

The Advisor



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ESTATE PLANNER'S TIP

Withholding and estimated tax payments deserve attention in the new year, with lower income tax rates in effect for many taxpayers. The goal should be to avoid refunds when 2018 income tax returns are filed in 2019 – or at least keep them to a minimum. Taxpayers must pay in at least 90% of the taxes owed for 2018 in the form of withholding or timely estimated tax payments to avoid a penalty [Code §6654]. Because it can be difficult for many taxpayers to know exactly how much they will owe, a safe harbor allows them to pay in 100% of the 2017 income tax liability (110% for those whose 2017 adjusted gross income exceeded \$150,000) [Code §6654(d)]. Part of clients' 2017 tax preparation and planning for 2018 should include a review of current withholding for those still employed and a fresh look at estimated quarterly payments.

DAF QUESTIONS ADDRESSED

The IRS recently issued guidance to donor advised fund sponsors, charities and taxpayers regarding incidental benefits and distributions to charities at which the taxpayer has an outstanding pledge.

Incidental benefits

An excise tax is imposed if a person advising a distribution from a DAF receives, directly or indirectly, a more than incidental benefit [Code §4967]. A DAF payment towards the price of a ticket to a charity-sponsored event, even where the account owner pays the non-charitable por-

tion, would be more than an incidental benefit. The IRS gave the example of a \$1,000 ticket to an event where \$900 is a charitable deduction and \$100 is considered the fair market value of the goods or services received (e.g., meal, greens fees). If the DAF distribution pays for the \$900, with the account owner paying the remaining \$100, the IRS said the DAF would be subsidizing the account owner's attendance or participation, resulting in more than an incidental benefit.

Pledges

Under Code §4941, it is self-dealing for a pri-

vate foundation to fulfill the legal obligation, such as a pledge, of a disqualified person. The IRS acknowledged that it can be difficult for the DAF sponsor to know if an account owner's pledge is legally binding or merely an indication of charitable intent. A distribution from a DAF to a charity to which the account owner has made a pledge, whether or not legally enforceable, will not be considered to be more than an incidental benefit, provided (1) the DAF sponsor does not reference the pledge when making the distribution, (2) the account owner receives no other benefit that is more than incidental and (3) the taxpayer does not attempt to claim an income tax charitable deduction under Code §170(a) with respect to the distribution, even if the receiving charity erroneously sends the donor substantiation that would constitute a contemporaneous written acknowledgment [Code §170(f)(8)] for an outright gift (Notice 2017-73).

HIGHER PUMP PRICES, HIGHER DEDUCTIONS

The IRS announced a one penny per mile increase in the standard mileage rate for business use of a vehicle. For 2018, the optional mileage rate increases from 53.5 cents to 54.5 cents per mile. For medical travel, the mileage rate is also

up one cent, from 17 cents to 18 cents per mile. The deduction allowed for charitable use of a personal vehicle is set at 14 cents per mile [Code §170(i)]. The mileage rate is in addition to the business deduction allowed for tolls and parking.

Taxpayers also have the option to keep records of actual expenses for maintenance, insurance and licenses and allocate the costs to the percentage of business use (IR-2017-204).

OOPS, SOCIAL SECURITY CORRECTS NUMBER

The maximum earnings subject to Social Security withholding in 2018 was originally announced as \$128,700, up from \$127,200 in 2017. The Social Security Administration recently issued a correction, lowering the amount to \$128,400. The error, it said, was due to corrected W2s provided by a national payroll service provider.

TRUST MODIFIED, BUT NO DEDUCTION ALLOWED

An unlimited deduction from gross income is allowed to trusts for amounts paid to charity during the year, pursuant to the terms of the governing instrument [Code §642(c)]. This is in lieu of the charitable deduction allowed to individuals under Code §170. A trust that did not provide for distributions to charity sought a judicial reformation to permit the grantor's child to exercise a power of appointment in favor of two foundations.

Under the laws of the state, trust modifications are allowed if they are consistent with a material purpose of the trust and not contrary to the grantor's probable intent. The IRS noted that the trust, which was not ambiguous, did not authorize charitable distributions during the lifetime of the beneficiaries.

Judicial reformations and settlement agreements will be given effect by the IRS if they arise from an ambiguity or will contest. In the case of

PHILANTHROPY PUZZLER

After attending a seminar on the advantages of charitable remainder trusts, Bob is considering contributing about \$250,000 in highly appreciated stock to fund a unitrust. In addition to the charitable deduction and avoidance of immediate capital gains on the sale of the stock, he would like to minimize income tax on his trust. He has asked if the trustee can sell the shares and reinvest in municipal bonds that would provide him with tax-free income. How do you respond?

this trust, however, the modification did not stem from a conflict. Therefore, said the IRS, the modification would not be considered to be the governing instrument for purposes of the deduction, since it changed the terms beyond the original intent of the trust.

The trust modification is not invalid and is considered binding on the parties under state law, said the IRS, but that treatment does not determine federal tax consequences. Because distributions to the foundations were outside the terms of the governing instrument, they did not qualify for the deduction (CCA 201747005).

NEW TAX LAW CHANGES 2018 NUMBERS

Many of the 2018 inflation-adjusted numbers were changed under The Tax Cuts and Jobs Act, signed into law on December 22. Among the numbers that changed:

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| Gift, estate, and generation-skipping transfer tax exclusion | \$11,200,000 |
| Standard deduction | |
| Single | 12,000 |
| Joint | 24,000 |
| Head of household | 18,000 |
| Married filing separately | 12,000 |
| Tax brackets | |
| 12% bracket starts | |
| Single | 9,525 |
| Joint | 19,050 |
| Head of household | 13,600 |
| Married filing separately | 9,525 |
| 22% bracket starts | |
| Single | 38,700 |
| Joint | 77,400 |
| Head of household | 51,850 |
| Married filing separately | 38,700 |
| 24% bracket starts | |
| Single, head of household, married filing separately | 82,500 |

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| Joint | \$165,000 |
| 32% bracket starts | |
| Single, head of household, married filing separately | 157,500 |
| Joint | 315,000 |
| 35% bracket starts | |
| Single, head of household, married filing separately | 200,000 |
| Joint | 400,000 |
| 37% bracket starts | |
| Single, head of household | 500,000 |
| Joint | 600,000 |
| Married filing separately | 300,000 |
| Alternative minimum tax exemptions | |
| Single, head of household | 70,300 |
| Joint | 109,400 |
| Married filing separately | 54,700 |

Personal and dependency exemptions, as well as the cutbacks to the exemptions and standard deductions, have been repealed.

PUZZLER SOLUTION

Under the four-tier system [Reg. §1.664-1(d)(1)], trust payouts are distributed in the following order: ordinary income first, then capital gain, "other" income (tax-exempt) and return of corpus. Because the trust would realize a capital gain on the sale of the stock, Bob's payout would not consist of tax-free income until all capital gains had been passed through, even if the trustee invests in municipal bonds. Tax-free income is possible immediately if the donor contributes cash or municipal bonds and the trustee invests in municipal bonds, but that plan may run afoul of state prudent investor rules. There can be no express or implied obligation for the trustee to invest in the municipal bonds (Rev. Rul. 60-370).

TIME TO SHINE FOR LIFE-INCOME GIFTS

With the estate tax exemption sheltering estates up to \$11,200,000 in 2018, clients who planned to make charitable bequests might want to accelerate their giving into life-income gifts. The larger income tax deductions available for charitable remainder trusts and charitable gift annuities could allow donors to exceed the higher standard deductions ushered in by The Tax Cuts and Jobs Act. The retained payments make the gifts nearly invisible for many donors. And if the gifts are funded with appreciated securities, donors enjoy capital gains tax savings.

Charitable remainder trusts

Paul and Stella planned to make a \$250,000 charitable bequest at the death of the survivor. Instead, the couple uses \$250,000 in securities for which they paid \$100,000, to fund a 5% charitable remainder unitrust. At their ages of 72 and 74, they are entitled to an income tax deduction of \$114,755 (assuming quarterly payments and a 2.6% §7520 rate) – far in excess of their standard deduction.

Paul and Stella will initially receive \$12,500 from the trust, with no loss to capital gains tax. If the value of the trust assets grows, so too will their annual payments. At the death of the survivor, trust assets will pass to their favorite charity, just as if they had included a bequest in a will or living trust.

Charitable gift annuities

Valerie, who inherited her father's home at his death last year, planned to put it up for sale. Her tax advisor suggested she instead use the home to fund a charitable gift annuity with a charity she and her father supported. She agrees to defer the start of annuity payments for two years, when she

would be ready to retire, and giving the charity time to sell the property. Thanks to the stepped-up basis, Valerie would not owe any capital gains tax if she sold the home.

Assuming the house is worth \$300,000 and Valerie is age 63, she would be entitled to an income tax deduction of more than \$111,800 (assuming quarterly payments and a 2.6% §7520 rate). Of the \$15,000 (5% annuity rate) Valerie starts receiving in two years, \$9,450 would be tax-free for her life expectancy.

"Gifts" without deductions

Clients who are age 70½ or older can take advantage of qualified charitable distributions (QCDs) from IRAs to support charities. Although no charitable deduction is available, the income tax that is normally owed on withdrawals is avoided on gifts up to \$100,000 annually. A QCD can take the place of required minimum distributions, reducing the donor's taxable income and saving tax, even without the deduction. The QCD must come directly from the IRA custodian and may pass only to public charities, not to donor advised funds or private foundations. A QCD may not be used to fund a charitable remainder trust or gift annuity.

Another option is an interest-free loan. Under Temp. Reg. §1.7872-5T(9), no interest is imputed on interest-free loans up to \$250,000 per charity. While the loan is outstanding, the donor removes any income that would be earned on the funds from his or her taxable income. The income charity earns from the borrowed amounts can "replace" gifts previously made by the donor. There is no charitable deduction since the gift is incomplete.

Cherí E. O'Neill
President and CEO

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

D. Mark Helmus
Senior Vice President
for Development