500k of income, your deduction is capped at \$300,000.
- **Implication:** If you move more than \$300,000 to Year 2, you cannot deduct the additional amount that year

## The Comparison: Lump Sum vs. Optimized Deployment

The goal is to move as much of the deduction as possible to Year 2 to capture the 37% rate, without exceeding the \$300,000 cap.

Metric	Strategy A: Lump Sum	Strategy B: Optimized Split
Deployment Schedule	\$1,000,000 in Year 1	\$700,000 in Year 1 \$300,000 in Year 2
Year 1 Tax Impact	\$250k offsets Salary (37%) \$750k offsets Cap Gains (20%)	\$250k offsets Salary (37%) \$450k offsets Cap Gains (20%)
Year 2 Tax Impact	\$0 Deduction	\$300k Deduction
Effective Rate Arbitrage	Heavy allocation to the 20% bucket	Maximized allocation to the 37% bucket
Total Federal Tax Savings	\$242,500	\$293,500
Net Economic Benefit		+\$51,000

By simply waiting until the following year to deploy the final \$300,000 of your gift, you generate an additional \$51,000 in savings.

## Critical Considerations

### Cash vs. Appreciated Stock

The strategy above assumes the donation of cash proceeds. If you are donating appreciated private stock to avoid the recognition of gain, the contribution must generally occur in Year 1. In this scenario, the “split strategy” is not applicable to the stock gift itself, though carryover rules may naturally force deductions into Year 2 if AGI limitations (30% for private stock) are triggered.

### AGI Limitations

- Cash contributions are deductible up to 60% of AGI.
- Appreciated securities are deductible up to 30% of AGI. Proper modeling is required to ensure the “split” amounts do not unintentionally trigger carryforwards that push the deduction into low-income years (Year 3+).

### Key Takeaways

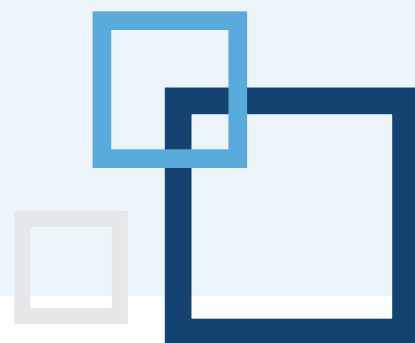
- You have to pay attention to the AGI cap. With \$500k in Year 2 income, you might be tempted to move \$500k of the gift to Year 2 to wipe it all out. However, the IRS limits your cash deduction to \$300,000 (60% of AGI). The optimized split (\$700k/\$300k) respects this limit while maximizing savings.
- Don't let the \$20MM distract you. It is easy to think that you have \$20 million in gains, I need a large deduction now. But deduction math is about rates, not total volume.
- The administrative effort is minimal. The return on optimizing this deployment timing is \$51,000.

**Note:** Charitable deductions do not reduce the 3.8% net investment Income tax (NIIT). Therefore, the “opportunity cost” of shifting the deduction away from capital gains is strictly the 20% Federal rate.



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