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Monthly Updates

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Donor-Advised Funds: A Tax Planning Tool for Church and Charity Donations

Do you give money to 501(c)(3) charities?

Do you get a tax benefit from those donations?

Recent changes in the tax code have done much to destroy your benefits from church and other tax-deductible 501(c)(3) donations. But there's a way to donate the way you want, get revenge on the tax code, and realize the tax benefits you deserve.

This get-even tool is the donor-advised fund, an increasingly popular way to donate to your church and other 501(c)(3) organizations. Indeed, donor-advised funds have exploded over the past few years, with over one million donor-advised fund accounts in existence as of 2020.

Example. You donate $100,000 to the fund today. You get the $100,000 deduction now. From the fund, you donate $10,000 a year to a charitable organization (probably more as your money in the fund grows tax-free).

National investment firms such as Fidelity, Schwab, and Vanguard have all created donor-advised funds. These "commercial" donor-advised funds hire an affiliated for-profit investment firm to manage the assets in the accounts for a fee that varies based on the account balance.

You can also establish a donor-advised fund account with a community foundation that has a local orientation; a single-issue non-profit, such as a university or an environmental charity like the Sierra Club; or an independent, non-commercial organization such as the American Endowment Foundation, National Philanthropic Trust, or United Charitable.

You can always donate cash, including money in IRAs and 401(k)s, to your donor-advised fund account. But many donor-advised funds also accept non-cash donations, including

- stocks, bonds, and mutual fund shares,
- real estate,
- privately owned company stock,
- LLC and limited partnership interests,
- Bitcoin and other cryptocurrency, and
- life insurance.

Donating stock or mutual fund shares that have appreciated is a great tax strategy. Here's why:

- If you owned the stock for more than one year, you get a deduction equal to its fair market value at the time of the donation.
- And you don't pay any capital gains tax on the appreciated value of the stock.

Example. Dennis owns 1,000 shares of Evergreen stock that's publicly traded on NASDAQ. He paid $10,000 for the stock back in 2010, and the shares are worth $100,000 today.

He establishes a donor-advised fund in 2022 and donates the stock.

- He gets a $100,000 charitable deduction for 2022.
- He pays no federal tax on his $90,000 gain.

As you can see, there are many benefits to donor-advised funds for the charitably inclined, and few drawbacks.

Transferring Your Home to Your Adult Child

With today's home prices and the crazy real estate market, it's likely difficult for your children to buy a home. And it's conceivable that you are ready to move on from your existing home.

If this is true, consider the three options below.

Option 1: Make an Outright Gift

Say you're feeling so generous that you might just simply give your home to your adult child. What a deal for the kid!

Tax-wise, if you make the gift this year, it will reduce your $12.06 million unified federal gift and estate tax exemption. To calculate the impact, reduce the fair market value of the home you would be giving away by the annual federal gift tax exclusion, which is $16,000 for 2022. The remainder is the amount that would reduce your unified federal exemption.

If you're married, your spouse has a separate $12.06 million unified federal exemption. If you and your spouse make a joint gift of the home, each of your unified federal exemptions will be reduced. To calculate the impact, take half of the fair market value of the home minus the $16,000 annual exclusion. The remainder is the amount by which you would reduce your unified federal exemption. Ditto for your spouse's separate exemption.

If your child is married and you give the home to your child and his or her spouse, you can claim a separate $16,000 annual exclusion for your child's spouse.

If you expect the home to continue to appreciate (seemingly a pretty good bet), getting it out of your estate by giving it away is a good estate-tax-avoidance strategy.

Option 2: Arrange a Bargain Sale

Say you're feeling generous, but not so generous that you want to simply give away your home. Fair enough.

Consider selling the home to your child for less than fair market value. For federal gift tax purposes, this is treated as a gift of the difference between the home's fair market value and the bargain sale price. Tax-wise, this can work out okay.

Warning. Do *not* make a bargain sale or an outright gift of the home if you intend to continue living there until you die. In these scenarios, expect the IRS to argue that the home's full date-of-death fair market value must be included in your estate for federal estate tax purposes, even if you were paying fair market rent to your child.

Option 3: Arrange Full-Price Sale with Seller Financing from You

The idea of giving your child a free house might be unappealing to you. Very well.

Consider selling the home to your child for its current fair market value with you taking back a note for a big part of the purchase price.

Assume you're feeling charitable. If so, you can charge the lowest interest rate the IRS allows without any weird tax consequences. That's called the "applicable federal rate" (AFR).

AFRs change monthly in response to bond market conditions and are generally well below commercial rates. In May 2022, the long-term AFR, for loans of more than nine years, is only 2.66 percent (assuming annual compounding). The mid-term AFR, for loans of more than three years but not more than nine years, is only 2.51 percent (assuming annual compounding).

As this was written, the going rate nationally for a 30-year fixed-rate commercial mortgage was around 6.1 percent, while the rate for a 15-year loan was around 5.1 percent.
So, for a loan made in May 2022, you could take back a 30-year note that charges the long-term AFR of only 2.66 percent. Alternatively, you could take back a nine-year note that charges the mid-term AFR of only 2.51 percent. Either arrangement would be a money-saving deal for your child.

Selling Your Appreciated Vacation Home? Consider the Taxes

The tax-code-defined vacation home rules come into play when you have both rental and personal use of a home. Thus, you can have tax-code-defined vacation homes in the city, in the suburbs, and in recreation areas.

If you have no combined rental and personal use of the home, the rules are easy. The property is one of the following:

- Principal residence
- Second home
- Rental property

But when you have both rental and personal use of the home, your tax life gets more complicated because you have entered the tax code's vacation home section. In this situation, the property in a more complicated way is one of the following:

- Principal residence
- Second home
- Rental property

If it's a **principal residence**, then the $250,000/$500,000 home sale exclusion is available when you sell.

If it's simply a **second home**, you can't use the exclusion and you pay taxes at capital gains rates—and you may suffer the net investment income tax (NIIT) as well.

If it's a **rental**, you face the capital gains rules, NIIT, unrecaptured Section 1250 gain taxes, and release of some (if grouped) or all (if not grouped) passive activity suspended losses.

When you have rental use after 2008 and then convert the rental to your principal residence, you must use a rental/residence fraction to determine how you will be taxed.

Tips for changing California residency/domicile

Although it's not impossible to change residency, someone who wants to move out of California has to truly relocate to the new state and sever ties with California, which is not as easy to do as it sounds. Here

are 10 items (in no particular order) that clients should be aware of if they want to survive a residency audit.

First, break all meaningful ties with California. It's not enough to build new ties with another state if ties with California do not significantly decrease. For example, keeping the family home in California, and/or continuing to use long-time professionals in California, can cause problems in an audit and should be carefully thought out.

Build solid new ties with another state that are, at a bare minimum, comparable to the ties in California. It's not enough to break California ties if you don't reestablish yourself permanently somewhere else.

Any return trips to California after the move need to be for a "temporary or transitory purpose." Returning back to California to visit family, for vacations, for business trips, for medical treatment, etc., should all be fine as a nonresident as long as they're carefully managed.

Also, watch the timing of the change. It's one thing to move out of California and successfully change your residency or domicile to another state., but precisely when did that change take place? Remember that auditors often take a dim view of residency changes that happened to occur just before a large income event, which can result in a tougher burden to show a genuine move took place.

Watch out for California-source income issues. Consider and understand if there's income that has a California source because a change of residency won't keep that income from being taxed by the FTB. Nonresident sourcing was a major issue in the infamous Hyatt residency appeal, which dragged on for years.

Be careful of conduct after the move, too. California has a four-year period to audit the return, and the FTB may assume that a taxpayer really didn't move in Year 1 after all, if they increased their ties back to California in the immediate subsequent years.

Be aware that it's possible, although not frequent, that spouses may have different residences or domiciles, either as filed or as a result of an audit. If this is the case, keep in mind that community property needs to be divided between them.

Document the move contemporaneously, which is always preferred in an audit over documentation created after the fact. Although, it's common practice to obtain affidavits or declarations from the taxpayer, their friends, employers, or business associates in responses to issues raised by the FTB at audit.

Be prepared for an audit, and then be pleasantly surprised if it doesn't happen. The larger the potential tax effect from a change on audit, the more likely there will be an audit because of the way the FTB allocates audit resources.

And last, remember that taxes are an expense that's part of life, so consider whether it's worth it to give up a medical specialist you have a 20-year history with in California just because it might strengthen a potential residency audit position. Choosing the best tax-driven decision might not be the same as the best life-driven decision.

California Passthrough Entities Should Consider Making Passthrough Entity Elective Tax (PTET)

California passthrough entities such as partnerships, LLCs, and S-corporations can make an election to pay a passthrough entity elective tax (PTET) equal to 9.3% of its qualified net income. This state tax payment is a deduction on the federal tax return and passed through to the owners on Form K1. This bypasses the IRS Schedule A $10,000 State and Local Tax deduction limit.

For 2022, the entity will need to make a payment by June 15, 2022 in order to make this election. The payment is the greater of 50% of the elective tax paid for 2021 or $1,000.

Accordingly, if the PTET election was not made in 2021, then the payment for June 15, 2022, is $1,000. If your clients are not sure they are going to make the PTET election for 2022, they should make this $1,000 payment for their passthrough entity. Otherwise, the PTET election will not be available to them.

If clients do decide to make the PTET election for 2022, the remaining amount is due by the entity's original filing date deadline, March 15, 2023, for calendar-year entities. However, if the owners want to deduct the payment made to the Franchise Tax Board, the payment needs to be made by December 31, 2022, regardless of their method of accounting.

The PTE's bookkeeping may not be complete by December 31, 2022, so it would make sense to pay a little extra. If they come up short, the remainder is paid on March 15, 2023. However, if the balance is not paid by March 15, 2023, then interest and penalties will apply.

The payment is made with FTB Form 3893 Pass-Through Entity Elective Tax Payment Voucher. We are recommending all payments be made via the FTB Webpay Business portal.

Finally, if you are contemplating a large taxable transaction in your S Corporation or Partnership such as sale of real estate, you should consider taking advantage of the PTET for 2022. However, if you find out you may have a large taxable transaction after June 15, see if the transaction can be closed in January 2023 instead to be able to take advantage of the PTET in 2023.

Upcoming due dates

June 15

- 2nd Qtr Federal and State Estimated income tax payments.
- 2022 CA AB 150 Withholding payment greater of $1000 or 50% of the 2021 payment is due in order to participate in the 2022 AB 150 election. (S Corporations and Partnerships)

June 30th

- Calsavers Registration Deadline - The CalSavers program is a state-administered Roth-like retirement plan that's available to California employees who are working for businesses that don't offer a retirement plan. Employers who already offer a retirement plan to their employees are exempt, which means they're not required to enroll their employees.

  June 30, 2022, is the registration deadline for nonexempt employers with five or more California W-2 employees, at least one of whom is at least age 18.

  If a nonexempt employer fails to register for the program, significant penalties can result.

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