TAX IMPACT

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Tax Tips

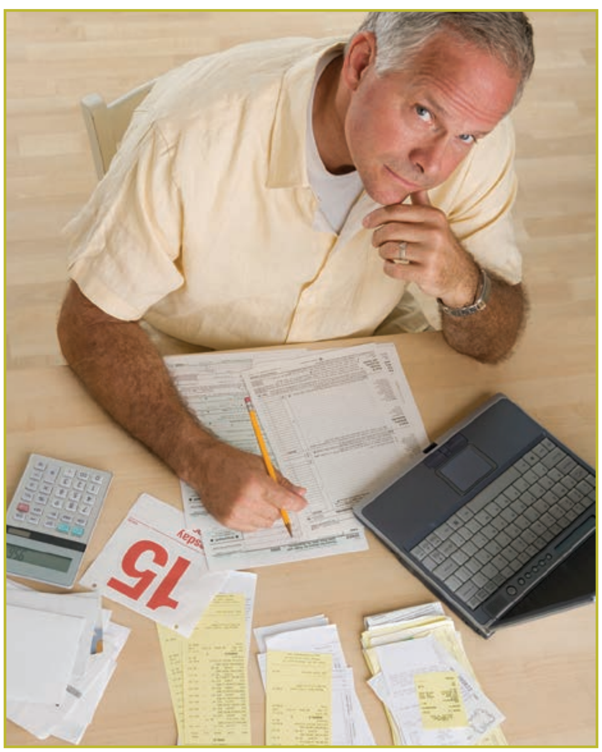
Deduct now, donate later

Donor-advised funds offer significant benefits

If you're planning to make significant charitable donations, consider a donor-advised fund (DAF). DAFs offer many of the tax and estate planning benefits of private foundations, at a fraction of the cost. (See "DAFs vs. private foundations" on page 3.) Most important, they allow you to take a significant charitable income tax deduction *now*, while deferring decisions about how much to give — and to whom — until the time is right.

What is a DAF?

A DAF is a tax-advantaged investment account administered by a not-for-profit "sponsoring organization," such as a community foundation or the charitable arm of a financial services firm. Contributions are treated as gifts to a Section 501(c)(3) public charity, which are deductible up to 50% of adjusted gross income (AGI) for cash contributions and up to 30% of AGI for contributions of appreciated property (such as stock). Like other gifts to public charities, unused deductions may be carried forward for up to five years. And funds grow tax-free until they're distributed.



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Although contributions are irrevocable, you're allowed to name the account and recommend how the funds will be invested (among the options offered by the DAF) and distributed to charities over time. You can even name a successor advisor, or prepare written instructions, to recommend investments and charitable gifts after your death.

Technically, a DAF isn't bound to follow your recommendations. But in practice, DAFs almost always respect their donors' wishes — otherwise, they'd have a hard time attracting contributions. Generally, the only time a fund will refuse a donor's request is if the intended recipient isn't a qualified charity.

What are the benefits?

DAFs offer a variety of valuable benefits, such as:

Immediate tax deduction. The ability to deduct DAF contributions immediately but make gifts to charities later is a big advantage. Consider this scenario: Rhonda typically earns around $150,000 in AGI each year. In 2016, however, she sells her business, lifting her income to $5 million for the year. Rhonda decides to donate $500,000 to charity, but she wants to take some time to investigate charities and spend her charitable dollars wisely. By placing $500,000 in a DAF this year, she can deduct the full amount immediately and decide how to distribute the funds in the coming years. If she waits until next year to make charitable donations, her deduction will be limited to $75,000 per year (50% of her AGI).

Even if you have a particular charity in mind, spreading your donations over several years can be a good strategy. It gives you time to evaluate whether the charity is using the funds responsibly before you make additional gifts. A DAF allows you to adopt this strategy without losing the ability to deduct the full amount in the year when it will do you the most good.

Another benefit of making donations in a big income year is that the higher the donor's tax bracket, the more valuable the deduction.

Capital gains avoidance. An effective charitable-giving strategy is to donate appreciated assets — such as securities, real estate or interests in a business. You're entitled to deduct the property's fair market value and you can avoid the capital gains taxes you would have owed had you sold the property. But not all charities are equipped to accept and manage this type of donation. Many DAFs, however, have the resources to accept contributions of appreciated assets, liquidate them and then reinvest the proceeds.

Ease of use. DAFs can greatly simplify the estate planning and charitable giving process, substantially reducing your costs. Once you've established a DAF, making a charitable gift is simply a matter of sending instructions to the sponsor. The sponsor takes care of confirming the charity's tax-exempt status, sending the contribution and obtaining necessary acknowledgments.

A DAF also enables you to streamline your estate plan by setting up a single vehicle for all of your charitable bequests. By naming a DAF, rather than individual charities, as a beneficiary of your will, trusts, retirement accounts or life insurance policies, you avoid the hassle and expense of modifying these documents if your charitable priorities change.

Anonymity. Making anonymous gifts to individual charities, while obtaining IRS-required acknowledgments, can be a challenge, particularly for noncash donations. But, when you use a DAF, the sponsor handles the transaction, making it easy to protect your privacy if you so desire.

Do your homework

If you're contemplating a DAF, be sure to shop around. Fund requirements — such as minimum contributions, minimum grant amounts and investment options — vary from fund to fund, as do the fees they charge. So, work with your financial advisor to find a fund that meets your needs. ■

DAFs vs. private foundations

Donor-advised funds are similar to private foundations in that they allow you to make tax-deductible contributions while retaining the right to make charitable gifts over time. But foundations are expensive to set up and administer, and they're subject to excise taxes, minimum distribution requirements and lower contribution limits (30% of AGI for cash; 20% for appreciated property).

Private foundations offer important advantages, however, for those who can afford them. For example, they give you complete control over investments and gifts, they're permitted to compensate family members who work for the foundation, and they're allowed to make gifts to individuals (such as scholarships or grants) under certain circumstances.

Is it time to revisit captive insurance?

Many businesses, both large and small, use captive insurance companies to meet their risk management needs while controlling costs and reducing taxes. Recent developments have created new opportunities to take advantage of captives. At the same time, new restrictions designed to curb perceived abuses of "microcaptives" may require some companies to modify their captives' ownership structures.

Captive benefits

Captives can be structured in many ways, but essentially they're insurance companies owned and controlled by those they insure. Benefits include access to coverage that's unavailable (or prohibitively expensive) commercially, stable premiums, lower administrative costs, and participation in the captive's underwriting profits and investment income.

Captives offer significant tax advantages. For example, unlike self-insurance reserves, premiums paid to a captive are deductible. And, as an insurance company, the captive can deduct most of its loss reserves. "Microcaptives" — those with annual premiums of $1.2 million or less — enjoy even greater tax advantages. They may elect to exclude premiums from their income and pay taxes only on their net investment income (although they'll lose certain deductions).

A captive can also be a powerful estate planning tool. By placing ownership of a captive in the hands of family members, business owners can transfer wealth to their heirs free of gift and estate taxes.

To provide these benefits, a captive must qualify as an insurance company for federal income tax purposes. Among other things, that means premiums must be priced properly based on actuarial and underwriting considerations and the arrangement must involve sufficient distribution of risk.

There's no "bright-line test" for risk distribution, but the IRS has ruled that it exists when a wholly owned captive:

1. Insures the parent's 12 operating subsidiaries, none of which pay more than 15% of the premiums, or

2. Receives more than 50% of its premiums from unrelated third parties.

A captive that insures only the risks of its parent does *not*, in the IRS's view, distribute risk.

Recent developments

Several new Tax Court cases may create fresh opportunities for companies to establish captives.

In the court's view, risk distribution exists when there's a large enough pool of unrelated risks, regardless of the number of entities involved. In other words, a captive achieves risk distribution if coverage is spread over a sufficient number of employees, facilities, vehicles, products or services, even if they're all part of the same entity. It's not certain, though, how the IRS will react to such arrangements.

Last year's Protecting Americans from Tax Hikes (PATH) Act has a big impact on microcaptives. Beginning in 2017, the premium limit goes from $1.2 million to $2.2 million, making this vehicle available to more companies. But at the same time, to combat perceived abuses, the act establishes a "diversification" requirement that will be monitored through annual information returns. To qualify, a captive must meet *one* of these two tests: 1) No more than 20% of premiums come from any one insured, or 2) ownership of the captive mirrors (within a 2% margin) ownership of the insured business.

The first test may be difficult for smaller captives to meet. The second test essentially prohibits the use of a microcaptive as an estate planning tool.

Review your insurance arrangements

The recent developments described above may open up captive insurance to more businesses, so if you've ever considered establishing a captive, now's a good time to revisit this strategy. If your business owns a captive, you have until January 1, 2017, to determine whether it meets the new diversification requirement and to restructure it, if necessary, to comply with that requirement. ■

Why you may need a prenup

Prenups usually become relevant when a couple gets divorced. But they also provide several benefits for successful marriages, including protection from liability for your spouse's separate debts and implementation of estate planning strategies.

Most states give a surviving spouse certain rights to a deceased spouse's property. In community property states, for example, a surviving spouse enjoys a 50% interest in all community property. In most other states, surviving spouses can choose to receive an "elective share" amount — usually between one-third and one-half of the deceased spouse's estate.

These rights supersede the terms of a will, but they can be waived in a prenup, which doesn't necessarily mean that you'll be disinheriting your

spouse. Prenups typically preserve a spouse's right to receive a substantial portion of the other spouse's wealth. But by waiving marital property rights, they allow you to specify the manner in which your assets will be distributed and ensure that your estate plan will operate as intended.

Suppose, for example, that you own a closely held business that you run with your children from a previous marriage. Assume further that the business makes up 75% of your net worth and you want your children to inherit it. A prenup can prevent your spouse from acquiring an interest in the business — either through a divorce or spousal inheritance rights — while preserving his or her right to the other 25% of your estate.

How it works

A prenup should work in concert with your estate plan, rather than against it. For example, if you use a premarital transfer, each party must provide "adequate consideration" for the agreement to be legally enforceable. That is, the parties must exchange items or promises of comparable value to create a binding contract. Typically, prenups transfer property rights from one spouse to the other in exchange for the release of certain marital rights. But if the transfer takes place before marriage, it can trigger income and gift taxes.

The best strategy is to make the transfer after the wedding, because transfers between spouses generally are exempt from both income and gift taxes. However, there are exceptions when a non-U.S. citizen spouse is involved.

Maximizing the estate tax exemption

For couples with larger estates, an important goal of estate planning is to maximize the use of each spouse's estate tax exemption ($5.45 million for 2016). Often, this is accomplished by placing assets up to the exemption amount in a credit shelter trust. The excess amount would then be distributed to the surviving spouse, either outright or in a marital trust.

If a prenup distributes too much to the surviving spouse, it can leave the credit shelter trust underfunded, triggering unnecessary estate taxes in the surviving spouse's estate. A prenup should have the flexibility to accommodate this estate planning strategy and adapt to future changes in the exemption amount.

A prenup should work in concert with your estate plan, rather than against it.

Disposing of the family home

Prenups often provide for the sale or other disposition of the family home, or give the surviving spouse the right to continue living there. The prenup should be drafted so that it doesn't impede your ability to execute home-related estate planning strategies, such as transferring the home to a qualified personal residence trust.

Work with your advisor

A prenup agreement is essential if you are married or are considering marriage. Moreover, a well-drafted agreement can make a huge difference to the welfare of your estate. ■

Take another look at the research credit

After more than 30 years of short-term extensions, the research tax credit (often referred to as the "research and development," "R&D" or "research and experimentation" credit) was finally made permanent by the Protecting Americans from Tax Hikes (PATH) Act of 2015. The act also enhances its benefits, particularly for smaller businesses. So, if you haven't taken advantage of the credit before, it may be worth another look. For example, eligible small businesses may now offset the credit against the alternative minimum tax, and qualifying start-ups may offset the credit against the employer portion of FICA payroll taxes. ■

Consider a charitable IRA rollover

The PATH Act reinstated qualified charitable distributions (QCDs) from IRAs, and made this tax break permanent. If you're 70½ or older, a QCD — commonly known as a charitable IRA rollover — allows you to transfer tax-free up to $100,000 per year directly from an IRA to a qualified charity, and to apply that amount toward any required minimum distributions for the year.

The alternative would be to take a taxable distribution, donate it to charity, and claim a charitable deduction. The problem with this approach is that the charitable deduction is available only if you itemize. And, even if you do so, it's disallowed to the extent it exceeds 50% of your adjusted gross income (AGI). So, depending on your tax situation, you may be unable to use the deduction to offset the tax on the distribution. In addition, taking a taxable IRA distribution *increases* your AGI, which can raise taxes on your Social Security benefits and net investment income, or decrease your itemized deductions.

A charitable rollover avoids these problems because it goes directly to charity and is never included in your income. Also, certain states don't allow charitable deductions. Thus, high income taxpayers may lose a portion of their itemized deductions. ■

Are you current with your payroll taxes?

Don't underestimate the risks associated with falling behind on your payroll taxes. It's not unusual for employers that are short on cash to tap withheld taxes for operating expenses. But unless cash flow improves, these businesses can find themselves with a significant tax liability that's quickly spinning out of control. And the penalties can be severe.

What's more, "responsible persons" — including certain officers, directors and shareholders — can be held personally liable for unpaid taxes and penalties, and in extreme cases may even face jail time. If your business is experiencing cash-flow problems, talk to your financial advisors about potential solutions that won't jeopardize your payroll tax deposits. ■