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Tax & Business Alert

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LIFETIME VERSUS TESTAMENTARY CONTRIBUTIONS

Many taxpayers with charitable intentions struggle with the decision of whether to donate property to charity during their lifetimes or to make a charitable bequest in their wills that will be fulfilled from property included in their estates (testamentary bequests). While taxpayers frequently base their choice between lifetime charitable gifts and testamentary bequests on nontax considerations, they need to be aware of the tax implications of their decision.

For income tax purposes, the deduction for charitable contributions is limited to a percentage of adjusted gross income (AGI), depending on the type of charity and the type of property donated. In contrast, no percentage limitation exists on the amount of charitable donations that may be deducted from the gross estate (as long as the donated property is included in the gross estate). However, in most instances a charitable gift during lifetime will provide a double tax benefit. The donation produces an income tax deduction at the time of the gift, plus the donated property and any future income and appreciation from the property are fully excluded from the donor's gross estate. The cost of the double benefit is giving up the property and all future income while the donor is still living.

Example: Greater tax benefits by lifetime giving.

Tom, who is in the top tax bracket, plans on leaving $1 million to a qualifying charity. If he makes a $1 million testamentary bequest, this could save his estate up to $400,000 ($1,000,000 × an assumed marginal federal estate tax rate of 40%). If Tom makes a current gift, this will save him up to $396,000 in federal income taxes ($1,000,000 × 39.6% for 2014). In addition, if he has a taxable estate, it could also save another $241,600 [($1,000,000 − $396,000) × 40%] based on his estate being reduced by the net amount of $604,000, the difference between the value of the donated property and income taxes he saved. Thus, the total income and estate tax savings from making a current gift is $637,600 ($396,000 + $241,600).

The donor generally must transfer his or her entire interest in the contributed property for the gift to qualify for the charitable donation income tax deduction. Transfers of less than the donor's entire interest in the property (i.e., split-interest gifts) qualify for the deduction only if they meet certain criteria.

A charitable bequest has the obvious advantage of allowing the donor full use of the property until death. However, many lifetime gifts can be structured in a manner that allows the donor to continue to use the property or receive its income for life. In these instances, the donor gets the double tax benefit associated with lifetime contributions while retaining some benefit from the property until his or her death. ■

WHEN IS A MARRIAGE TERMINATED FOR TAX PURPOSES?

A couple remains married for tax purposes until a final decree of divorce is issued by a domestic relations court; a domestic relations court issues a final decree constituting a legal separation under local law, requiring the couple to live apart; or the abandoned spouse rule applies.

An individual is required to live apart from his or her spouse for the entire last six months of the tax year to achieve abandoned spouse status. In some divorce situations, where the abandoned spouse rule does not apply, a spouse may be reluctant to file a joint return due to the joint and several tax liability resulting from joint returns. Accordingly, in situations in which the abandoned spouse rule cannot be met but a spouse is reluctant to file a joint return, one option is for the spouse to file under the status of married filing separately, then wait to determine if any instances of concern regarding joint and several tax liability arise, and then elect to file an amended joint return within three years of the original due date of the separately filed returns. An amended return can be filed under joint return status where separate returns had originally been filed. However, the amended return must be filed within three years of the original due date, excluding extensions, of the separate returns.

An individual who has not received either a decree of divorce or separate maintenance from a court as of the last day of a tax year and who fails to qualify as an abandoned spouse is considered married for tax purposes. The taxpayer must therefore file a joint return or file as married filing separate.

The potential tax savings from delaying the divorce to file a joint return may not justify the additional liability exposure created by the joint filing. In some instances, completing the divorce and terminating the marriage may in fact save income taxes.

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Once a marriage is terminated for tax purposes, the former spouses are no longer eligible to file a joint income tax return for that year. The individuals are then faced with the problem of dividing income and deductions on the divorce-year return. Also, special issues arise for allocating mortgage interest and taxes in divorce situations. Finally, the rules governing the reporting of income and deductions differ significantly between community property and equitable distribution states. ■

FILING STATUS FOR SEPARATED, DIVORCED, OR DIVORCING COUPLES

A divorced or divorcing couple's tax filing status is determined as of the last day of a tax year. A couple in the process of divorce may find that they are still married for tax purposes even though they do not live in the same household.

There are five filing categories for individuals. Married individuals can either file jointly, as married persons filing separate returns, or as head of household, if they qualify. Unmarried taxpayers generally file as single persons, but if certain criteria are met, they may qualify for head of household status or as a qualifying widow or widower.

PASSIVE ACTIVITY LOSS LIMITATIONS

The passive activity loss (PAL) rules were introduced by the Tax Reform Act of 1986 and were designed to curb perceived tax shelter abuses. However, the PAL rules are far-reaching and affect activities other than tax shelters. Additionally, these rules limit the deductibility of losses for federal income tax purposes.

The PAL rules provide that passive losses can only be used to offset passive income, not active income the owners may earn from business activities in which they materially participate or portfolio income they receive from investments, such as dividend and interest income. So, while taxpayers may not benefit currently from losses sustained from passive activities, they may be able to use those losses to offset gains in future years.

A *passive activity* is a trade or business in which the taxpayer does not materially participate or, with certain exceptions, any rental activity. Rental activities generally are passive regardless of whether the taxpayer materially participates. However, the rental real estate activities of certain qualifying taxpayers in real estate businesses are subject to the same general rule that applies to nonrental activities. In other words, if the taxpayer satisfies certain participation requirements, the rental activity is nonpassive and any losses or credits it generates can be used to offset the taxpayer's other nonpassive income. Additionally, federal regulations provide several exceptions to the general rule allowing a rental activity to be treated as either a trade or business or an investment activity.

A special rule allows taxpayers who actively participate in a rental activity to deduct up to $25,000 of loss from the activity each year regardless of the PAL rules. Examples of what would constitute active participation include approving new tenants, deciding on rental terms, and approving capital or repair expenditures. The $25,000 special allowance is, however, subject to a limitation. The $25,000 amount is reduced if the taxpayer has an adjusted gross income (AGI) (before passive losses) in excess of $100,000. The allowance is reduced by 50% of the amount by which AGI exceeds the $100,000 level. Consequently, the allowance is completely phased out when AGI exceeds $150,000. If taxpayers have rehabilitation or low-income housing credits, a special rule allows the credits to offset tax on nonpassive income of up to $25,000, regardless of the limitation based on AGI.

Another special rule is the exception for real estate professionals. This provision allows qualifying real estate professionals to deduct losses from rental real estate activities as nonpassive losses if they materially participate in the activity. To qualify as a real estate professional, a taxpayer must demonstrate that he or she spends more than 750 hours during the tax year in real property businesses in which they are a material participant. In addition, they must demonstrate that more than 50% of the services they perform in all of their businesses during the tax year are performed in real property businesses in which they materially participate.

Please contact us to discuss the passive activity provisions or any other tax planning or compliance issue. ■

MINIMUM REQUIRED DISTRIBUTION REMINDER

Taxpayers who turned 70½ in 2013 are required to take their first minimum required distribution (MRD) from a traditional IRA by April 1, 2014. In addition, their 2014 MRD must be taken by the end of 2014.

IRA owners nearing age 70½ should make sure their IRA trustee has the correct information to properly calculate their MRD. Failure to take required distributions will subject the owner to a 50% penalty on the amount not distributed.

TAXPAYER ADVOCATE REPORTS TO CONGRESS

National Taxpayer Advocate Nina E. Olson recently released her annual report to Congress, urging the Internal Revenue Service to adopt a comprehensive Taxpayer Bill of Rights (TBOR)—a step she said would increase trust in the agency and, more generally, strengthen its ability to serve taxpayers and collect tax. The Advocate also expressed deep concern that the IRS is not adequately funded to serve taxpayers, pointing out that the IRS annually receives more than 100 million telephone calls from taxpayers and that, in fiscal year 2013, the IRS could only answer 61% of calls from taxpayers seeking to speak with an IRS customer service representative.

The report reiterates the Advocate's longstanding recommendation that the IRS adopt a TBOR. In a prior report, Olson analyzed the IRS's processing of applications for tax-exempt status and concluded its procedures violated eight of the ten taxpayer rights she has proposed. The report argues that the rationale for a TBOR is much broader.

"Taxpayer rights are central to voluntary compliance," the report says. "If taxpayers believe they are treated, or can be treated, in an arbitrary and capricious manner, they will mistrust the tax system and be less likely to comply with the laws voluntarily. If taxpayers have confidence in the fairness and integrity of the system, they will be more likely to comply."

The report emphasizes that the U.S. tax system is built on voluntary compliance. Of all tax revenue the IRS collects, 98% is paid timely and voluntarily. Only 2% results from IRS enforcement actions. For the taxpayer, voluntary compliance means not having to face IRS enforcement. For the government, voluntary compliance is cheapest, because enforced compliance requires the IRS to devote resources to detecting and collecting amounts that are not voluntarily reported or paid. ■