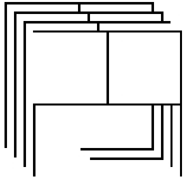

Northwest Planned Giving Roundtable

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GOVERNMENT RELATIONS REPORT

June 2011

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Federal Activity

Estate Tax Situation may not be Settled

A number of speakers at the 2011 Heckerling Conference suggested that the future may include a series of legislative patches going forward, perhaps every two years. Remember the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 expires after December 31, 2012. Unless Congress takes further action, on January 1, 2013 the tax laws that existed prior to the Tax Relief Act of 2010 will return, including the $1 million estate, gift and GST tax exemptions and the 55 percent top estate, gift and GST tax rates. None of the speakers expected that result to occur, but stay tuned to the ongoing happenings in Washington.

Trusts & Estates, February 3, 2011

New Congress, New Issues, New Debates – Not Much Happening, but Stay Tuned

The big news occurred with the adoption of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Not much has occurred on the federal level since then.

The debate has turned to the federal debt limit. The Republicans are insisting on significant spending reductions before agreeing to raise the debt limit. The Democrats are saying such "draconian" measures will have drastic impacts on the economy. The Republicans have indicated they will not shut down the government.

President Obama wanted a vote on just raising the debt limit. On Tuesday, May 31, the bill to increase the borrowing limit with no spending cuts was dead on arrival, it was voted down 318-97 vote. The real battle will be in formulating the budget for the next fiscal year that starts in October. Watch the chips fly as the sparring begins for the 2012 elections.

Some have noted that the government in Washington is more polarized today than in the past making it harder for legislators to compromise. The issue for some seems to be that Senators and Legislators do not remain in Washington to socialize on weekends, but return to their home districts to campaign. They are then forced to take hard political stands, rather than seek compromise to move things forward.

Legislation Still Being Considered to Modify Charitable Deduction

President Obama unveiled an aggressive deficit reduction framework, which calls for a $4 trillion reduction in the deficit to come from a combination of spending cuts and tax reform, and significant revisions to major itemized deductions like the charitable deduction. The President has indicated his displeasure that the tax code allows for what he sees as government spending through itemized deductions, adding, "while the goals of these expenditures are laudable, like home-ownership and charitable giving, we cannot deny that they mostly benefit the wealthy." President Obama has previously proposed limited the charitable deduction benefit. Recent Gallup polls have suggested that 70% of Americans oppose eliminating the charitable deduction.

PPP Legislative Update, May 17, 2011

Bill to Ban Tax Patents
The Senate Judiciary Committee unanimously approved legislation to reform patents. The Patent Reform Act of 2011 (S 23) is a broad reformation of patent law. It specifically includes sections similar to the bill introduced by Senator Charles Grassley and Senator Max Baucus that would ban patents on tax methods.

Senator Grassley was very pleased with the passage. He stated, "Tax strategy patents may undermine the fairness of the federal tax system by removing from the public domain particular ways of satisfying a taxpayer's legal obligation." Senate bill 23 expressly provides that a strategy for reducing, avoiding or deferring tax liability can not be considered a new or non-obvious idea, and, therefore, a patent on a tax strategy can not be obtained.

The bill passed the Senate 95-5 and is now in the House. The House Judiciary Committee passed patent reform legislation (HR 1249) containing a ban on the practice of patenting tax strategies. HR 1249 now goes to the full House for consideration, a vote could possibly occur in the next couple of months. S 23 and HR 1249 are companion pieces of legislation.

This issue is a concern to gift planners because patents have been sought on some charitable planning techniques.

Enhanced Form 1099 Requirements Repealed
President Obama signed into law a complete repeal of the enhanced Form 1099 reporting requirements that were set to take effect next year. Enacted as part of last year's healthcare reform law, the enhanced reporting rules would have required all businesses and tax-exempt organizations to issue a Form 1099 to all vendors from whom they buy goods totaling $600 or more annually.

PPP Legislative Update, May 17, 2011

State Activity
There are two bills that are of interest to the charitable community in the 2011 Oregon legislature.

Oregon Inheritance Tax
Under **HB 2541** Oregon's exemption amount for the state inheritance tax would increase from $1 million to $1.5 million. About half the estates that file under the current law are estimated at between $1 million and $2 million. The bill passed the House on a 34-25 vote and was moved to the Senate. Legislative bills are facing a must pass deadline that is looming. The bill has not been moved out of committee and may not come up for a vote.

28 states have no state estate tax. In states with estate taxes, exemptions range from $330,000 in Ohio to a high of $5 million in North Carolina. Estates valued at less than $50 million are exempt from federal estate tax.

Some lawmakers said there should be no replacement for a state inheritance tax that all agreed was unworkable. Other lawmakers said that despite efforts by the House Revenue Committee, the bill still would cost the state $700,000 in the two-year budget cycle starting July 1. A technical change in how a natural-resources credit is applied to small farms, forest and fisheries is responsible for the revenue loss. The bill was intended to be revenue neutral.

Rep Kim Thatcher doesn't like HB 2541. She would have rather seen her bill passed that would have abolished the inheritance tax. In her words, "we should have no taxation without respiration."

It is uncertain whether HB 2541 will be passed during this session.

Bill on Bad Charity Crackdown (SB 40) still being considered
This bill would allow the Attorney General to disqualify a charity from receiving tax-deductible contributions for Oregon income tax purposes if the Attorney General finds that the charity has failed to expend at least 30% of

its total annual functional expenses on program services when those expenses are averaged over the most recent three fiscal years.

For the first time this legislation would establish administrative cost ratios for Oregon and the first state to establish such ratios. In the view of the proponents this bill would eliminate tax subsidies for organizations that spend less than 30% of the money raised toward their purported charitable cause. John Kroger, Attorney General, says "the bill would take away the state tax deduction for what he calls "fake charities."

The bill passed the Oregon Senate 28-2.

Earlier AFP had opposed SB 40 because administrative costs alone are poor indicators of nonprofit effectiveness. Smaller organizations may have higher administrative costs. Unpopular missions associated with some nonprofits may be related to higher administrative expenses. AFP opposed the establishment of an "arbitrary mathematical formula that might impede the altruistic mission of our state's charitable organizations." AFP indicated that the organization supports transparency and ethical behavior, but opposes the establishment of administrative dost ratios.

AFP has also noted that there may be a constitutional challenge to the legislation because the Supreme Court has ruled that government cannot judge charities and/or charitable appeals based solely upon spending formulas.

The Nonprofit Association of Oregon supports passage of SB 40. "Oregon nonprofits routinely accomplish a great deal with limited resources. That is why we support the Attorney General's efforts to publicize the few organizations that don't. And in doing so, we aim to get out there in front of this issue and tell the real story about the good works nonprofits do every day for Oregon communities." The Nonprofit Association believes that SB 40 recognizes legitimate reasons for underperformance and creates appropriate exceptions. SB 40 imposes no additional regulatory burdens on the roughly 98% of the charities operating effectively in the state. There are no additional fees, no additional forms, and no additional disclosures for those that operate above the minimum imposed. In addition, it does not apply to organizations with less than $200,000 in annual income.

The Direct Marketing Association's Nonprofit Federation hopes to kill the bill.

An editorial in the June 1 edition of the Oregonian newspaper indicates the bill is bottled up in the House thanks to Rep. Vicki Berger, Republican of Salem. Berger is co-chair of the House Committee on Revenue and has not allowed it to have a hearing. Berger fears that bad publicity about fake charities could hurt the good ones that really need help.

Berger has said that she is considering holding a "courtesy hearing" on SB 40.

Court Cases & Regulatory Matters

Appraisal Isn't Protected by Attorney-client Privilege

In United States v. Richey, 107 AFTR 2d 2011-573 (January 21, 2011), the US Court of Appeals for the Ninth Circuit reversed a district court's holding that an appraiser's work file relating to an appraisal attached to an income tax return was protected by the attorney-client privilege and the work product doctrine.

The Donors were involved in granting a conservation easement for property to the Nature Conservancy. The Donors claimed a charitable contribution of approximately $200,000 on their 2002 federal income tax return, due to their proportionate share of the alleged value of the easement. The Donors' attorney retained an MAI-certified appraiser who prepared an appraisal report that was filed with the Donors' 2002 federal income tax return.

The appraisal report noted: "This report may not include full discussion of the data, reasoning, and analyses that were used in the appraisal process to develop the appraiser's opinion of value. Supporting documentation concerning the data, reasoning, and analyses is retained in the appraiser's file. Further deductions (approximately $1.3 million) based on the easement were carried forward on the Donors' 2003 and 2004 tax returns.

The court held that the district court erroneously concluded that the entire appraisal work file was protected by the attorney-client privilege. The attorney-client privilege protects confidential communications between attorneys and clients, which are made for the purpose of giving legal advice. The privilege may extend to communications with third parties who have been engaged to assist the attorney in providing legal advice. But, if the advice sought isn't legal advice, then the privilege doesn't exist.

The court held that any communications related to the preparation and drafting of the appraisal for submission to the IRS wasn't made for the purpose of providing legal advice, but instead, for the purpose of determining the value of the easement. In addition, the attorney-client privilege shouldn't protect documents in the files that were communications.

The court also held that the district court erred by concluding that the entire work file was protected by the work-product doctrine. The work-product doctrine protects documents prepared by a party or his representative in anticipation of litigation. The court found that regardless of whether the IRS examined the return, the Donors would still have been required to attach the appraisal to the income tax return. Therefore, the appraisal wasn't prepared in anticipation of litigation and wasn't protected under the work-product doctrine.

Lesson – be aware of the appraisal rules and advise donors to do it right. If not, not doing it the IRS way will return to bite you.

Trusts & Estates, May 2011, pages 12-14

Substantiation Requirements Not Met: Deduction Denied

The Tax Court has denied an income tax charitable deduction for the contribution of a façade easement based on the donors' failure to file a properly completed Form 8283 and attach to their tax return a qualified written appraisal. In addition, the contemporaneous written acknowledgement from the done organization failed to state if the done provided the donors with any goods or services in consideration for their contribution.

Planned Giving Design Center, March 30, 2011

Language in Testamentary Document Rules

In Ltr. Rul. (T.A.M.) 20100422, Decedent established a charitable trust and later executed a will and three codicils. The will and codicils created various trusts that distributed to the charitable trust upon termination. However, neither the will nor the codicils addressed the disposition of the decedent's residuary estate. Decedent's son and sole heir contended that he was entitled to the residuary estate. The charitable trust claimed that it was the residuary beneficiary, arguing that the omission of a residuary clause was the result of scrivener's error. It provided evidence to that effect, including an affidavit by the attorney who drafted the will and codicils, previous wills where the charitable trust was the residuary beneficiary, and a history of charitable giving by the Decedent during his lifetime.

The son and the charitable trustee entered into a settlement agreement under which the son would receive a certain sum outright and free of tax and the charitable trust would receive the balance. The settle agreement was approved by the local state court.

Not so fast. Under applicable state law, the residuary estate passed by intestacy in the absence of a residuary clause. Because the omission did not create an ambiguity, the proffered extrinsic evidence should be disregarded. There was no evidence in the will that the Decedent intended the residuary to pass to the charitable trust, and the charitable trust did not have an enforceable right under state law.

Gift of House and related Expenses Not Deductible

The Tax Court has held that a donor is not entitled to an income tax charitable deduction because she failed to establish that she conveyed legal title of a donated house to the charitable donee. Consequently the value of the house and costs incurred and related to relocating it may not be deducted.

This is a case with many twists and turns. What follows is a digest of some of the most helpful aspects related especially to the gift of the house. **Remember – the taxpayer bears the burden of proof to establish entitlement to any claimed deduction.**

In 2001 the Donor organized and caused to be incorporated an organization with the acronym "HOME" (Holistic Opportunities for Mental Empowerment). HOME later qualified as a 501(c)(3) charitable organization. For reasons not entirely clear, from time to time the Donor directly paid HOME-related expenses rather than making a donation to HOME so the expense could be paid from HOME's corporate checking account.

For three months during 2004 HOME conducted literacy classes at Good Shepherd Missionary Baptist Church in Houston, Texas. The Donor was a member of the church. Members of Good Shepherd volunteered to teach classes offered through the HOME literacy program.

Good Shepherd owned a house on property across the street from its church building. During 2004 Good Shepherd decided to use the property as a parking lot, but first the house had to be razed or moved. The Donor agreed to move the house at her expense to property that she had acquired in 1999 in Cleveland, another Texas town about 50 miles from Houston.

On a building permit application submitted to the City of Cleveland for the construction of a foundation for the relocated house, the Donor indicated that her mother was the owner of the property. The Donor had only been authorized to act as agent to obtain the permit.

The Donor claimed she had donated the Cleveland property to HOME in June 2004, and the relocated house was moved there to be used by HOME.

However in the eyes of the IRS, the Donor failed to establish that she conveyed legal title to the Cleveland property to HOME during 2004. Consequently, the value of the Cleveland property and the costs incurred to have the relocated house move there may not be deducted. The Donor acknowledged that the original deeds showing the transfer of the Cleveland property to HOME in 2004 were not recorded and, for reasons not fully explained, are no longer available. According to the deeds, the Cleveland property, together with the relocated house was conveyed to HOME on May 17, 2004. At trail the Donor produced copies of deeds prepared and notarized in February 2009. Copies of similar, but not identical, deeds apparently provided to the IRS during the examination of a 2004 tax return show a signature line for the Donor's mother. But there was no signature line for the Donor's mother on the copies of the deeds notarized in February 2009.

It is true that a deed need not be recorded to effectively pass title to real estate and an unrecorded deed is binding on the parties to the conveyance. But the Donor's case was not helped when copies of the original deeds could not be produced and they were not recorded.

Because it was unclear whether HOME obtained legal title to the relocated house during 2004 and HOME did not use the home in 2004, the Donor is not entitled to any deduction for costs of repairs to the house. The Donor paid $10,944 to have the relocated house moved from Houston to the Cleveland property. Presumably the Good Shepherd Church would have had to incur some expense to have the relocated house moved or razed so the property could be used for its purposes. To the extent that Good Shepherd realized a financial benefit in excess of the value of the relocated house, the Donor would be entitled to include that excess amount as a charitable deduction.

Summary: Tax Court held that the Donor is not entitled to an income tax charitable deduction because she failed to establish that she conveyed legal title of the donated house to the charitable done (Good Shepherd). So, the value of the house and costs incurred and related to relocating it may not be deducted.

Planned Giving Design Center, April 25, 2011

Other Information

S Corporation Shares

A question was raised at the last NWPGRT membership meeting regarding S corporation shares and nonprofits. Effective in 1998, charities became eligible to own shares in S corporations. Until 1998, charities were ineligible shareholders and a transfer of S shares to charity voided the company's S election.

S corp stock …

- May be accepted as an outright gift to a charity.
- May not be used to fund a charitable trust.
- May be used to fund a gift annuity, however caution should be exercised, UBI may deplete the remainder associated with the gift annuity over time. When a gift of S corporation stock is used to establish a gift annuity, the annuity amount will be reduced to reflect the anticipated UBIT.

As an alternative, an S corporation may establish a CRT as a donor with company assets.

Charities that accept gifts of S corp stock generally will be liable for some income taxes. Items of income, loss credit, or deduction, and any gain on the sale or disposition of the shares, will flow through to the charity and will be included in computing unrelated business income tax. Items of income, such as dividends, interest, and other passive income, which are normally excluded from UBI or unrelated trade, are subject to tax as UBI, if such items are passed through from an S corporation to a 501(c)(3) charity.

Even though a gift of subchapter S corporation stock may yield a significant gain to a charity, the nature of S corporation stock requires special scrutiny. A charity that receives a gift of S corporation stock will be subject to unrelated business income tax (UBIT) on its portion of the S corporation's accounting income for every day that it owns the stock. The gain from the sale of S corporation stock is also subject to UBIT. The donor's income tax deduction for a gift of S corporation stock must be reduced by the proportion of gain that may be treated as ordinary income if the underlying assets of the corporation were sold.

Each potential gift of S corporation stock must be carefully evaluated by the donee charity. The review process should include an analysis of potential purchasers of the stock, anticipated gain from the stock, anticipated income or cash flow to the charity, determination of the corporation's ability or willingness to redeem the stock, adequacy of appropriate insurance by the corporation, and a qualified appraisal of the stock. If it is the intent of the charity to locate a buyer and liquidate the stock soon after the gift is received, consistent with its policy regarding publicly-traded stock, then it must consider the number of potential purchasers. With each proposed gift of S corporation stock, the charity must be assured that: 1) cash will distributed at such times and in sufficient amounts to pay any UBIT tax installments that may be due, 2) distributions will be made to the charity in the same proportionate amounts as other shareholders, and 3) shareholder-employees will not engage in practices that may potentially be harmful to the minority shareholders. An analysis of the stock's value and the potential return to the charity must be received from qualified financial and legal advisors familiar with subchapter S corporation stock. Each gift of S corporation stock should be reviewed and approved by the organization's board of directors or an appropriate committee.

Yes, S corporation stock may be accepted as a gift by charities.
No, such a gift will not void the corporation's S corp status.
However, charities are warned to proceed with caution when accepting S corp stock.

Sources:
Charitable Giving Tax Service, R&R Newkirk Company
Charitable Giving, Richard Fox, Thomson Reuters Company

Disclaiming Retirement Account Means Low-Cost Charitable Bequest

Making charity the contingent beneficiary of retirement plan death benefits and giving heirs the right to disclaim part or all of their distributions may be a good way to benefit your charity. Heirs who understand the severity of IRD taxes – including state/federal income and estate taxes – may decide it best to have retirement assets pass to a worthwhile cause and channel the gift to charity. Caution must be exercised in the following areas:

- Except for a surviving spouse, an individual cannot make a valid disclaimer of IRA benefits into a charitable remainder trust if that person will be a beneficiary of the trust [Reg. §25.2518-2(e)(3)].
- Disclaimers of assets to a private foundation will create tax problems if the person disclaiming is a director of the private foundation. One alternative would be to provide for a disclaimer to a donor advised fund of a community foundation.

Gift Planning Tips, R&R Newkirk Company, April 2011

Borrowing by Trustee Poses Risks for Charitable Remainder Trusts

Prior to the Tax Relief and Health Care Act of 2006, a charitable remainder trust that had *any* unrelated business taxable income (UBTI) – even one nickel – lost its exemption from income taxes. Loss of tax-exempt status affected the current year only, but if the trust sold business assets while nonexempt, heavy taxes could occur. UBTI is defined by statute to include any *debt-financed income*, that is, trust income that can be traced to indebtedness incurred by the trust.

The law was changed to provide that UBTI will now be subject to a 100% excise tax, but the trust keeps its tax-exempt status [IRC §664(c)]. The confiscatory tax may not be a particular problem where the trust receives small amounts of income from an operating business – but it may be disastrous where the trust has borrowed funds to prepare trust property for sale. Indeed, debt-financed income tax can be far worse under the new rules.

Suppose the trustee of a unitrust borrows funds to improve trust real estate for sale. The trust would incur UBI for so-called acquisition indebtedness under IRC §514(c)(1) that would result in significant UBIT when the property is sold. The problem is especially acute where trust property has a low cost basis. Here is a simplified example:

Suppose an office building having a value of $1,000,000 is contributed to a unitrust. The trustee has a carryover basis in the property of $100,000 and borrows $50,000 to refurbish the property prior to placing the property on the market. Under IRC §514, the taxable portion of income realized from sale of the property is based on the ratio of the average acquisition indebtedness ($50,000) to the average basis in the property ($100,000), or 50%, with the result that 50% of the gain from sale of the property ($450,000) is considered UBTI – and taxed at a 100% rate. The unitrust is left with only $550,000 after taxes. (See pages 8-17 to 8-20 of the *Charitable Giving Tax Service)*. Under prior law, the trust would have lost its tax-exempt status upon realizing debt-financed income, but the $900,000 gain would have been taxed at long-term capital gain rates, not the confiscatory 100% rate illustrated in our example.

Clearly, any borrowing by the trustee needs to be planned carefully. Ideally, the donor will have funded the trust with some additional cash or securities that can be liquidated to prepare property for sale. Assuming the trust permits additional contributions, the donor alternatively could transfer funds to the trust to pay the fix-up expenses, or perhaps the trustee could sell an undivided fractional interest (to the remainderman, for example) to create the needed cash. Upon sale, proceeds would be divided between the trust and the remainderman.

Gift Planning Tips, R&R Newkirk Company, May 2011.

New Recommended Charitable Gift Annuity Rates Approved – Effective July 1, 2011

At its April 2011 meeting the Board of Directors of the American Council on Gift Annuities (ACGA) approved a new schedule of maximum charitable gift annuity rates. The rates are effective for gifts on or after July 1, 2011.

Organizations that issue charitable gift annuities generally follow the recommended payout rates of the American Council on Gift Annuities. Unlike the past several rate changes which tended to move either up or down in the same direction, the rates on the 2011 schedule trend in different directions for different age groups. The new rates are slightly higher for recipients 75 and older, slightly lower for persons under age 70 and the same for those ages 70-74. Here is a sampling of the new rates for one-life annuities:

One Life Rates

Age of Recipient	Payout Rate	Age of Recipient	Payout Rate
60	4.8%	76	6.6%
62	5.0	78	7.0
64	5.2	80	7.5
66	5.4	82	7.8
68	5.6	84	8.2
70	5.8	86	8.6
72	6.0	88	9.2
74	6.3	90 or over	9.8

The recommended rates are based on actuarial and investment assumptions that would leave organizations with a 50% residuum from funds transferred for gift annuities. The new schedule reflects 1) ACGA's long-standing residuum target of 50%, with an additional requirement that the present value of the residuum be at least 20% of the gift amount; 2) the results of a recent study on charitable gift annuitant mortality conducted by the ACGA's actuarial consultants, the Hay Group, and 3) a more conservative investment return assumption.

For a complete listing of one-life and two-life recommended rates, go to http://ACGA-web.org.

Gift Planning Tips, R&R Newkirk Company
GiftLaw, Crescendo

** Note that the NWPGRT Government Relations Report is a compendium of information drawn from many sources. Credit is given to sources when known and where appropriate. This information is of an educational nature and is intended solely for the benefit of the members of the NWPGRT. It is not to be construed as legal advice. The author derives no monetary benefit from providing this service or the information contained herein.

That's it for issue #16. Please feel free to comment, send tips, or provide questions.