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- InterActive Legal
 - Matthew Tove
 - (321) 252-0100
 - <u>sales@interactivelegal.com</u>

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Estate Planning and Charitable Giving Proposed Regulations

Proposed Regs

- One of the most talked about changes is the imposition of severe limitations on deducting state and local taxes ("SALT") which are now capped at \$10,000.
- Just Proposed IRS regulations restrict contributions in lieu of state tax payments to avoid SALT restrictions. [REG-112176-18, "Contributions in Exchange for State or Local Tax Credits."
- High tax states most affected have tried several tactics to help circumvent these rules. One of those tactics, creating means to make charitable contributions to state-created charities, in lieu of paying certain state income taxes (accomplished by receiving a state income tax credit based on the qualifying donation), was restricted in new Proposed Regulations

Revenue Impact

- "The Joint Committee on Taxation estimated that the limitation on state and local tax deductions along with certain other reforms of itemized deductions would raise \$668 billion over ten years." Footnote 1 of the Proposed Regs.
- The IRS has to be tough as the SALT limitation pays for many of the tax cuts that were the hallmark of the 2017 Act. If the high tax Blue states could facilitate an end-run around the new restrictions the revenue projections for the Act would implode

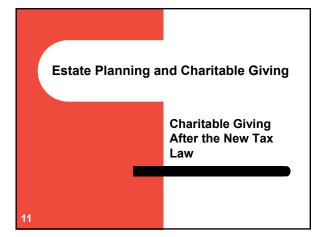
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How Many Taxpayers Affected

- "After passage of the Act, which significantly increased the standard deduction, it is estimated that ninety percent of taxpayers will not claim itemized deductions of any kind.... It is estimated that approximately five percent of taxpayers will itemize but will not have state and local income tax deductions above the SALT cap."
- So, only about 5% of taxpayers will have their state income tax deduction limited by the new rules.

How Proposed Regs Work

- Taxpayer makes a payment or transfers property to or for the use of a state charity (listed in 170(c)), the taxpayer's charitable contribution deduction will be reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer.
- Example: "A, an individual, makes a payment of \$1,000 to X, an entity listed in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70% of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by \$700 (70% x \$1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the \$1,000 payment to X may not exceed \$300."



How Tax Cut Jobs Act Hurts Charity – 2 key Changes

- Estate tax exemptions doubled to over \$11M per person. Very few estates will get any tax benefit from charitable bequests.
- Standard Deduction doubled to \$12,000 per person. Few individual taxpayers will get any tax benefit from charitable gifts. Most other standard deductions have been restricted or eliminated. The number of itemizers will drop from 30M to 5M.

New Tax Landscape Affects **Charitable Giving**

- Estate/gift/GST exclusion \$11.18 million (with inflation adjustments), through to Dec. 31, 2025, reverting to \$5 million (plus inflation) in 2026
- New top ordinary income tax rates of 37% and 20% LTCG/Qualified Dividends.
- Top brackets for trusts/estates start at \$12,500
- Medicare Surtax of 3.8% (net investment income tax) or 0.9% (wages) • remain:
 - Affects taxpayers with AGI over \$200k/\$250k.
 - Charitable gifts do not reduce NIIT for individuals.
 - Trusts/estates AGI over only \$12,500.
 - Charitable gifts from a trust's gross income do reduce net investment income tax (NIIT).

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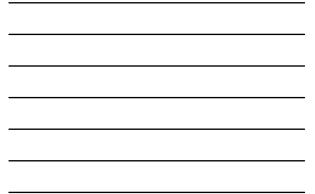
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In some states' income tax schemes, the charitable deduction is more advantageous from trusts as well.

New Tax Law A Negative to Giving

- The doubling of the standard deduction to \$24,000 (married filing joint) is estimated to lower charitable giving by \$13 billion+ per year.
- The doubling of the estate tax exemption to more than \$11 million doubling the exemption is estimated to lower charitable giving by \$4 billion per year.
- https://www.councilofnonprofits.org/sites/default/files/docu ments/tax-bill-summary-chart.pdf
- Creative tax planning, and emphasizing non-tax benefits, may help offset some of this loss.





New Update Your Will/Revocable Trust for the Law

- Update wills and revocable trusts since charitable bequests may not provide a deduction. See planning ideas below.
- Provide for powers of appointment in trusts: "My spouse may appoint during her lifetime any assets of this trust, up to the entire corpus, to our descendants or to any charitable organization [optional: provided, however, that she may only appoint cash or other assets to charity that is traceable to gross income and otherwise qualifies for a trust income tax deduction under IRC §642(c)]."
- Some may cap or limit distributions under a power of appointment to other parties as well.

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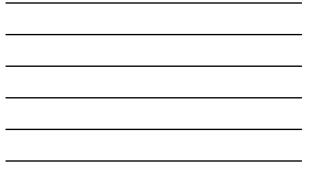
New Update Powers of Attorney for the Law

- Consider permitting your agent to make charitable gifts "in accordance with my historic pattern of giving."
- Consider permitting agent to prepay bequests under wills to secure a possible income tax deduction if there will no longer be an estate tax deduction.

New Update Life Insurance and Insurance Trust for the Law

- Doe client need the life insurance coverage any longer?
- If not consider options:
 - Convert to a paid up policy.
 - Repurpose the insurance plan to provide cash flow to you
 - instead of a benefit to heirs.
 - Sell the policy in the secondary market.
 Donate the policy to charity.
 - Donate the policy to charity.
- If estate is large and you will undertake sophisticated planning to use the new high \$11M exemption before it is changed, repurpose life insurance to





Technical Changes Affecting Charitable Giving

- The income tax laws have limited donations to public charities and private operating foundations to 50% of adjusted gross income ("AGI"). This was increased from 50% to 60% but only for cash contributions.
- Donations to colleges that provide a right to purchase tickets to athletic events will no longer be deductible. IRC Sec. 170(I)(2).
- An exception to the requirement to obtain contemporaneous written acknowledgement from a charity has been repealed so that an acknowledgement for every donation must now be obtained in all instances. IRC Sec. 170(f)(8)(D).
- Pease limitations had reduced benefit for higher income individual taxpayers were eliminated. Section 68(e).



Bunching Deductions to Get Over High Standard Deduction

- Most taxpayers will not accumulate enough itemized deductions to exceed the new standard deduction. But if they plan deductions to be incurred over other (or every third) year they may periodically exceed the standard deduction and thereby secure a tax benefit for donations.
- The key is pushing some deductions off to a future year, then in that year accelerating deductions from a future year.
- Bunching of donations into targeted years using donor advised funds (DAFs), to hold the larger periodic charitable gifts until they are dispersed. This can also be done by making donations to a specific charity to be held by that charity in a fund for the donor until disbursed for specific projects or pursuant to a donor agreement.

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Bunching Deductions to Get Over High Standard Deduction

- <u>Example</u>: Taxpayer, as a result of the loss of SALT and other deductions, cannot itemize each year but instead take the standard deduction. She has traditionally given about \$10,000 each year in charitable contributions. In 2019, she defers charitable contributions, making none. Instead she makes pledges to charities that she wishes to benefit.
- <u>Target Year</u>: In 2020, the taxpayer donates \$30,000 to a donor advised fund. She uses some of those funds to pay off 2019 pledges. She also makes some charitable gifts in 2020. She incurs elective medical expenses as well.
- In 2020, she also made significant home medical improvements
- resulting in a large deduction for that year.
- In 2021, she uses some of the funds remaining in the DAF for charitable gifts in 2021 when she will not be making donations.



Qualified IRA Distributions to Charity

- When it is available, donations from IRAs is one of the best charitable giving tools after the new law. It completely avoids the standard deduction and gives the donor full dollar for dollar benefit.
- For federal tax purposes, qualified distributions up to \$100,000 from an IRA made directly to charitable organizations are excluded from the owner's gross income if the distributions are made on or after the date the IRA owner reaches age 70 %.
- This requirement can be confusing for some taxpayers in that it is not available for the year in which the taxpayer/plan holder turns 70.5 but only after attaining that age.
- These are referred to as Qualified Charitable Distributions ("QDCs").

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 Taxpayers can direct the IRA from which they are taking required minimum distributions ("RMDs") to pay a portion or all of that RMD, not to exceed \$100,000/year, to a qualified charity.

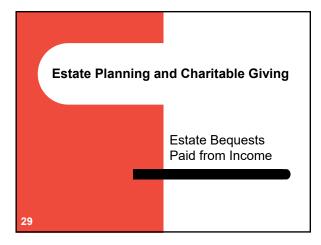
Qualified IRA Distributions to Charity

- The donation must be made directly from the IRA custodian to the charity. The funds cannot be distributed to the plan holder and then donated.
- Thus, every dollar of QDC will provide a tax benefit by reducing taxable income.
- If you are planning to convert your traditional IRA to a Roth, leave some amount in the traditional IRA for charitable gifts.
- You may be able to rollover funds from a qualified plan into your IRA and use it for donations.



Donating Appreciated Property

- The traditional approach of donating appreciated stock remains beneficial.
- Even if the taxpayer/donor does not qualify for an income tax charitable contribution deduction the gain inherent in the appreciated stock will permanent avoid income taxation thereby saving capital gains.
- In the past that same donation may have also generated an income tax deduction based on the fair value of the stock. While the latter benefit may no longer be realized the former will.
- Thus, donations of appreciated stock will continue to be preferred over mere cash donations for many.



Estate Bequests Paid from Income

- A bequest could be drafted to be paid out of the income earned by an estate so that an income tax deduction would be realized by the estate to the extent of such income.
- This can provide a tax benefit even though the estate may be too small to realize an estate tax charitable contribution deduction because of the new high exemption amounts.
- The difficulty of this type of charitable gift could be estimating the income and the uncertainty of what the ultimate charitable gift might be.

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Example

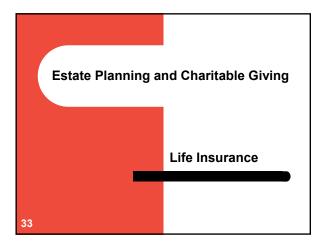
- Client wants to bequeath 15% of her \$3 million estate to charity at death.
- A \$450,000 estate tax deduction has no tax benefit, since her estate is well under \$11.18 million, and would probably be under the approximately \$6.5 million or so even if the law reverts in 2026.
- Instead her estate leaves assets in trusts for her children. She mandates that the first \$150,000 of gross income from the three trusts after her death go to charity, and after that the beneficiaries may appoint at their leisure any future income to charity.

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Example – Continued

- The beneficiaries' trusts realize an above the line deduction from trust income (including from the 3.8% net investment income tax), generating \$450,000 of income tax deductions.
 These deductions generate the savings to the family of
- \$150,000+.
- The charity would probably receive the "bequest" 1-3 years later than an ordinary bequest, as it comes from ongoing trust income, but they get more because the trust encourages further giving.



Life Insurance

- Life insurance policies that clients no longer wish to maintain might be repurposed to charitable use.
- Example: Client owns a \$2 million life insurance policy he intended to use to cover estate tax costs, or to provide an inheritance to his heirs. With the increase in the value of his estate he is no longer concerned about the inheritance his heirs will receive being reduced by an estate tax (but he should act to secure that high exemption now).
- Perhaps an alternative strategy is he sees no merit to retaining the life insurance for its original purposes is to name a favorite charity as a beneficiary and use the policy to accomplish important charitable goals.
- If the policy is in an irrevocable life insurance trust (ILIT) it may be feasible, depending on the terms of the trust, to distribute the policy out to the beneficiaries, have them then donate it.





Advancement

- Taxpayers should update/amend durable powers of attorney and revocable trust gift provisions to permit charitable gifts if they had not previously done so (many if not most standard forms do not).
- Further, consideration should be given to authorizing the agent under the power of attorney or the trustee under the revocable trust to prepay charitable bequests as an advancement of testamentary bequests since for all but the wealthiest clients bequests will no longer provide a federal estate tax benefit.
- This is a result of the doubling of the federal estate tax exemption to about \$11 million per person, and about \$22 million per couple (assuming porting of the first to die spouse's exemption).
- The taxpayer/agent can coordinate the payment of a bequest with the bunching of deductions (see above) to obtain the maximum income tax benefit.

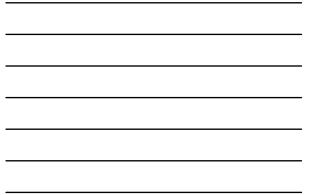




Everyone with any type of revocable, irrevocable, inter-vivos or testamentary trust should consider including powers of appointment that permit beneficiaries to appoint gross income to charity or charitable trusts (*even* those who are not especially charitably-minded or who think their beneficiaries are not), especially in light of:

- recent tax reform that eliminates or severely restricts the practical benefit of any charitable deduction for most;
- the superior tax planning opportunities it opens up without locking in families like traditional split interest charitable trusts (CRTs, CLTs) do
- Exception: marital trusts during surviving spouse's lifetime as it will disqualify for marital deduction treatment.





Non-Grantor Trusts May Salvage Charitable Giving Deductions

- Non-grantor trusts may solve the charitable contribution dilemma for moderate wealth clients (wealthy clients may make contributions that easily exceed the exemption but may nonetheless also benefit from adding charities as beneficiaries to certain trusts).
- Non-Grantor "complex" trusts are separate taxpayers from the settlor (in contrast to grantor trusts) and generally, subject to the DNI rules, pay their own income tax.
- How can non-grantor trusts facilitate charitable planning? For taxpayers
 who are charitably inclined, and unlikely to receive a contribution
 deduction because of the high standard non-grantor trusts might afford
 another option. This trust can be created to benefit a class of persons
 including descendants and charities (DAFs may be ideal in this
 application). In order to avoid grantor trust status, neither the settlor ror
 the settlor's spouse can benefit from the trust.
- The donor/taxpayer could create a relative low-cost trust in his or her home state.

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Non-Grantor Trusts May Salvage Charitable Giving Deductions

- The taxpayer could gift a portion of his or her (non-IRA, non-retirement plan) securities portfolio to the trust.
- Distributions to heirs or charitable contributions can be made in the discretion of an independent trustee (e.g. a family member like a sibling or aunt).
- Since the trust is characterized as a non-grantor trust, there is no standard deduction and income is offset by the charitable contribution deduction so long as the tax law requirements that distributions be made out of the trust's gross income, etc., are met.
- This assures that the contributions will provide an income tax benefit and leaves the standard deduction to offset non-trust income on the taxpayer's personal return.
- If the amounts available to allocate to charity exceed what is desired to gift to charity in a given year, those amounts could instead be directed to the heirs listed as beneficiaries of the trust.

Non-Grantor Trusts May Salvage Charitable Giving Deductions

- <u>Example</u>: The client is charitably inclined but lives in a low tax state and is unlikely to ever exceed the new standard deduction amount. The client gifts \$250,000 of marketable securities to a non-charitable non-grantor trust. The trust benefits named charities the client donates to regularly, and children and their descendants.
- There likely will be little concern about allocating GST exemption to a trust that is an inefficient use of GST exemption since the transfer tax exemptions greatly exceeded the client's wealth.
- The \$250,000 generates \$12,500 of taxable income a year.
- The trustee pays \$10,000 to charity and \$2,500 to heirs. The trust deducts the \$10,000 charitable contribution and all remaining income passes out to the children.
- If the trust paid all \$12,500 to charity and then made discretionary distributions of corpus to the children, the children would have no gross income to report from the trust.

More Thoughts on 642(c) - 1

- Section 642(c) contributions have several advantages over Section 170 contribution deductions:
 - Trust donations, unlike those by an individual, can benefit a foreign charity. Trust donations are not subject to the 20%/30%/50% of AGI limits as are donations by individuals.
 - Unlike an estate or trust, the contribution by an individual need not be paid from gross income. This is a significant difference and mean that trusts must sell an appreciated security and donate cash, rather than transfer the security to the charity as is common with year end planning for individuals.
- Trust contributions reduce the 3.8% Medicare net investment income surtax, unlike individual taxpayers who realize no surtax benefit Many states base their state trust income tax on the trust's taxable income after the Section 642(c) deduction. This may provide an above the line state income tax deduction which could be more advantageous than a mere deduction

More Thoughts on 642(c) - 2

- Section 642(c) contributions have several advantages over Section 170 contribution deductions:
 - A trust can distribute and deduct gross income from a prior year that had not previously been distributed or deducted. Section 642(c)(1).
 - A trust may elect in the current year to treat a charitable contribution paid from gross income earned in the immediately preceding year as though it had been paid in the prior year. The contribution must be made before the income tax return for the trust is due for that preceding year. In contrast, Individuals cannot take a deduction in a prior year for a contribu-tion made in any later year.
 - To claim a deduction the governing instrument of the estate or trust evidence a charitable intent.
 - The trust agreement may limit distribution to charities to a percentage of gross income and exclude non-taxable income such as muni-bond income or capital gains from the income to be distributed to charity. Such allocations must have substantial economic effect.

More Thoughts on 642(c) - 3

- Section 642(c) contributions have several advantages over Section 170 contribution deductions:
 - The charitable deduction for trusts is not dependent on the type of charita-ble organization that receives the contribution, as it is for individuals. Section 642(c) does not distinguish between contributions to public charities and, for example, private foundations. It does not appear that trusts are subject to the charitable deduction sub-
 - to use not appear in a trust are assumption to inclinate decounting sub-stantiation rules of Section 170 which apply to individuals, including the contemporaneous written acknowledgment requirement. However, if a trust has UBI the deduction is under 170 not 642(c) so that substantiation rules may apply in that instance. See below.

Watch Out for UBI

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- There is no limit under Section 642(c) as to the amount a nongrantor trust may deduct for transfers of gross income for charitable purposes pursuant to the terms of its governing instrument.
- Section 681 disallows any Section 642(c) deduction to the extent the income of the trust is unrelated business income (UBI.
- UBI is defined under Section 681 in essentially the same manner as unrelated business taxable income defined in Section 512. This includes income generated by acquisition debt defined in Section 514.
- Thus, as to UBI the trust's deduction under 642(c) is no better than an individual's deduction under 170.

Trusts and Contributions – Modifications to Add Charity

- Where a trust makes no provision for a payment to a charitable organization, a charitable income tax deduction will not be allowed to an estate or trust, even though all of the beneficiaries may agree to the contribution. Query what if all parties agree to a nonjudicial modification and add a charitable beneficiary?
- A question of deductibility under Section 642(c) may arise when a trust that does not have the requisite "positive charitable intent or purpose of the settlor" is decanted or other wise reformed by transferring trust assets to a new trust that has the requisite intent or purpose. Will this apply to the trust that is merged into the surviving trust?
- The law is not clear so a safer option might be to have the trust invest in a partnership that makes the donations and passes the deduction back to the trust.

Trust Invests in Partnership That Donates

- Using a partnership may provide a work around to the require that the trust instrument demonstrate positive charitable intent or purpose of the settlor.
- The trust invests in a partnership that makes contributions to charity from gross income of the partnership. Under Section 702(a)(4), charitable contributions of the partnership pass through to the partners. A trust that is a partner must take into account its distributive share of the partnership's income, gain, loss, and deductions which includes charitable contributions.
- The IRS held that a trust was allowed a deduction under Section 642(c) for the trust's distributive share of a charitable contribution made by the partnership from the partnership's gross income, even though the governing instrument of the trust did not authorize or direct the trustee to make distributions to charity. Rev. Rul. 2004-5, 36.

Trusts and Contributions – Power to Allocate Among Charities

If the grantor retains the power to allocate the beneficial enjoyment of the trust among charitable beneficiaries, of a trust which is irrevocably payable for charitable purposes, the trust will not be characterized as a grantor trust. IRC Sec. 674(b)(4). Treas. Reg. Sec. 1.674(b)-(1b)(4).

Trusts and Contributions – Power to Add Charity and Grantor Status

 The power to add a charitable beneficiary (not merely to allocate among charities) can make the trust a grantor trust. IRC Sec. 674(b)(4); Treas. Reg. Sec. 1.674(b)-1(b)(4).

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- The power to add charitable beneficiaries must extend to all corpus of the trusts in order to create grantor trust status. PLR 9709001 stated that a nonadverse trustee's power to add charitable beneficiaries to the trust was sufficient to make the trust a grantor trust under section 674(a) but would not cause the trust assets to be includible in grantor's estate.
- With the new emphasis on non-grantor trusts a nonadverse party cannot be given the power to add charitable beneficiaries. However, if the client is uncertain about the possible use of the non-grantor trust assets for donations why not instead include a donor advised fund in the trust instrument. Practically, that may be the equivalent of being able to add charitable beneficiaries but permit non-grantor status.

Safeguards for Trusts Donating to Charity

- Post 2017 Tax Act more non-grantor trusts will be created and authorized to make donations to salvage tax deductions for contributions. These trusts might consider additional safeguards.
- These trusts could require the trustee to obtain the consent of one or more of the beneficiaries of the trust to a void the appearance that the trustee is trying to garner favor with one or more charities at the "expense" of the beneficiaries.
- Another approach might be for such trusts to permit one or more beneficiaries to hold the power to make charitable gifts conditioned on obtaining the consent of another beneficiary and/or the trustees. This might avoid concerns that the charity has unfairly influenced the beneficiary or that a beneficiary is trying to "punish" another beneficiary by giving away trust income to a particular charity.
- A third approach is to designate a charitable distribution advisor that can direct the trustees as to which donations to make.





CLAT Example

- Senior contributes the \$1,000,000 investment portfolio to a lifetime CLAT which in turn is required to distribute a fixed annuity of \$38,500 to charity over a 28-year period (the expected annual income). Since the value of the remainder interest to Senior's children is zero (hence the term a "zeroed-out CLAT"), there is no taxable gift at the time the trust was created. At the end of 28 years, the CLAT terminates and distributes all \$1,000,000 to the children without incurring any gift or estate taxes. Therefore, the children net \$1,000,000, and the charity receives the same \$1,078,000 over the 28-year period.
- Each year the trust reports the \$38,500 as taxable income and each year the trust is permitted to deduct the entire \$38,500 as a charitable contribution as the trust is not exposed to the phase-outs of itemized deductions that apply to individuals.

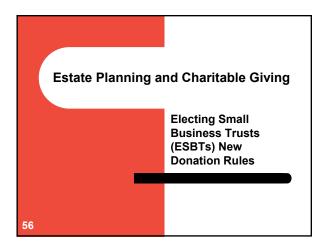
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Charitable Lead Trusts ("CLTs")

- Add charitable lead trusts into your dispositive scheme to address the possible reduction of the estate tax exemption.
- Example: A client is single with a \$8 million estate and two children as heirs. She provides a bequest to dynastic trusts, ½ for each child, up to the current high exemption, and the excess to a charitable lead trust.
- If she dies before the new higher exemption sunsets (or a future administration changes the estate tax) the estate will pass transfer tax free into GST exempt dynastic trusts for each child.
- If the estate tax exemption is reduced to the \$5 million pre-Act level as scheduled in 2026 (or by a different administration before that date) the \$5 million inflation adjusted exemption amount will pass transfer tax free into the GST exempt dynastic trusts for each child, and the remainder of the estate could pass into a CLT that reduces or
- 54 eliminates any estate tax, and then to the children.

Grantor vs. Non-Grantor CLT

• If the charitable lead trust is a grantor trust, the granter is entitled to an income tax deduction for the present value of the interest committed to charity under the terms of the trust.



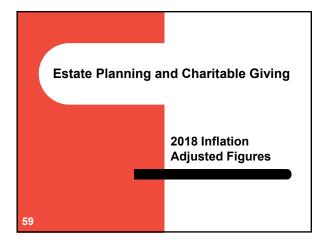
Electing Small Business Trusts (ESBTs) New Donation Rules

- An S corporation reports to each of its shareholders each's pro rata shares of certain separately stated items of income, loss, deduction, and credit. For this purpose, charitable contributions of an S corporation are separately stated.
- The deductibility of a charitable contribution passing through from an S corporation depends on the shareholder. An S corporation may only make deductible contributions if the governing instruments of the S corporation permits the Board of Directors to make charitable gifts.
- Under prior law, the deduction for charitable contributions applicable to trusts, rather than the deduction applicable to individuals, had applied to ESBTs. Generally, a trust is allowed a charitable contribution deduction without limitation for amounts of gross income which are paid for a charitable purpose.

Electing Small Business Trusts (ESBTs) New Donation Rules

- No carryover of excess contributions is allowed.
- The Act changes the charitable contribution deduction of an ESBT and provides that the rules under section 170 applicable to individuals should control the deductibility of charitable contributions attributable to the ESBT.
- Thus, the percentage of contribution base limitations and carryforward provisions applicable to individuals apply to charitable contributions deemed made by the portion of an ESBT holding S corporation stock.
- Further, the ESBT should be able to deduct the fair market value of long-term capital gain property gifted in-kind to charity, subject to applicable percentage limitations.

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Rev. Rul. 2018-18 New Charitable **Numbers**

- Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns. • Low cost article. For taxable years beginning in 2018, for purposes of defining the term "unrelated trade or business" for certain exempt organizations under
- § 513(h)(2), "low cost articles" are articles costing \$10.80 or less.
 Other insubstantial benefits. For taxable years beginning in 2018, under
- § 170, the \$5, \$25, and \$50 guidelines in section 3 of Rev. Proc. 90 –12, 1990
- C.B. 471 (as amplified by Rev. Proc. 92–49, 1992–1 C.B. 987, and modified by Rev. Proc. 92–102, 1992–2 C.B. 579), for the value of insubstantial benefits that may be received by a donor in return for a contribution, without causing the contribution to fail to be fully deductible, are \$10.80, \$54.00, and \$108, respectively.
- Tax Responsibilities of Expatriation. For taxable years beginning in 2018, the amount that would be includible in the gross income of a covered expatriate by reason of § 877A(a)(1) is reduced (but not below zero) by \$711,000. 60

