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A Game Plan for Reaping the Full Tax Benefits for Gifts and Charitable Donations in 2023

Perhaps the year 2022 will be remembered as the beginning of the transition to relative normalcy following the dramatic lifestyle changes resulting from the COVID-19 pandemic in 2020 and 2021. For instance, in 2022, staycations were replaced with revenge travel; mostly empty sports venues with posters of fans were replaced with sports venues filled with real fans; and tax filing deadlines returned to their standard dates.

Of course, plenty of new disruptive events emerged in 2022. Persistent inflation, negative stock market returns, and a faltering cryptocurrency industry have made for a treacherous economic environment. It is against this backdrop of volatility that individuals, business owners and family offices must review their 2022 and 2023 financial status and identify tax planning opportunities.

The best place to begin is to take stock of any major life events or transactions that took place in 2022. Financial events such as the sale of a business, a promotion, or retirement can have important implications for purposes of tax planning. It is also important to consider personal events such as marriage, divorce, inheritance, or necessary updates to an estate plan.

Particular focus should be given to goals related to gifts and charitable donations. Amidst all of life's uncertainties, this is one of the few areas that are almost entirely within a taxpayer's control. What follows is a discussion of the recently revised exemption and exclusion amounts for estate and gift taxes as well as the deduction limits for charitable donations. Additionally, a primer on IRS substantiation requirements for charitable donations is included. Failure to strictly follow these substantiation rules is sufficient grounds for IRS to deny a charitable deduction.

Maximize the Benefit of Current Estate and Gift Tax Exemptions and Exclusions

The American Taxpayer Relief Act of 2012 (ATRA) set a permanent estate tax and gift tax exemption at $5 million per person, indexed for inflation. When the Tax Cuts and Jobs Act (TCJA) was enacted in 2017, the exemption had almost doubled to $11,180,000 per person. Adjusted for inflation, the exemption in 2023 is set to be $12,920,000 per person and $25,840,000 per married couple. The TCJA is scheduled to sunset at the end of 2025 and if Congress does not proactively act to extend the current increased exemptions, as of January 1, 2026, the exemption will revert to the ATRA level of $5,000,000, indexed for inflation (expected to be in the mid-to-high $6,000,000 range).

For the first time in several years the annual gift tax exclusion was increased from $15,000 to $16,000 for gifts of a present interest made on or after January 1, 2022 ($17,000 for gifts on or after January 1, 2023). Gifts to non-U.S. citizen spouses qualify for an enhanced exclusion ($164,000 for 2022 and $175,000 for 2023).

In light of this potentially time-limited opportunity and current depressed markets, individuals and families should consider if additional gifting in 2023 is advantageous for their situation.

In addition to gifting, several wealth transfer techniques focus on giving away future appreciation. Some of these "estate freeze" transactions include Grantor Retained Annuity Trusts (GRATs), Charitable Lead Annuity Trusts (CLATs), and installment sales to grantor trusts. While this article will not discuss these specific techniques, the key consideration regarding these transactions in the current economic climate is that they are all interest-rate driven. Said succinctly, the higher the interest rate, the worse they tend to perform. Given the uncertainty of future interest rate hikes, it may be prudent to lock in current rates and enter into one of these estate freeze transactions now.

Charitable Contribution Limits and Substantiation Requirements

For tax years beginning prior to 2018, the deductibility of cash contributes to public charities was limited to 50% of a taxpayer's adjusted gross income (AGI) (with lower limitations for other types of contributions). The TCJA expanded this limitation to 60% of AGI; however, like the gift and estate exemption amounts above, this expanded limit is scheduled to sunset with the TCJA at the end of 2025.

The rules for charitable contributions were expanded in 2021 as part of COVID-19 recovery but beginning in 2022, the rules revert to pre-pandemic rates. The charitable contribution limits are as follows:

- Cash contributions to a public charity in years 2022-2025: 60% of AGI
- Cash contributions to public charity after 2025: 50% of AGI
- Short-term capital gain property contributions to public charity: same as above
- Cash and short-term gain contributions to the private foundation: 30% of AGI
- Long-term capital gain contributions to public charity: 30% of AGI
- Long-term capital gain contributions to the private foundation: 20% of AGI

Most importantly, it is critical that any charitable contributions strictly comply with Sec. 170 substantiation requirements (i.e., contemporaneous written acknowledgment and qualified appraisal). Charitable donations are not deductible unless they are substantiated in the manner prescribed by IRS. The nature of the substantiation requirements for charitable contributions depends on the dollar amount of the contribution and on whether the contribution consists of cash or property. IRS and courts have increasingly denied charitable deductions to taxpayers due to substantiation failures, including lack of contemporaneous written acknowledgment letters and failure to obtain a qualified appraisal and fully completed and signed Form 8283, *Noncash Charitable Contributions*.

There was an exception under former Sec. 170(f)(8)(D) to the contemporaneous written acknowledgment requirement for tax years beginning before 2017. Under this exception, a contemporaneous written acknowledgment was not required if the donee organization filed a return that included the information required for a contemporaneous written acknowledgment. However, this exception was repealed under the TCJA for tax years beginning after 2016.

When a noncash contribution requires an appraisal, it is imperative that the taxpayer receives the qualified appraisal and signed Form 8283 before the contribution is first claimed on a tax return. While the regulations allow for the taxpayer to first claim a charitable deduction on an amended return with a qualified appraisal received before the amended return is filed, if the taxpayer first tries to claim an unsubstantiated charitable contribution on the originally filed return, the taxpayer will be entirely denied the deduction on audit without the chance to correct the omission. These rules are extremely inflexible and even the slightest, seeming minor misstep in following them can and often will lead to a complete loss of the deduction, with little or no recourse.

Increase in IRS Enforcement

Under the Inflation Reduction Act of 2022, IRS received a nearly $80 billion funding boost with about $46 billion earmarked for enforcement. IRS has stated that it plans to target individual taxpayers with income above $400,000 and pass-through entities.

Individual taxpayers and their advisors should be prepared for a comprehensive exam. Given the amount and depth of information and documentation that the IRS may demand, with a very short response time, preparation will be critical. Taxpayers should consider a pre-audit to review tax returns and other financial information to prepare for potential questions and information document requests (IDRs) from IRS. This increased audit activity makes it even more important that taxpayers keep proper and timely records and documentation so that all tax positions on returns can be supported.

The Takeaway

Planning strategies include maximizing gifts and charitable donations for tax year 2023 and beyond as well as considering estate planning strategies aimed at transferring wealth during a period of depressed asset values. For purposes of the charitable contribution deduction, it is important to remember that expanded limits applicable to 2021 are no longer in effect beginning in 2022. For any charitable donation, be sure that substantiation requirements are strictly met. If the taxpayer fails to meet these requirements, the taxpayer may be entirely denied the deduction on audit. In addition, as a result of increased funding for the IRS, taxpayers and advisors should carefully document their tax positions on returns.

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A Softer Landing - Maximizing Bonus Depreciation by Leveraging Extended Placed-in-Service Dates for Certain Aircraft

Buckle your seat belt and lift your tray table, the 2022 tax year was the last time 100% bonus depreciation was generally available for the purchase of a private aircraft. However, with a phase-down in increments of 20% until 2027, it will be a slow descent until the time when the bonus depreciation deduction is no longer available. It will be an even softer landing for an aircraft that qualifies as longer production period property (LPPP) and for certain aircraft placed in service after December 31, 2022, for which the bonus depreciation phaseout periods are extended by one year.

In 2017, the Tax Cuts and Jobs Act amended bonus depreciation to allow 100% of the cost of the aircraft to be deducted in the first year. This is applicable to both new and pre-owned aircraft acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for certain aircraft). Thus, 100% bonus depreciation is available (when it applies) for aircraft placed in service during the calendar year 2022. However, after 2022, bonus depreciation will begin to phase-down to 80% in 2023, 60% in 2024, 40% in 2025 and 20% in 2026. Beginning in 2027, conventional accelerated depreciation rules, known as the modified accelerated cost recovery system (MACRS), apply to 100% of the purchase price.

Extended Bonus Depreciation Phase Down for Longer Period Production Property (LPPP) and Certain Aircraft

The bonus depreciation phase-down periods are extended by one year for LPPP and certain aircraft placed in service after December 31, 2022, as follows:

Placed-in-Service Year	Applicable Percentage
2023	100%
2024	80%
2025	60%
2026	40%
2027	20%

Certain Aircraft Qualification Requirements

An aircraft owned by a business for business travel (not in a charter business) will often meet the criteria for *certain aircraft*. Certain aircraft is depreciable property that:

- Is of a specified type, such as property with a recovery period of 20 years or less (including noncommercial and commercial aircraft),
- Has an original use that began with the taxpayer or, under certain conditions, was not used by the taxpayer before the taxpayer acquired it,
- Is placed in service by the taxpayer before January 1, 2028,
- Is acquired by the taxpayer (or acquired pursuant to a written binding contract entered into) before January 1, 2027,
- Is not transportation property (i.e., charter) other than for agricultural or firefighting purposes,
- At the time of the contract for its purchase, the taxpayer made a nonrefundable deposit of at least the lesser of 10% of the cost, or $100,000, and
- Has an estimated production period exceeding four months and cost exceeding $200,000.

Longer Period Production Property (LPPP) Qualification Requirements

An aircraft owned in an air transportation business (i.e., charter) may be eligible under the LPPP rule. However, as most aircraft do not have a production period longer than a year, it may be difficult to qualify under this rule. LPPP is depreciable property that:

- Is of a specified type, such as property with a recovery period of 20 years or less (which includes noncommercial and commercial aircraft),
- Has an original use that began with the taxpayer or, under certain conditions, was not used by the taxpayer before the taxpayer acquired it,
- Is placed in service by the taxpayer before January 1, 2028,
- Is acquired by the taxpayer (or acquired pursuant to a written binding contract entered into) before January 1, 2027, and
- Has a recovery period of at least 10 years or is *transportation property*, which is defined as tangible personal property used in the trade or business of transporting persons or property (e.g., aircraft used for charter purposes),
- Is subject to the uniform capitalization rules (Sec. 263A), and
- Has an estimated production period longer than one year and its cost exceeds $1 million.

Special Rules for Aircraft Depreciation

Special rules under Sec. 280F apply in determining eligibility for accelerated depreciation under MACRS. If these criteria are not met, depreciation is required to be computed based on the alternative depreciation system (ADS) method. No bonus depreciation is allowed for aircraft required to be depreciated on the ADS method. Aircraft that fail the Sec. 280F qualified business use tests must use the ADS method for that year and all future years and are not eligible for bonus depreciation. The business use must meet a two-part test: 1) the 50-Percent Test and 2) the 25-Percent Test. The depreciation is prorated for the amount of personal use versus business use, so if 100% bonus depreciation is taken, it is advisable to use the aircraft entirely for business use in the year the aircraft is placed in service. If accelerated depreciation is used (MACRS or bonus) in an earlier year, recapture income will be computed if the two-part test is failed in a future year. Thus, to avoid recapture, the taxpayer must maintain business usage under the two-part test for the remaining ADS recovery period (6 or 12 years). Section 1245 ordinary income recapture will also apply on the sale of an aircraft. Given the repeal of the Sec. 1031 tax-free exchange provision as it applies to aircraft and the phase down of bonus depreciation, taxpayers should expect to trigger taxable income upon the future sale of the aircraft, without offsetting bonus depreciation on a replacement aircraft.

The Takeaway

The 2022 tax year was the last time 100% bonus depreciation was generally available for the purchase of private aircraft. However, with a phase-down in increments of 20% until 2027, a generous accelerated depreciation deduction will remain available for years to come. This is especially the case for an aircraft that qualifies as a certain aircraft or LPPP placed in service after December 31, 2022, for which the bonus depreciation phase-down periods are extended by one year.

Taxpayers should consult with their tax advisor to understand how the bonus depreciation phase down may impact their aircraft purchases. A qualified tax advisor can assist to ensure that requirements are met for claiming the bonus depreciation deduction, determine whether a potential purchase qualifies as LPPP or *certain aircraft*, and model the impact of the phase out of the bonus depreciation deduction on future purchases.

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Multigenerational Wealth Planning in a Down Market: Opportunity Awaits for Those Who Have Yet to Make a GST Allocation

A depressed market like in 2022 and possibly 2023 represents an opportunity to make late allocations of generation-skipping transfer (GST) tax exemption to prior years' gifts. This opportunity arises when an asset's value has declined since the actual date of the gift and can result in significant transfer tax savings.

The Generation-Skipping Transfer Tax

The generation-skipping transfer tax rules currently provide that a transfer to trusts, which qualifies as a generation-skipping transfer, is subject to the GST tax. A GST transfer is defined as a direct skip – a direct transfer to a skip-person (grandchild or lower generation) or a trust, all the beneficiaries of which are skip-persons; a taxable termination – the death of a non-skip-person resulting in a skip-person succeeding in the interest of that deceased non-skip-person (usually in a trust); or a taxable distribution – a distribution from a trust to a skip-person. Similar to the gift and estate tax, a GST tax can be avoided by using, or allocating, GST exemption to a transfer. As the name implies, the GST exemption provides relief from the GST tax and will reduce or avoid altogether imposition of GST tax.

Unlike the gift and estate tax exemption, the use of GST exemption is elective. In other words, a taxpayer can decide whether to allocate exemption to a transfer whereas gift and estate tax exemption is automatically used in the gift and estate context. In addition, how the GST exemption is allocated is also at the election of the taxpayer. The amount of GST tax exemption is based on the same threshold as the gift tax applicable exclusion amount (during life) or the estate tax applicable exclusion amount (at death), both of which increased from $12.06 million in 2022 to $12.92 in 2023.

The Opportunity

Through timely opting out of an automatic allocation to a *GST trust* (a trust under Sec. 2632(c) to which there would be an automatic allocation of GST exemption unless a taxpayer affirmatively opts-out of the allocation), the opportunity for a late allocation can be created. This late allocation of exemption can result in a trust with a zero inclusion (i.e., fully GST exempt) with the taxpayer using less exemption than otherwise would have been used in a timely allocation. Below is an example that highlights both the procedural aspects as well as the potential benefits of a late allocation:

On November 26, 2021, a taxpayer creates a trust that is intended to be GST exempt and funds the trust with 100,000 shares of common stock with a price of $90 per share, for a total gift of $9 million. By the time the gift tax return, Form 709, is to be filed in October 2022 (assuming the income tax return was extended to October 17, 2022), the value of those shares drops to $20 per share. Absent any GST elections by the taxpayer on the 2021 gift tax return, $9 million, the same value of the gift, of GST exemption will be allocated to that transfer. However, if the taxpayer affirmatively opts out of the GST allocation on a timely filed 2021 gift tax return, the taxpayer could then file what is technically a 2022 gift tax return after October 17, 2022, making a late allocation of GST exemption using the current value of the stock, $2 million. Under these facts, the use of the late allocation preserved $7 million of GST exemption for later use.

Making the Election

Procedurally, when making a late allocation on a gift tax return, the value of the property for purposes of the allocation is the value as of the late allocation. In other words, the value is the value as of the date the gift tax return reporting the late allocation is filed. Of course, to be able to value the trust property, prepare, have signed, and file the gift tax return all on the same day is usually not practical. Thankfully, under Reg. 26.2642-42(a)(2) there is an election allowing taxpayers to value the trust assets as of the first of the month in which case the return must then be filed before the end of that month.

For taxpayers other than those granted an extension to file 2021 tax returns due to Hurricane Ian in Florida, the opportunity to use a late allocation on 2021 gifts has likely passed. However, that does not mean taxpayers can't take advantage of depressed values with a late allocation. Any existing trust not currently GST-exempt is a potential candidate for a late allocation. For example, if a taxpayer funded a successful GRAT, more often than not that GRAT remainder would be held in further trust. Generally speaking, for technical reasons GST exemption cannot be allocated to a GRAT so it is likely that the remainder trust would not be GST exempt. If the value of the trust assets is depressed, as long as the trust terms are such that it would be appropriate for that trust to be GST exempt (i.e., it is multigenerational), then a late GST allocation could be advantageous in this situation as well.

The Takeaway

While a down market certainly has many challenges, it also can present certain opportunities. For taxpayers wanting to make multigenerational transfers using GST exemption, a late GST allocation is one such opportunity. Like all wealth planning, decisions on how and when to use exemption should not be based solely on valuations, but instead only after taking into consideration all relevant facts. However, if it is determined to be appropriate in a given situation, a late allocation can provide significant tax savings for years to come.

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Silver Linings in Market Turmoil

The economic landscape in 2022 was driven by the Federal Reserve's steadfast commitment to combating high inflation with fast-paced monetary tightening. The Fed's efforts have resulted in a challenging investment period for both stocks and bonds. A balanced global portfolio with 60% stocks and 40% bonds was down approximately -20% through the end of October. Expectations are for the Fed to continue its restrictive policy for the near future, which leaves investors facing a challenging backdrop including a potential global recession and slowing economic growth.

The silver lining of this economic climate is that investors can take advantage of much higher yields on cash and bonds and can likely harvest losses to reduce current and future tax bills. With the right planning, investors can take advantage of this opportunity and reposition their portfolios for better long-term results.

Liquidity and Yields

It is always important for investors to prioritize maintaining sufficient liquidity for both emergencies and cash flow needs. However, managing liquidity becomes especially important when uncertainty in the economy and markets is high. Selling investments in a down market for cash needs can be a significant detractor to long-term performance. This topic is particularly relevant for retirees who depend on regular withdrawals from their portfolios to cover living expenses.

For much of the last decade, cash was an afterthought in portfolio allocations – accepting no yield for the relative safety and liquidity it provided. Today, one-month Treasury bonds are yielding close to four percent, while money market funds are offering approximately three and a half percent and are poised to go even higher as the Fed continues to raise rates. As current inflation threatens the purchasing power of idle cash, working with an advisor to manage your liquidity effectively can now provide both portfolio protection and contribute to overall performance.

With recent shifts in interest rates, forward-looking returns for high-quality corporate and municipal bonds look increasingly attractive. It is recommended that investors review their credit quality and duration of bond portfolios to ensure it is positioned to meet portfolio expectations. With the possibility of a recession in the future, there is a reasonable expectation that defaults could accelerate, and spreads between high-quality and low-quality bonds could widen. A move up in average credit quality can help insulate portfolios from the performance-impairing effects of rising defaults.

Tax Loss Harvesting

In the short term, investors can take action to improve after-tax portfolio returns by harvesting capital losses. Investors can lock in losses by selling assets that have fallen below their tax cost basis. These capital losses can then be used to offset portfolio gains in the current tax year, and excess losses can offset other sources of income up to $3,000 per tax year. Additionally, after netting current year gains, losses can be carried forward to offset capital gains in future years when the market rebounds, improving long-term after-tax returns.

If an investor wishes to maintain long-term exposure to a position that has been sold to harvest losses, they can consider a few options:

- Repurchase the position after the conclusion of the “wash sale” period. The “wash sale” rule disallows the usage of a capital loss if the security or substantially identical security is purchased 30 days before or after the sale that captures the loss.
- Identify and purchase an investment that is closely correlated with, but not “substantially identical” to the position that was sold.

Before harvesting losses, it is important investors consult with their advisors and consider the unique individual circumstances. For example, if it is expected that an investor’s effective tax rate will increase in future years, it may be beneficial to defer the recognition of losses until then (if possible).

A Great Time to Reassess Risk

Given market uncertainty, higher yields on conservative investments, and the ability to make portfolio changes in a tax-efficient manner, now is a great time to reassess risk exposure and take steps to align portfolios with long-term goals.

Bear markets are characterized by intense selloffs, but also by short-term rallies that can lead many to falsely believe the market has rebounded. During the 2000-2002 bear market, there were five rallies of more than 12% and three of more than 20%, all before falling further to an eventual bottom in October 2002. Nobody knows where the bottom will be – the most important thing is to develop a long-term investment plan to stick with through challenging market environments.

Additionally, diversification continues to be a very important component of investing. Many active and passive equity strategies have significant exposure to the same handful of large companies, leaving portfolios overexposed to the fate of a few firms. Working with advisors to determine underlying allocations and taking steps to further diversify away from concentrated positions can protect assets. Lastly, taxpayers should review portfolios and ensure they are diversified across different market sectors including dividend-paying stocks and alternatives.

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Weathering the Storm of Increased IRS Scrutiny on Transfer Pricing

The U.S. Inflation Reduction Act (IRA) allocates nearly $80 billion in new funding to the Internal Revenue Service (IRS). More than $45 billion of that amount is dedicated to compliance enforcement efforts with additional amounts for operations, systems modernization, and taxpayer service. The substantial increase in IRS enforcement funding, along with technology investments, is expected to result in additional scrutiny of transfer pricing arrangements. Multinational entities should take steps now to support their transfer pricing positions and explore opportunities for advance tax certainty.

The Congressional Budget Office's estimates show that the IRA's robust allocation of funding for IRS enforcement efforts is expected to generate $204 billion in additional revenue, which will help offset other incentives offered by the IRA. Large and medium corporations with international operations are likely to be a focus of that enforcement with IRS looking to narrow the tax gap and curb abusive practices.

Transfer Pricing Audits Expected to Rise

During a transfer pricing audit, IRS examines whether multinational taxpayers are operating in accordance with the *arm's-length standard*. Meaning that prices charged by one affiliate to another in an intercompany transaction where goods, services, or intangibles are transferred, should yield results that are generally consistent with the results that would have been realized if uncontrolled taxpayers had engaged in a comparable transaction under comparable circumstances. Section 482 grants IRS broad authority to adjust income and/or deductions in order to meet this standard.

In addition to the reallocation of income and deductions, various penalties may be assessed. There are two levels of severity based on the extent of the deviation from the *arm's-length standard*: a 20% penalty for substantial valuation misstatements and a 40% penalty for gross valuation misstatements. Penalty relief is available in limited circumstances by demonstrating reasonable cause and good faith; however, this applies only with respect to the transactional penalty. To avoid penalties an assessment of both types of penalties, taxpayers must prepare a formal transfer report as required pursuant to the "contemporaneous documentation" rules under Sec. 6662(e).

In June 2018, the Large Business and International Division (LB&I) of IRS issued a [Transfer Pricing Examination Process (TPEP)]() guide for use by its issue teams during transfer pricing examinations. LB&I also released [Transfer Pricing Frequently Asked Questions (FAQs)]() on how taxpayers can satisfy the documentation requirements under Sec. 6662 (last updated February 2022). LB&I further issued a series of directives to staff on how its agents should approach a transfer pricing examination. A common theme in the various pieces of IRS transfer pricing examination guidance is the value of clear and comprehensive documentation that accurately reflects the economic realities of the taxpayer's related party transactions. Senior LB&I officials have repeatedly warned that transfer pricing reports containing "conclusory statements" or "unsupported assertions" will not be granted penalty relief.

Take Steps Now to Support Transfer Pricing Positions

While IRS is expected to clarify its enforcement strategy in the coming months, there are certain actions that companies with international operations should take now. To withstand scrutiny, multinational organizations must be prepared to support their transfer pricing positions. For example, formal intercompany agreements should be up to date and accurately reflect current transaction flows. In addition, to qualify for penalty protection, formal transfer pricing report documentation must be comprehensive, clear, concise, and convincing.

Where appropriate, taxpayers may also consider dispute resolution opportunities that can provide tax certainty. The Organization for Economic Co-operation and Development (OECD)'s International Compliance Assurance Program (ICAP) is a voluntary program for large multinational companies that provides a coordinated, joint assessment of an entity's transfer pricing risks. Advance Pricing Agreements (APAs) are agreements between a taxpayer and a tax authority that determine transfer pricing methodology for pricing the taxpayer's international transactions for future years. Mutual Agreement Procedures (MAPs) provide an alternative mechanism available for taxpayers to leverage competent authority and bilateral tax treaties to resolve transfer pricing disputes. Companies considering these opportunities should consult with a transfer pricing professional to help navigate the complex administrative requirements of each program.

The Takeaway

Transfer pricing audits present noteworthy challenges. Significant delays and expenses are certain to arise if a formal transfer pricing report is not available or is out of date. To mitigate risk, taxpayers should also execute and/or update formal intercompany agreements. All supporting documentation should be evaluated regularly to ensure that transfer pricing policies are consistent with the relative economic contributions made by the entities in the multinational group.

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