Northwest Planned Giving Roundtable

4404 SE King Road, Milwaukie, OR 97222-5282

GOVERNMENT RELATIONS REPORT
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Al Zimmerman - Executive Director
Northwest Christian Community Foundation
503-892-6264 alz@nccf4christ.org

503-554-2106 azimmerman@georgefox.edu

Federal Activity

New Tax Law –It's Another Ride on the Roller Coaster
Everything is Fixed & Permanent – at Least for the Next Two Years!

After looking at eight different reports on the new tax law, I will try to provide a synopsis. All gift planners, estate planning attorneys, and financial planners and investment managers were waiting with baited breath for this legislation. And then President Obama had a conference with the Congressional leaders of both parties during the lame duck session following the election. **Let's strike a deal!**

What emerged from this was not expected by anyone and surprised everyone. But a deal was made. It was passed quickly by the Senate, and after some hesitation, passed the House. President Obama signed the legislation and it was done. For two years Congress couldn't decide what to do about the tax issues, and then suddenly it was done.

On December 17, 2010 the President signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 into law. This law changes the tax laws for calendar **years 2011 and 2012 only**. The main provisions of the legislation are:

- Increase and reunify the federal estate and gift tax exemption to $5 million per person.
- Increase the generation-skipping transfer (GST) tax exemption to $5 million per person.
- Reduce the top estate, gift and GST tax rates to 35 percent.
- Extend the Bush-era individual income tax rates.
- Create portability of the unused estate tax exemption for spouses.

Estate and Gift Tax Revisions

The federal estate tax had been scheduled to return in 2011 on estates above $1 million, with a top rate of 55%, following the one-year repeal in 2010. The new law reinstates the estate tax for 2011-2012, but limits it to estates over $5 million ($10 million can be sheltered by married couples), with a top tax rate of only 35%. A $5 million exemption also now applies to federal gift tax and GST tax, and the 35% top rate will apply to both taxes. All exemptions will be indexed for inflation after 2011.

This means that for all taxpayers but the tiny minority with estates in excess of $5 million ($10 million for married couples), federal transfer taxes will cease to be a concern for at least the next two years. **This is a virtual repeal of the estate tax for 99.9% of individuals.**

The reduction in rates reduces overall estate, gift and GST taxes and allows more assets to pass to non-charitable beneficiaries. The reduction in the rates (and likely increase in bequest amounts passing to heirs) may be a factor in reevaluating dispositive plans. Donors may be less-inclined to make taxable gifts during lifetime with the increased estate and gift exemption amounts and step-up in basis at death.

If taxes were a primary motivator for establishing a charitable gift plan, that motivation just took a back seat with this legislation. Most planned gift donors will not save transfer tax as a result of their gift because they had no transfer tax to pay in the first place. Most donors who make estate gifts do so because of their commit to your organization's mission, not because of the estate tax savings.

However, this change will have a big impact on the value/necessity of establish a charitable lead trust to reduce estate taxes.

Income in respect of a decedent will continue to be a problem for heirs. Donors should be encouraged to leave IRAs, savings bonds and other items of IRD outright to charity. CRTs funded with IRAs or savings bonds could provide lifetime income to family beneficiaries without erosion from income taxes.

Here's a strange thought: Could a charitable remainder trust be established that would not meet the IRS qualification requirements (nonqualified CRT) and pay beneficiaries all trust income, rather than a unitrust or annuity trust amount. The transfers would be subject to gift tax, but with the $5 million exemption that may not be an issue. Such assets in a trust would still avoid probate and may be attractive. Historically, our concern as planners is to focus on those vehicles that meet the IRS qualifications.

Here is now a significant disparity between state estate/inheritance tax rates and the federal rates. Oregon and Washington have both separated the state tax computation from the federal tax rates. The **Oregon exemption amount is $1 million**. It is quite likely that a donor may face no federal estate tax, but anticipate a large Oregon inheritance tax assessment of 14-16% of the estate amount over $1 million.

GST Tax Exemption

The GST tax exemption will increase to the estate tax exemption amount of $5 million. This increase provides additional benefit and flexibility to pass property to skip persons during the transferor's life or at death.

This also removes an incentive for considering use of the lead trust in planning.

Possibility of Unused Exemption

For many years, couples have had to do careful estate planning, such as the creation of a credit shelter trust, in order to claim their combined estate tax exemption. The new law allows the executor of a deceased spouse's estate to transfer any unused estate tax exemption to the surviving spouse without such planning. This provision is effective for estates of decedents dying after December 31, 2010.

This provision removes some of the motivation for establishing complicated A/B Trust plans for estate planning – also known as the Marital Trust/Credit Shelter Trust plan. There are valid reasons for having such a trust plan, but the same case cannot be made as those attorneys who were "selling living trusts" for everyone in the 1990s.

Reunification of Estate & Gift Tax

Prior to 2001, the estate and gift taxes were unified, creating a single graduated rate schedule for both. The single lifetime exemption could be used for gifts and/or bequests. The EGTRRA 2001 legislation decouples these systems. The new law has unified them once again, along with the GST tax, at least through 2012.

All federal income tax brackets temporarily extended for two years.

Income tax rates remain at 10, 25, 28, 33, & 35 percent. The capital gains and dividend rates have been 0 or 15 percent. For 2011, capital gain rates were scheduled to become 10% and 20% respectively, and qualified dividends were to be subject to the ordinary income rates (up to 39.6%). The current capital gains and qualified dividend rates have been extended for all taxpayers through 2012.

For the past several years, federal income, capital gains, and qualified dividend tax rates have been at historically low levels. While these low rates leave additional income in the hands of would-be donors, they also depress the income tax amounts donors can save by giving to charity. The new law extends

these rates for all taxpayers through 2012, thereby continuing the relatively low incentives for making lifetime charitable gifts, including planned gifts.

Some Provisions Encourage Charitable Giving

- Itemized deduction limitation repealed. Since 1991, the amount of itemized deductions that a taxpayer may claim has been reduced, to the extent the taxpayer's adjusted gross income is above a certain amount. Some donors could lose 3 percent of affected deductions (including charitable contributions) above a threshold amount, up to 80 percent of allowable deductions. This limitation on itemized deductions was repealed for 2010, but would have returned in 2011. The repeal of this limitation has been extended through 2012. This repeal means that donors who itemize and are in higher income levels will be able to use more of their charitable deductions.
- Deductions for charitable bequests, state death taxes, and tax breaks for qualified conservation easements and installment payment of estate taxes.
- Increased deductibility for 2010 and 2011 of gifts of appreciated real for conservation purposes by certain corporate farmers and ranchers.
- Enhanced deductions for gifts of food inventory by businesses.
- Enhanced deductions for gifts of book inventories to public schools by C corporations.
- Enhanced deductions for corporate gifts of computer equipment and software to public schools.
- Favorable basis adjustment for shareholders in S corporations that contribute property to charity in 2010 and 2011.

Extension of IRA Charitable Rollover

The TRUIRJCA of 2010 signed by President Obama provided a two-year retroactive extension of the IRA Charitable Rollover. The new law reinstated the Rollover for 2010 and allows any eligible gifts made by January 31, 2011 to be treated as a 2010 donation and to be used to satisfy the taxpayer's minimum distribution requirement for 2010. The expiration date for the Charitable Rollover is now set at December 31, 2011.

The following conditions remain for IRA Charitable Rollover gifts:

- The donor must be 70 ½ years of age or older.
- The transfer must go directly from the IRA to the charity.
- Gifts can be made for up to $100,000.
- Gifts must be made outright. Transfers to donor advised funds, charitable remainder trusts, and gift annuities do not qualify.
- Distributions can only be made from traditional IRA accounts or Roth IRAs. Charitable donations from 403(b) plans, 401(k) plans, pension plans, and other retirement plans are ineligible for the tax-free treatment.
- In order to benefit from the tax-free treatment, donors must obtain written substantiation of each IRA rollover contribution from each recipient charity.

There are trillions of dollars in IRAs. This is a potential pool of dollars for charities. However, it depends on the charity's constituency for the actual potential return from IRA gifts.

Now if could only get the rollover of IRA funds to deferred gift plans.

Information on TRUIRJCA of 2010 gleaned from following reports:

- Tax Law Update from R&R Newkirk Company.
- New Tax Law: A Summary for Gift Planners from PG Calc.
- Significant Tax Law Changes from Mitchell Silberberg & Knupp.
- Legislative Update from Partnership for Philanthropic Planning.
- Gift Planning Tips from R&R Newkirk Company.
- Overview of Key Tax Law Changes from Trusts & Estates.
- FPA Summary of 2010 Tax Relief Bill from Financial Planning Association.

Congress Failed to Repeal New Form 1099 Rules
Despite significant progress on a number of important issues, the lame-duck Congress failed to repeal the Form 1099 reporting requirements that were enacted last year as part of the healthcare reform bill. Set to take effect beginning in 2012, the reporting provision in question would require all businesses and tax-exempt organizations to issue a Form 1099 to all vendors from whom they buy goods totaling $600 or more annually. President Obama and key lawmakers in both the Senate and House have indicated they will work to repeal this requirement.

State Activity

Oregon legislature is just being seated as this report is written. With John Kitzhaber returning for a third term and the Oregon House divided evenly it will be an interesting session. Now that the federal estate tax exemption amount has been raised to $5 million, will there be pressure to raise the Oregon exemption amount?

Court Cases & Regulatory Matters

Donor Rescind Faulty Trust
Donors established a 7% charitable remainder annuity trust funding it with shares of appreciated stock. For several years they received quarterly payments from the trust. After preparing a report for a state franchise board, it was discovered that the remainder interest had a negative value at the time the trust was created. Even if the payout had been only the minimum 5%, the trust still would not have qualified.

To rectify the problem, the donors, the charitable remainderman and the trustee executed a rescission agreement that was approved by the state's attorney general. The agreement treated the trust as void ab initio, with the trust assets being returned to the donors.

IRS determined that the rescission would not constitute an act of self-dealing. Although the donors thought they were creating a qualified charitable remainder annuity trust, the trust did not satisfy the requirement of IRC §664(d)(1)(D) that it have a charitable remainder value of at least 10% of the value of the assets transferred to the trust. Therefore the trust was never qualified under IRC §170(f)(2), ruled the IRS. The donors will have to file amended returns and pay any federal or state income taxes due, along with interest and penalties. Ltr. Rul 201040021 Analysis & Comment, R&R Newkirk Company

Trustee's Participation Determines Whether Trust Activity is Passive Under IRC §469
In Ltr Rul. 201029014, the Internal Revenue Service explained how to determine whether an activity is passive under IRC §469, which disallows passive activity losses for individuals, estates, trusts, closely held C corporations and personal service corporations.

Under IRC §469(c)(1), a passive activity is an acidity involving the conduct of any trade or business in which the taxpayer doesn't materially participate. Material participation requires the taxpayer to be involved in the operations of the activity on a basis that's regular, continuous and substantial, which means day-to-day involvement.

While temporary regulations have been enacted that govern individuals, there are no such regulations applicable to trusts. The ruling clarifies that until such regulations are passed, the statutory test of IRC §469(h) will apply to trusts. According to the ruling, to determine whether a trust's activity is passive, the sole means for a trust to establish that's it's materially participating in activity is to show that the trustee's (not the beneficiary) involvement in the activity is regular, continuous and substantial.

Other Information

Inflation Adjusted Numbers from the IRS

Because there has been very low inflation in the past year, there will be no increase in Social Security payments for 2011. In addition, numerous tax-related numbers that are adjusted each year will largely remain unchanged.

IRS has published certain inflation-adjusted tax numbers for 2011 that take effect on January 1:

- Annual exclusion amount remains at $13,000 under IRC §2503.
- Annual gift tax exclusion for non-citizen spouse increased to $136,000.
- Token (de minimis) gift amounts: A low cost item will be $9.70 or less. For gifts of $48.50 or more, the low cost item may be distributed to donors with no tax impact. The token gift value may be increased for larger donor gifts and must be less than 2% of the gift or a maximum of $97.
- Special use valuation for real property devoted to farming or closely held business use increased to $1,020,000.

Implications of the Low 7520 Rates

The December 2010 AFR (§7520) rate was 1.8% and was the lowest since the floating midterm rates were introduced to value split-interest gifts in March 1989. The rate for January did come up to 2.4. It is helpful to consider the implications of some of these extremely low rates.

- Even using the lowest payout rate allowed (5.0%), a one life charitable remainder annuity trust could not be established for a beneficiary under age 73, assuming quarterly payments and the use of the 1.8 §rate, under the IRS 5% probability test. For a two-life annuity trust, the beneficiaries would have to be at least 75 each.
- For a one life 5% unitrust, the beneficiary could be as young as 27 and still meet the required 10% minimum charitable remainder value.
- Using the 1.8% §7520 rate, the annuitant of a one-life charitable gift annuity would have to be at least 60 years of age before the value of charity's interest would exceed 10%, assuming quarterly payments and the use of suggested gift annuity rates of the ACGA. For a two-life gift annuity, both annuitants would need to be at least 67 years of age to generate a 10% charitable deduction. Solution: decrease the annuity payout rate until the calculation provides a deduction that will qualify under the 10% rule.
- Keep in mind that donors can elect to use either rate for the month of the transfer or either of the two prior months whichever is most favorable. The donor must inform the IRS when filing a tax return if he rate for a prior month is being used.
- Low rates greatly benefit donors funding charitable lead annuity trusts and making gifts of homes or farms with retained life interests. It's possible to "zero out" the transfer taxes with a charitable lead trust at a much lower payout rate (unlike remainder trusts, charitable lead trusts do not have a minimum payout) or with a shorter term.

  For a sample form to issue as a "Statement Concerning Use of Alternative Valuation Date," send an email to the author of this report – Al Zimmerman.

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That's it for issue #15. Please feel free to comment, send tips, or provide questions.