Lifetime vs. 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 non-tax 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 x 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 x 39.6% for 2014). In addition, if he has a taxable estate, it could also save another $241,600 [($1,000,000 - $396,000) x 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.

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 non-rental activities. In other words, if the taxpayer satisfies certain participation requirements, the rental activity is non-passive and any losses or credits it generates can be used to offset the taxpayer's other non-passive 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 non-passive 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 non-passive 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.