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IRS Announces Exemptions for 2019 and Clarifies Post-TCJA Issues

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The Tax Cuts and Jobs Act (**TCJA**) of 2017 amended **Internal Revenue Code Section 2010(c)(3)** to provide that, for decedents dying and gifts made after December 31, 2017, and before January 1, 2026, the "basic exclusion amount" that acts as an equivalent exemption against federal gift and estate tax be increased from $5 million per taxpayer to $10 million per taxpayer, indexed for inflation.

Even after this significant increase in the amount individuals can pass on free of estate or gift tax, careful and creative charitable planning remains a vital tool—especially for those with estates that exceed the maximum equivalent exemption.

For instance, high-net-worth individuals can reap significant transfer-tax savings by employing a nongrantor charitable lead trust that directs a stream of payments to charity during the trust term and then distributes the remaining assets to noncharitable beneficiaries. While such vehicles do not generate income-tax deductions, they do generate gift- or estate-tax deductions equal to the present value of the charitable interest in the trust at the time of creation.

A donor who regularly makes large annual charitable gifts could decide, for example, to create a $10 million nongrantor lead trust that will make annual distributions of $500,000 to charity for 20 years, after which the remainder will pass to the donor's children. Because the present value of the charity's income is approximately $7.2 million, only the balance of approximately $2.8 million will be treated as a taxable transfer. Regardless of how much the trust grows during the trust term, no additional amount will ever be subjected to gift or estate tax when the remainder is distributed to the children.

Recent actions by the **IRS** related to gift and estate taxes may affect how taxpayers will conduct their planning, both charitable and noncharitable.

For 2019 the **IRS** has announced that the inflation-adjusted amount will be $11.4 million (Revenue Procedure 2018-57). This means that a couple could make up to $22.8 million of tax-free transfers. The amount of current gifts of present interests that are excluded from gift tax remains at $15,000 per donee.

TCJA also added **IRC § 2001(g)(2)**, which directs the Treasury to prescribe such regulations as may be necessary or appropriate to carry out **IRC § 2001** with respect to any difference between the basic exclusion amount **(BEA)** applicable at the time of a decedent's death and the **BEA** applicable with respect to any gifts made by the decedent for estate-tax purposes.

The issues this presents are especially important in light of the fact that, absent further action by Congress, the increased exemption amount created by **TCJA** goes away at the end of 2025 and the exemption reverts to $5 million adjusted for inflation on January 1, 2026. While it is theoretically possible that the equivalent exemption amount could go down from one year to the next between 2019 and 2025, the major question is what happens starting in 2026.

The Treasury has responded to **IRC § 2001(g)(2)** by announcing Proposed Regulations. It has announced a public hearing on those proposed regulations for March 13, 2019, and set a deadline of February 21, 2019, for receiving comments.

These proposed regulations attempt to address the thorny issues raised by the increase in the equivalent exemption and its subsequent reversion to pre-2018 levels under **TCJA**. The Background section of the proposed regulations discusses several scenarios:

1. **Impact of pre-2018 gifts on which gift tax was actually paid on the BEA available. Conclusion:** The increased **BEA** is reduced only by the amount of **BEA** allowable against the pre-2018 gifts, not by the entire amount of the transfer.

2. **Impact of pre-2018 gifts on which gift tax was actually paid when a decedent dies during the increased BEA period. Conclusion:** The results are the same as in number 1 above. The increased **BEA** is reduced only by the amount of **BEA** applied to the pre-2018 gift, not the entire transfer.

3. **Effect of decrease in BEA on gift tax.** In other words, if the amount of exemption used between 2019 and 2025 is greater than the exemption amount available after 2025, will the excess be deemed to be a taxable transfer? **Conclusion:** No. According to the language of the proposed regulations, "[T]his would effectively reverse the benefit of the increased **BEA** available for gifts made during the increased **BEA** period."

4. **Effect of decrease in BEA on estate tax.** How does a drop in the **BEA** after 2025 affect the estate tax for a decedent who dies after 2025 and who made gifts during life the tax on which was fully or partially sheltered by a **BEA** larger than the amount in effect at the date of death? **Conclusion:** A literal reading of the application of **IRC § 2001(b)**, which sets out the steps for calculating estate tax, would subject any amount of the **BEA** in effect at the time of the lifetime transfer that is in excess to the **BEA** in effect at the time of death to federal estate tax.

That, of course, is a huge potential problem. The proposed regulations offer an example of a decedent who made an $11 million gift in 2018 when the **BEA** was $10 million and dies in 2026 with a taxable estate of $4 million when the **BEA** is $5 million. A literal reading of **IRC § 2001(b)** would lead to a conclusion that the decedent's taxable estate would be $9 million—the $4 million the decedent has at the date of death and the $5 million by which the **BEA** in effect in 2018 exceeded the $5 million **BEA** in effect in 2026. Estate tax would be $3,600,000 (40% of $9 million).

It follows with an even more extreme example in which the facts are the same except the decedent dies with no taxable estate. Even with no taxable estate at death, estate tax would be $2 million (40% of the $5 million by which the **BEA** in existence in 2018 exceeds the $5 million in effect in 2026).

The proposed regulations would address this problem by amending Regs. **§ 20.2010-1** to provide a special rule in these kinds of situations. That rule would, in effect, change the computation of estate tax to allow any amount sheltered from gift tax by some or all of a **BEA** higher than the **BEA** in effect at the date of death to be exempt from estate tax.

It is important to note that the proposed regulations also indicate that only the amount of the increased **BEA** used to shelter gifts during the increased **BEA** period will be available in determining estate tax after 2025. For example, if a taxpayer makes $9 million of taxable transfers prior to 2026 and, therefore, uses $9 million of the available $10 million equivalent exemption, the balance of $1 million will not carry forward to be used against post-2025 estate tax. (**NOTE: The equivalent exemption amounts noted in the examples above are not adjusted for inflation.**)

When a Gift Is Not a Gift

A recent Tax Court case addresses the intriguing question of when transfer of funds constitutes a gift and when it constitutes taxable income (Felton v Commissioner, T.C. Memo. 2018-168, October 10, 2018).

Members of a St. Paul, Minnesota, church could choose to make their contributions in three different envelopes, each of a different color. According to church policy, contributions in white envelopes were deemed to be contributions for general purposes for the general operation of the church. Those in gold envelopes were for special programs and projects. The church provided reports and receipts to members for funds received in white and gold envelopes and treated them as tax-deductible contributions.

However, if church members wanted to make what they understood to be a nondeductible gift directly to their pastor, Reverend Wayne Felton, they did so in blue envelopes—understanding that the contributions would not be recorded as tax-deductible gifts but rather treated as personal gifts to the pastor.

Based on this long-standing process, Reverend Felton did not report any of the gifts earmarked for him in the blue envelopes when he filed his income tax. The **IRS**, however, viewed them differently and wants back taxes and penalties for 2008 and 2009, the years in question in this case. The amounts given in blue envelopes for those years were, respectively, $258,001 and $234,826.

The court was personally complimentary of Reverend Felton and his wife for their hard work in serving the church and in planting multiple additional churches around the country and around the world. It noted that he regularly followed the direction and policies of the board and that while the board did budget a salary for him, he did not take it. He did though, take a $6,500 per month parsonage allowance that Reverend Felton himself classified as a "very, very nice and handsome housing allowance" that was nontaxable to the extent it was used for qualifying housing expenses.

The white envelopes did have a line that could be checked to designate gifts for compensation for Reverend Felton—and which the donors understood to be deductible for themselves—and the Feltons also received funds from a separate counseling business. As such, they reported approximately $70,000-$80,000 for taxable compensation each year in 2008 and 2009. However, they also claimed approximately $50,000 each year for charitable contributions which, along with other deductions and exemptions, resulted in no taxable income.

The court conceded that blue envelopes were not routinely distributed but only given out by ushers when one was requested by a member of the congregation. However, they also concluded that amounts given in those envelopes were intended to provide incentive for Reverend Felton to continue preaching at their church, which would call into question whether the gifts were given in "detached and disinterested generosity."

It also believed receipt of those donations was pursuant to a "routinized, highly structured program." Ironically, the court opined that the very existence of the blue envelope system itself was evidence of such a structured program. This weighed against finding the contributions to be gifts as opposed to taxable compensation.

In addition, the Court determined that the fact that Reverend Felton did not receive a separate salary from the church supported a conclusion that the "gifts" in the blue envelopes really were intended to be his primary compensation, notwithstanding the extremely generous nature of his parsonage allowance. Accordingly, the Court upheld the **IRS**'s claim for underpayment of taxes and also upheld the application of penalties for failure to timely file and for accuracy-related penalties.

IRS: Advertising Income Is Not UBTI

Many charitable organizations publish journals, yearbooks, and various other publications in the course of and in pursuit of their exempt purposes. Occasionally such publications contain advertisements, a fact that reasonably raises the question: "When does receipt of advertising revenue constitute unrelated business activity giving rise to unrelated business taxable income?"

The **IRS** addresses such a situation in a recent Technical Advice Memorandum (TAM 201837014).

The charity in question publishes a scholarly journal. It has contracted with a company to publish the journal. The agreement provides that the charity will cover all expenses of gathering and preparing editorial materials in the journal and also provides that the publisher will pay an annual stipend for salaries and expenses of the journal's editorial office and expenses for the annual editorial board meeting.

Beyond that, the publisher will "publish, produce, sell, distribute, and internationally promote the Journal at its own expense" and will be responsible for fulfilling subscription orders. In essence, this allows the charity to be able to have a journal at little or no expense to the organization.

This raises the question of what is in it for the publisher? The publisher also has the sole responsibility for selling advertising space in the journal at rates determined in the publisher's sole discretion, with the charity reserving only the right to ensure the advertisements meet its reasonable advertising standards. Subject to a few minor provisions, the publisher retains the revenue from the sale of advertisements.

The agreement does call for payment of "earned royalties" to the charity based on a percentage of "revenues," but advertising revenues are specifically excluded from the definition of "revenues" for this purpose. Presumably, the majority of revenues would come in the form of subscriptions for the magazine.

In analyzing the case, the **IRS** turned to **IRC § 512(a)** for definition of the term "unrelated business taxable income." A key element of that definition is a requirement that the activity generating the revenue be "regularly carried on" by the entity.

The memorandum also noted that Regs. **§ 1.513-1(b)** provides that activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical that contains editorial matter related to the exempt purpose of the organization.

That turned the focus clearly on whether or not the charity was regularly involved in the business of selling advertising. After citing several prior cases for purposes of comparison, the memorandum concluded that, based on the facts in this case, there was no indication that the charity engaged in any advertising activities or that any portion of the payment from the publisher was attributable to the advertising. Thus it was the publisher, not the charity, involved in the business of selling advertising, and the charity did not receive any unrelated business taxable income from advertising.

Briefly…

Gift to private foundation deemed "qualified stock." A recent private letter ruling determined that a contribution of stock by an LLC constituted a gift of "qualified stock" and was deductible at fair-market value (PLR 201848005). A revocable trust was the sole member of the LLC, and the taxpayer ultimately affected by the outcome was the sole settlor and trustee of the trust. Because of application of insider trading considerations under SEC Rule 10-b(5)-1 and volume issues under SEC Rule 144(e), the nature of involvement and activity of an additional trust and an additional LLC came into play in the analysis.

The ruling relied on representations that the collective parties had not contributed an aggregate of more than 10% of the corporate stock to a nonoperating private foundation and that no transfers would otherwise run afoul of SEC requirements. Therefore, since the stock contributed had appreciated beyond its adjusted basis, had been held more than one year, and was publicly traded on exchanges for which there were readily available quotes, it constituted qualified stock within the meaning of **IRC § 170(e)(5)(B)** and was deductible at fair-market value.

CRUTs with charitable and noncharitable beneficiaries qualified. The **IRS** has determined that a pair of charitable remainder unitrusts with both charitable and noncharitable income beneficiaries will be treated as qualifying CRUTs (PLR 201845014). A taxpayer had proposed to create a pair of trusts, the first of which would name him an income beneficiary along with one or more qualified charities. The second would be similar except that his wife, if she survives him, would be an income beneficiary along with charitable beneficiaries.

The trusts provided that the amount paid to either the taxpayer or his wife would be subject to determination by an independent trustee to be at least the minimum amount that would be deemed not to be de minimis—and the balance of the required annual unitrust amount would be payable to charitable beneficiaries. Because the amount payable to the noncharitable beneficiaries was required to be more than de minimis, the trusts would qualify as CRUTs.

Further, the ruling found that since the settlor had retained the right to revoke his wife's survivor interest and to change the identity of the charitable income beneficiaries, those gifts would not be complete for gift or estate tax. In addition, it confirmed that upon the death of the settlor the amount passing to charity in the trust in which he was the only noncharitable beneficiary would qualify for an estate-tax charitable deduction—and in the case of the other trust, any interest passing to his wife, if she survives him, would qualify for the estate-tax marital deduction and the interest passing to charity would qualify for the estate-tax charitable deduction.

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