The Advisor

April 2018

ESTATE PLANNER'S TIP

High-net worth clients should consider taking advantage of several features of the Tax Cuts and Jobs Act, to position them to save taxes in future years. One option is to make lifetime gifts, sheltered by the gift tax credit ($11.2 million in 2018). Although transfers will come back into the gross estate as adjusted taxable gifts at death, if death occurs prior to 2026, the higher estate tax credit should cover any tax. The IRS has not yet determined what will happen if death occurs after 2025, when the credits are to revert back to 2018 levels, with inflation adjustments for the intervening years. Another strategy for wealthy widows and widowers is to take full advantage of the election for a deceased spouse's unused election amount (DSUE). A surviving spouse in 2018 could claim any remaining portion of a deceased spouse's $11.2 million exemption amount. The survivor would still have the larger unused amount, even if he or she died in 2026 or later, in addition to his or her own smaller exclusion, assuming the surviving spouse had not remarried.

HOME EQUITY LOAN INTEREST RULES CLARIFIED

Under the Tax Cuts and Jobs Act of 2017, interest on home equity loans was eliminated through 2025. The IRS has now clarified that, in some cases, the interest can continue to be deducted. Provided the home equity loan is used to buy, build or substantially improve the taxpayer's home that secures the loan, and that the total indebtedness does not exceed $750,000, the interest is deductible. If the home equity loan is used to pay personal living expenses, the interest is not deductible.

In IR-2018-32, the IRS gave three scenarios:

■ A taxpayer takes out a $500,000 mortgage to purchase a main home worth $800,000 and then takes out a $250,000 home equity loan to build an addition to the home. Both loans are secured by the home and the total does not exceed the cost of the home. Because the total amount of the loans does not exceed $750,000, all the interest is deductible. If the home equity loan proceeds had been used to pay off student loans or credit cards, the interest would not be deductible.

■ A taxpayer takes out a $500,000 mortgage to purchase a home. The loan is secured by the

home. The homeowner then takes out a $250,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of both mortgages does not exceed $750,000, the interest is deductible. If the taxpayer had instead taken out a $250,000 home equity loan secured by the main home to purchase the vacation home, the interest would not be deductible.

■ A taxpayer takes out a $500,000 mortgage to purchase a main home. The loan is secured by the home. The taxpayer then takes out a $500,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of the mortgages exceeds $750,000, only a portion of the interest is deductible.

ONE-TIME PAYMENT NOT ALIMONY

The divorce agreement entered into by Mark and Sherri Hexum called for Mark to pay the mortgage and expenses for the couple's home between the date of the divorce and the home's sale. During that time, Mark paid nearly $26,000, which he claimed was not marital property. The circuit court, rejecting his argument that he should be reimbursed for the expenses prior to splitting the sales proceeds, ordered him to pay Sherri half of the entire amount.

On his 2013 income tax return, Mark claimed an alimony deduction for the nearly $13,000 that he paid to Sherri. The IRS disallowed the deduction, saying that Mark's obligation to pay under state law would not have ended if Sherri had died prior to the sale of the house. Payments are not considered alimony unless the paying spouse has no further obligation after the death of the receiving spouse [Code §71(b)(1)(D)].

Mark acknowledged before the Tax Court that he would have continued to have an obligation to make payments even if Sherri died before the sale. He said that the funds would have gone to his sons, adding that he "wouldn't have a problem" with the money going to his children. The court agreed with the IRS that the payment was not alimony.

Mark appealed to the U.S. Court of Appeals (7th Cir.), saying that the payment must be alimony, since, according to his reading of state (Illinois) law, the increased equity was his property rather than marital property. The court found that unpersuasive, saying that Illinois law unambiguously provides that the payment would not terminate at Sherri's death and is categorized as either maintenance in gross or a property settlement, not alimony (*Hexum v. Comm'r.*, 2018-1 USTC ¶50,168).

PHILANTHROPY PUZZLER

Laura revised her will shortly before her death, leaving her entire $17 million estate to her favorite charity. Her only relative, a nephew, challenged the provisions, saying that Laura had promised to leave him a bequest from her estate in return for the years of service he had provided her. To avoid a protracted and costly legal battle, the nephew and charity agreed to split the estate. Laura's executor now wants to know whether the estate is entitled to a deduction for the portion passing to charity.

STATE HAS A RIGHT TO KNOW DONORS' NAMES

Citizens United, a 501(c)(3) organization, and Citizens United Foundation, exempt under 501(c)(4), annually since 1995 submitted their IRS Forms 990 to the New York Attorney General, but never included the sections of Schedule B that disclosed the identities of their donors. In 2013, Attorney General Eric Schneiderman notified the organizations that they had failed to comply with the state's disclosure requirements and faced revocation of their state solicitation privileges.

Both groups filed suit in state district court challenging the requirement, claiming the disclosure requirement prior to soliciting contributions was an unconstitutional prior restraint on speech

and the disclosure of names could intimidate donors. The court granted the attorney general's motion to dismiss, saying the complaint failed to state any First Amendment, preemption or New York constitutional violations. The groups appealed.

The disclosure regulations intimidate potential donors, said the groups, thereby reducing the groups' support and undermining their ability to engage in expression. This amounts to an unconstitutional prior restraint on their ability to solicit donations. The U.S. Court of Appeals (2nd Cir.) applied an exacting scrutiny standard, which requires a "substantial relation between the disclosure requirement and a sufficiently important governmental interest." The attorney general argued that knowing the source and amount of large donations helps the office carry out its responsibility to "protect the public from fraud and self-dealing among tax-exempt organizations." Disclosure of the donor list is "essential" to detecting fraud.

The court acknowledged the risk that the "confidential information will spring a leak," but that risk alone does not create constitutional problems. The "small extent of speech chilling is more than commensurate with the government's goal," said the court. The mere possibility of publication cannot be enough to prohibit the collection of donor information. The organizations will be prevented from soliciting contributions only if they fail to comply with "content-neutral, unambiguous and narrowly-drawn" disclosure rules, said the court, which ordered that the claim be dismissed with prejudice (*Citizens United and Citizens United Foundation v. Schneiderman,* Docket No. 16-3310).

COURT RESULTS NOT VERY "INTERESTING"

Lowell Patton established a 15-year charitable lead trust in 2003, naming five charities to receive annual distributions. Three family members were to receive the remainder when the trust terminated. The trustee had the authority to withhold any distributions, without interest, if the property "may be subject to conflicting claims, to tax deficiencies or to liabilities." Several years later, the real property funding the trust was sold for $3 million. No distributions had been made to the charities.

In 2006, Patton and the trustee sought to overturn the trust on the grounds of fraud. The charities were named as defendants. The suit was settled with four of the charities, resulting in $1.4 million in accumulated lead trust payments being made to Patton's church. The Ventura County Council Boy Scouts of America (VCC), which had not been part of the settlement, sought to compel a distribution from the trust.

The trial court directed the trust to distribute $238,669 – the amount VCC would have received in annual distributions – to VCC. VCC appealed the court's refusal to award interest, saying the order to compel the payments was an "implied finding" that the trustee breached the trust agreement.

The California Court of Appeals agreed with the trial court, noting that there was no finding of a breach of trust. Trust language expressly allowed the trustee to withhold annual payments in the event of conflicting claims and the trial court had ordered payments to be withheld pending court approval (*Patton v. Ventura County Council Boy Scouts of America*, 2d Civil No. B278628).

PUZZLER SOLUTION

Assuming Laura's will is otherwise valid (no duress or incapacity), the bequest to charity would have been deductible. Therefore, amounts passing to charity under a compromise agreement in settlement of a bona fide will contest with the nephew will be considered as transferred by Laura, as required under Reg. §20.2055-1(a), and will qualify for a charitable deduction [Reg. §20.2055-2(d)].

OPPORTUNITIES – AND DRAWBACKS – WITH S STOCK

According to IRS statistics, S corporations are the most prevalent type of corporation, representing more than 60% of all corporations. More than 8.8 million taxpayers own S corporation shares. S corporations differ from C corporations primarily in their tax treatment. Profits are taxed only once to S shareholders in proportion to their ownership interest, similar to a partnership, proprietorship or limited liability company. Under the Tax Cuts and Jobs Act of 2017, many S corporation owners will be entitled to a 20% deduction on the first $157,500 (single taxpayers) or $315,000 (married taxpayers) of S corporation income.

The charitable deduction for a gift made by an S corporation passes through to the shareholders and is deductible up to the donors' basis in their stock [Code §1366(d)(1)]. The 60% and 30% contribution ceilings that apply to individuals also apply to S corporation shareholders [Code §170(b)(1)].

S corporation stock may be transferred directly to charity without voiding the company's S election [Code §1361(c)(7)]. There are several differences, primarily for the charitable recipients, between gifts of S and C stock:

■ S shares may be more difficult to liquidate. Most charities immediately sell gifts of publicly traded stock. The market may be limited in the case of S stock and other closely held shares. A sale to a third party within a short time of the gift might be considered a prearranged sale by the IRS, with capital gains implications for the donor.

■ The donor's deduction will have to be reduced if there is any ordinary income element in the stock value (e.g., appreciated inventory). Ordinary income property is property which, if sold at fair market value on the date of the gift, would produce gain other than long-term capital gain [Reg. §1.170A-4(b)(1)].

■ If the charity does not or cannot sell the S stock, the charity will be subject to tax on its proportionate share of the corporation's income, even if all income is not distributed to the shareholders. Although only unrelated taxable income exceeding $1,000 is subject to tax, incorporated charities will pay tax on the excess at the 21% corporate rate. Charities organized as trusts will reach the top 37% bracket at UBTI of only $12,500 over the exempt amount (2018 level).

■ A donor of S stock may have a relatively low basis, which will carry over into the hands of the charitable donee, resulting in large capital gains upon a sale, greater UBTI and a lower net gift to the charity.

S corporation stock may not be contributed to charitable remainder trusts. S shares may be owned only by individuals, estates and special trusts known as qualifying subchapter S trusts (QSST). A QSST must distribute all of its income to only one individual who is a citizen or U.S. resident. An irrevocable election must be made to treat the trust as a QSST [Code §1361(d)]. These requirements conflict with the charitable remainder trust provisions of Code §664, which require that an annuity or unitrust amount, not all trust income, be paid annually to at least one individual, with the remainder passing to charity.

S corporations, as well as partnerships and LLCs, can be grantors of charitable remainder trusts that benefit the corporation (term-of-years trusts only) or a shareholder (for life or a term of years) but the shareholder will be taxed on a distribution. An S corporation could, for example, fund a charitable remainder trust using an asset such as undeveloped land. S corporations apparently can also establish charitable lead trusts. Such trusts may be an effective way for a family corporation to benefit charity and pass valuable appreciating assets to a child of the shareholders – at reduced transfer tax cost (Ltr. Rul. 9512002).

BALL STATE UNIVERSITY FOUNDATION
2800 W. Bethel Ave., Muncie, IN 47304
(765) 285-8312 • (765) 285-7060 FAX
bsu.edu/give

Cherí E. O'Neill
President and CEO

D. Mark Helmus
Senior Vice President
for Development

If you know another professional advisor who would benefit from this publication, please contact The Foundation.