Northwest Planned Giving Roundtable

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GOVERNMENT RELATIONS REPORT
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And the verdict on the tax issues is ……. ???

There is a lot of smoke rising from the talk about takes, but there isn't much fire behind it. Everybody in Washington is focused on the November elections. There are still a number of issues on the table and of interest to gift planners:

- Income tax rates
- Capital gains tax rates
- Limitations of charitable deductions
- Estate tax rates
- Carry-over basis vs. step-up in basis
- IRA charitable rollover

At the present time no one in Washington wants to tackle these issues – they are too hot to handle. A vote was scheduled the week of September 27 in the House on the tax rate issue. The Democrats, many of whom are up for election, did not want to vote one way or another. The Speaker indicated there would be no vote on the tax issues until after the election.

In an article in the August 16 issue of GiftLaw published by Crescendo, the contrasting positions of the factions were outlined:

> Majority Leader Steny Hoyer (D-MD) indicated that increased taxes on the top two brackets are expected to raise $38 billion in 2011 and nearly $700 billion over the next decade. He estimates that 96% of the added tax would be paid by taxpayers with incomes over $500,000 per year.
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> Minority Leader John Boehner (R-OH) published a release to state his opposition to "hitting small businesses with a job-killing tax increase" in 2011. Rep. Boehner points to the current high unemployment and indicates that his Ohio constituents are asking him, "Where are the jobs?" With the high level of unemployment, Rep. Boehner suggests that raising taxes on small business owners is the wrong strategy.
>
> "We will not fix the deficit until we cut spending and have real economic growth – and we won't have real economic growth if we keep raising taxes on small business."

Key question – which party is going to control Congress? If the Republicans gain control of the House that will set up a contest of wills with President Obama. If the election changes control of the House, what will happen during the lame duck session? Will the Democrats try to push things through in November, knowing the ability to control the process will change in January? If the Democrats retain control of the House, does that mean the tax issues will be settled quickly? (Don't count on that happening!)

Stay-tuned for the latest results and see which way the wind is blowing.

Remember – if Congress does nothing, the estate tax will revert to a tax rate of 55% with $1 million exemption amount. If Congress does nothing, the income and capital gains tax rates revert to the rates in effect in 2001.

Implications for estate planning

An article in the August 2010 issue of Trusts & Estates, "Scratching Your Head over 2010 Estate Plans?" was based on a series of questions presented to four leading estate planning experts: David Handler, David Hodgman, Charles Redd, and Joshua Rubenstein [They weren't famous to me either, but in the rarified air of certain legal offices I'm sure they are experts.] Here are some random exerts from this article.

There are some differences between income taxes and transfer taxes. The avoidance of income taxes is called "tax evasion," however the avoidance of transfer taxes is called "tax planning." Transfer taxes can be avoided in one of three sanctioned manners:

1. Leaving money without tax to surviving spouses (so that they don't become public burdens);
2. Leaving money without tax to charity (again to reduce the public burden); and
3. Gifting assets at reduced tax cost during one's life to children (so that they can receive assets not in their dotage but when they need it, and so that the wealth creator is still alive to help teach them how to manage the funds – again reducing the public burden).

Probably of greater impact than any tax law uncertainty is the impact of market conditions. He dramatic market downturn in 2008 and 2009 caused many clients to adopt a "hunker down and wait" mentality.

At all other times, we have at least known what the tax laws are; now, we don't even necessarily know what the options are for what they will become, let alone for what they may be at the moment. [Confused yet?]

Most clients, however, resist having taxes be the tail that wags the estate planning dog. If all of our clients listened to all of our tax advice, they all would have died this year. Clients, in the light of tax advice, make decisions predominantly for business and personal reasons – as they should. Just because we don't know what to tell them doesn't mean there aren't things they need (and want) to do. So there's still lots of need to do planning now for all of the traditional reasons that have little, if anything to do with taxes – aging, providing for beneficiaries, successioning businesses, art collections and other illiquid assets, etc. And of course, there is still a gift tax, and everyone believes that the estate tax will return. [Don't let the state of the economy, tax legislation, or anything else hinder us gift planners from discovering the right prospects who are motivated for the right reasons to make a significant gift that will fulfill their planning objectives.]

Dealing with the carryover basis system imposed by IRC §1022 with respect to 2010 descendents has already proven to be a train wreck. Assembling cost basis data for assets held for decades is often impossible.

What about retroactive reinstatement of the estate tax and GST tax? Charles Redd predicts that will not occur.

1. The developed law doesn't clearly establish that retroactive reinstatement would pass muster under the due process clause.
2. As a practical matter, Congress has waited too long to implement retroactive reinstatement. The longer Congress dithers, the less likely the courts would sanction retroactive reinstatement and the more pressure members of Congress will feel just to turn the page and make any transfer tax changes prospective only.

David Hodgman: While I was wrongly convinced that Congress would act before the end of 2009, I'm even more convinced that Congress will not allow the estate and gift tax system to revert to the 2001 level of exemptions. Nor do I think revenue concerns will change that result. There are too many people, including small business owners, who come to rely on exemptions of $3.5 million per person. Given the highly partisan atmosphere in Washington, it seems quite possible that no agreement will be reached until they are at the brink. That could be as late as the due date for a tax payment for the first people to die in 2011 – which would be September 30, 2011.

Charles Redd: I think 2010 will pass with no changes in federal transfer tax law. Political paralysis and the lure of additional campaign funds will prevail for the rest of this year and into the next.

Limitations on Charitable Deductions
Several states are considering capping charitable deductions – New York is the latest. The Obama administration proposed capping charitable deductions (and other itemized deductions) to fund health care proposals. The cap on deductions is included in President Obama's 2011 budget proposal.

In a proposal introduced by Senators Ron Wyden (D-OR) and Judd Gregg (R-NH) (S. 3018) standard deductions would increase significantly: $30,000 for those married filing jointly, $15,000 for singles. Such a change would effectively eliminate the charitable deduction (and other itemized deductions) for most taxpayers other than high-income individuals.

The charitable deduction is under attack.

Tax / Gift Planning Strategy Patents
Those in the gift planning community are generally supportive of sharing information, concepts, strategies, and other useful information. But what if you are on the other side and make your living devising strategies and developing forms and agreements to put those concepts into practice?

Some have sought to "patent" the strategies they have developed. This effectively creates a monopoly for the patent holders to determine who can and cannot utilize parts of the tax code. Tax advisors (which may include attorneys and gift planners) have the burden to be aware of such patents, and either provide tax advice that complies with the patent holder's requirement, risk a lawsuit for themselves and the clients (and the charities they represent), or potentially not provide the most advantageous advice to clients and donors.

There are pending patents that would affect taxpayers' ability to create a financial plan for funding college education; utilize incentive programs for health care savings account cards; insurance against tax liabilities; and use life insurance to generate income. There have also been attempts to patent donor advised fund and supporting organization strategies.

The number of tax strategy patents has grown to 117 issued and 151 pending.

HR 2584 is presently in the House and would seek to ban tax strategy parents. S 2369 has been introduced in the Senate as a companion bill. A coalition of 18 national organizations representing consumer, taxpayer, charitable, financial planning, and tax advisor groups have sent a letter urging lawmaker to enact legislation ban tax strategy patents during the current Congress. Included in the signers of the letter is Tanya Howe Johnson, president and CEO of the Partnership for Philanthropic Planning

From Planned Giving Design Center, 9/30/2010.

Supreme Court Finds Hedging Process Ineligible for Patent
In a similar case, the US Supreme Court ruled that a hedging process developed for buyers and sellers of commodities in the energy market wasn't eligible for a patent. Petitioners argued that the hedging technique was a "process" eligible for a patent under Section 101 of Patent Act (35 U.S.C. 101), which provides that a patent may be obtained for any "new and useful process, machine, manufacture or composition of matter, or any new and useful improvement thereof."

In the lower court decision, the Court of Appeals for the Federal Circuit held that a process must be tied to a machine or transformation to be eligible for a patent. It held that the "machine or transformation test" was the sole test governing what is patentable under Section 101.

The Supreme Court wholly rejected this attempt to restrict the scope of patent-eligible processes to only those that are related to a machine or transformation. It held that the machine or transformation test is a helpful guide in determining what is patentable, but isn't an exclusive test. The court held that business methods aren't per se ineligible for patents. However, a lengthy concurrence by Justice John Paul Stevens disagreed with this point and reasoned that, given the history of patent law and its purposes, legislative history and Congressional intent, business methods should be outside the scope of patentable processes.

The majority ultimately refused to define the boundaries of a patentable process or establish any new gloss on the definition processes. Instead, the majority relied on other grounds to determine that the hedging process at issue wasn't a patentable process. It held that the process was an attempt to patent an abstract idea, which is prohibited by the case law.

Under this case, Bilski, the potential for patenting tax-planning strategies remains uncertain because the case hasn't limited the definition of a patentable process or resolved to what extent business methods may be patentable. Trusts & Estates, August, 2010, page 12.

Pertinent to gift planners? What if the concept of a unitrust that was designed to flip from a net income to a standard unitrust on a specific date or upon the happening of certain triggering events was a patentable planning strategy?

And this is why HR 2584 and S2369 are important to estate planning attorneys and planned gift officers.

Other Washington Rumors

Lawmakers in U.S. and Canada Seek to Restrict Nonprofit Salaries
(As reported in the AFP Public Policy Update for Summer 2010)
Federal and local governments are contemplating unprecedented restraints on nonprofit compensation. A provision in New Jersey's recently passed budget includes a limit on what nonprofit groups can pay their chief executives if they are providing social services under state contracts. Other states are considering similar measures. Federal lawmakers have expressed concern as well. Senator Charles E. Grassley, Republican of Iowa, has told Treasury Secretary Timothy F. Geithner that he is concerned that the Internal Revenue Service is not tough enough in policing pay in the nonprofit sector and that regulations governing compensation are too weak, reports *The New York Times*.

What's in the future? Regulation, transparency, more reporting – perhaps an even more convoluted Form 990.

IRS, Court Cases, & Regulatory Matters

Appraisal Issues Galore

Who signs the 8283 does matter
IRS requires certain steps if noncash gifts are contributed to charity. If a noncash gift includes items or property valued at more than $500 (or a group of items with a value in excess of $500), IRS Form 8283 must be completed and submitted with the donor's tax return. As a courtesy, the charity may provide the Form 8283 to the donor; however it is the donor's responsibility to see that the form is included with his/her income tax filing.

If the value of the donated property exceeds $5,000, a qualified appraisal must also be obtained. A copy of the appraisal must be retained by the donor, but may not be required to be submitted with the tax return. Stocks not traded on the public markets (i.e., NYSE, NASDQ, AMEX) with a value in excess of $10,000 must be appraised to determine the value of the gift. If the value of nonpublicly traded stocks is less than $10,000, a qualified appraisal is not required. However, the donor must complete parts of IRS Form 8283 and a representative of the charity must sign the form.

The IRS has established specific requirements that must be met before an appraisal will be accepted as "qualified." These rules are discussed in IRS Publication 561.

Who signs the Form 8283?
If the value of the donated item is more than $5,000 (Section B, page 2) …

- Donor/taxpayer – Part II
- Donee/charity – Part IV
- Appraiser – Part III

Note – Form 8283 and the appraisal may not be signed by the appraisal firm. Both documents must be signed by the individual who completed the appraisal.

The language contained in Part III of Form 8283 and the instructions clearly indicate that the individual appraiser must sign the form. The statutory language defining an appraiser as an individual and the regulations requiring each individual appraiser who works on the appraisal to sign the appraisal clearly indicates that a person, not a firm, must sign Form 8283 and the appraisal.

The reasoning behind this is that a person must be able to be held responsible for any false or fraudulent overstatement in the appraisal.

Reported by Planned Giving Design Center, 6/7/2010

<u>No Qualified Appraisal – No Deduction</u>
Petitioner, Henry Lord, and his wife owned real property in Baltimore, Maryland. On December 30, 1999, they granted a deed of conservation easement relating to the property to Land Preservation Trust, a 501(c)(3) charity. Page Appraisal Company prepared an appraisal for Lord stating that the easement contribution's estimated market value was $242,500. The appraisal had an effective date of December 31, 1999, and a report date of January 4, 2000.

On April 25, 2003, Lord and his wife submitted a 1999 joint Federal income tax return on which they claimed a charitable contribution deduction relating to the easement contribution. With the 1999 return they included Form 8283 and reported the easement contribution (12/30/1999 contribution date, 12/31/1999 appraisal date, and $242,500 appraised value). However note that the tax return was not filed in a timely manner.

A qualified appraisal must include the date (or expected date) of the contribution, the date on which the property was appraised, and the appraised fair market value of the property on the date (or expected date) of the contribution.

IRS contended that appraisal done by the Page Appraisal Company failed to state:

- The contribution date
- The date the appraisal was performed
- The fair market value of the easement contribution on the contribution date.

Lord contended that he had substantially complied with the regulations by providing the IRS with the appraisal, and Form 8283.

It was ruled that the appraisal was not a valid appraisal because it failed to include the critical elements. Lord tried to assert that he had substantially complied with the requirements. However, the doctrine of substantial compliance is not applicable if significant information is omitted. **The appraisal left out the crucial information, so it was not valid – therefore no tax deduction.**

From Planned Giving Design Center, 9/15/2010

<u>No Appraisal – No Timeshare Gift Deduction</u>
Maria Towell acquired a timeshare in 2001 for $12,396. After completing payments on the timeshare in 2004, she deeded the timeshare to an agent for a 501(c)(3) charity in 2006.

Towell filed Form 8283 and claimed a charitable deduction of $12,900. The IRS audited the taxpayer and denied the deduction.

The Tax Court noted that a noncash contribution greater than $5,000 must be supported by filing IRS Form 8283 and a qualified appraisal. Towell did not present any evidence of the claimed appraisal to the Court. Because she did not actually obtain an appraisal, Form 8283 was not valid and the deduction was denied.

> Special note of timeshare gifts: The actual value of a timeshare may be worth less than the $5,000 threshold for obtaining an appraisal. If this were the case, then Form 8283 would still be required because the asset is over $500 in value. However, if she stated a reasonable method for valuation and claimed a value less than $5,000, she could have filed Form 8283 without an appraisal and obtained a charitable deduction.

[Now that you know the rest of the story, how many timeshare gifts do you want to receive?]

<u>Appraisal Fails Because of Lack of Substantiation</u>

James and Lori Hendrix discovered it would cost about $10,000 to demolish their existing home in order to build a larger one. They entered in an agreement with the local fire department to use the house for training and then demolish it. They obtained an appraisal estimating the fair market value of the property at $520,000.

Mr. and Mrs. Hendrix claimed a charitable deduction on their 2004 income tax return of $287,400. The IRS disallowed the deduction. The IRS said the appraisal obtained by the Hendrixes did not satisfy the requirements of §170(f)(11(A)(1) and the contract with the fire department did not qualify as a contemporaneous acknowledgment under §170.

The court found that the appraisal did not give the expected date of the contribution, terms of the agreement with the city, qualification of the appraiser, or include the required statement that the appraisal was prepared for income tax purposes. A contemporaneous acknowledgment of a gift must include a description of any property other than cash; indicate whether any goods or services were provided in consideration and a description and good faith estimate of the value of such goods or services.

Because none of the documents satisfied this standard, the taxpayers are not entitled to a deduction.
From R&R Newkirk, October 2010

<u>Appraisal of Life Insurance Policies</u>

Gifts of life insurance policies have been especially problematic since the new appraisal rules were set forth. The new requirements imposed new guidelines on who is a qualified appraiser and the strict penalties for incorrect policy or asset valuations. As a result, it has become much more difficult and expensive to obtain an appraisal of a gift of a life insurance policy.

The Mass Mutual Financial Group (MMFG) has requested that Treasury adopt a policy of accepting a “fair market value statement” from the issuing life insurance company as a qualified appraisal from a qualified appraiser for purposes of valuing charitable donations of inforce life insurance policies as a safe harbor for charitable gifts.

MMFG asserted that the appraisal is not meaningful when the asset donated is a life insurance policy for two reasons:

1. The IRS itself has established allowable methods for valuing life insurance policies, and those methods can be followed with a “qualified appraisal.”
2. The deduction allowed for donation of life insurance is typically limited to the policy’s cost basis, not its fair market value, because its gain is taxed as ordinary income. The policy-holder incurs a cost to obtain a qualified appraisal that does not have any practical impact on the amount of the allowable deduction.

MMFG asserts that the administrative burden, along with the cost of hiring a qualified appraiser, may discourage donations of a valuable asset to worthy charities.

MMFG proposed that the IRS accept a “fair market value statement” from the issuing life insurance company as a qualified appraisal from a qualified appraiser.

From Planned Giving Design Center, 9/30/2010

[It will be interesting to see how the IRS responds. There are only a couple of well-known appraisers now willing or able to appraise gifts of life insurance policies.]

Is Parking Lot Income UBIT

In Ocean Pines Association, Inc. v. Commissioner, the Tax Court held that income from two parking lots was taxable to a nonprofit association. (135 T.C. No. 13; No. 6127-08 (30 Aug 2010)

This issue arises not only in connection with property donated to charity, but even more importantly to a charitable trust. Until 2006, if a charitable remainder trust had any unrelated business taxable income for the current year –even one nickel – lost its exemption from income taxes, for the current year only. **Under current law such income is subject to a 100% excise tax, but the trust keeps its tax-exempt status.**

Is income from a parking lot UBI? It depends. Generally the view is that if the parking lot spaces are provided on an hourly basis to the general public that is an ongoing, operating business – and therefore UBI. If the charity rents the entire parking lot to another entity (neighboring business) on a month to month basis that is rent and not UBI.

The Ocean Pines Association operates many recreational facilities and owns a beach property and two parking lots with some usage restricted to members. The lots produced revenue to the Association, some from leasing the property to third party businesses from 4:00 pm to 3:00 am each day, and some from payments made by association members for parking stickers allowing them to use the parking lots during the summer.

The IRS declared the revenue from the parking lot was UBI. The Association claimed that the revenue was not subject to UBI because: 1), the parking lot was “substantially related” to its use of facilitating the community welfare. 2), the revenue from the parking lot constituted rent from real property and therefore was exempt from UBI.

The court noted that under §513(a) a charity may escape taxation on revenue for activities that are related to its exempted purpose. However, if the activity is “regularly carried-on” and is “not substantially related” to the exempt purpose, then it is taxable.

Clearly, the parking lots were regularly carried-on business activity. Because the use of the parking lot was limited to the members, the court determined that is was not exempted. If a homeowner’s association provides services to its members, that service is not for the general public and therefore not exempted.

The second claim by the association is that parking lot fees were “rents from real property.” If this is so, then under §512(b)(3)(A)(i), they would be excluded from UBI. However, the court noted that Reg. 1.512(b-1(c)(5) states that the furnishing of hotel services or “use or occupancy of space and parking lots” is not exempted. **However, because the lease revenue for the evening use of the parking lots was a lease payment by a third party, this revenue is exempt from UBI.**

From GiftLaw, September 2010.

When is a gift a gift?

When working with donors, gifts are often structured to take advantage of the annual exclusion for gifts to individuals – currently the annual exclusion amount is $13,000. Anyone can give anyone else a gift valued at up to $13,000 and does not have to report or pay gift tax on the amount transferred to the other person.

In a 2010 Tax Court case the Tax Court ruled whether gifts of limited partnership interests were properly characterized as present interests, thus qualifying for annual gift tax exclusions (not lifetime gift tax exclusions).

The court ruled that the gifts did not offer the donee an "unrestricted and noncontingent right to immediate use, possess, or enjoy either the property itself or income from the property" and therefore did not qualify for the annual gift tax exclusion.

Facts: Walter & Sandra Price gifted minority limited partnership interests in Price Investments Limited Partnership (Partnership) to their children from 1997 through 2002. Gift tax deficiencies were asserted for 2001 and 2002. According to the partnership agreement, the limited partners have no right to withdraw their capital accounts in the Partnership.

Additionally, the partnership agreement prohibits partners from selling or transferring their interests to third parties without the unanimous consent of all other partners. Without the unanimous consent of the partners, a partnership interest can only be transferred to another partner or to a partner's trust. K Furthermore, the sale or transfer to third parties are subject to the Partnership's and its partners right of first refusal to purchase the offered interest, which does not specific a time limit for fulfilling he partners' obligation once the right is exercised.

IRS position: The annual exclusion gifts made by Walter and Sandra Price to their children were gifts of future interests because the partnership agreement imposes transfer restrictions to third parties. Also, the partnership agreement does not require distributions of Partnership income to the partners.

The court ruled that the gifts did not offer the done an "unrestricted and noncontingent right to immediately use, possess, or enjoy either the property itself or income from the property" and therefore did not qualify for the annual gift tax exclusion.

From a bulletin distributed by the Financial Consulting Group of Perkins & Company

[Beware of when a gift is not really a gift.]

Other Information

<u>2010 Token Benefit Limitations Announced</u>

A donor is not deemed to have received a quid pro quo when she receives a token benefit. According to IRS guidelines, the donor may disregard the value of de minimis benefits and deduct the full amount of a payment, provided the gift was made as part of a fund raising campaign in which the nonprofit organization informs the donor how much of the payment is a deductible contribution and ...

- The fair market value of all the benefits received by the donor in connection with the contribution is not more than 2% of the payment, or $96 (up from $95 in 2009, changes each year), whichever is less, or

- The donor's contribution/payment is at least $48.00 (2010, changes each year) or more and the only benefits received are token items (such as bookmarks, calendars, key chains, mugs, etc.) that bear the organization's name or logo and have an aggregate cost of no more than $9.60.

<u>ACGA releases new suggested gift annuity rates</u>

New recommended gift annuity rates increased slightly (0.1% – 0.2%) or remained the same for many age brackets. The new rates became effective in July.

Assumptions underlying the new rates:

1. Residuum realized by the charity upon termination of an annuity is 50%.
2. Life expectancies are based on the Annuity 2000 Mortality Tables for female lives with a two-year setback in ages. The rates also incorporate projections for increasing life expectancies.
3. Annual expenses for investment and administration are 1.0% of the FMV of gift annuity reserves.
4. The total annual return on gift annuity reserves is 5.5% (up from 5.25%).
5. The rates for the youngest and oldest ages are somewhat lower than the rates that would follow from the first four assumptions.

The new single-life rates are 0.1% - 0.2% higher for annuitant gages 66-81 and unchanged for all annuitant ages 82 and above. At young annuitant ages, those 50 and younger, the new rates are 0.4% - 0.5% higher than the ones they replace. The new joint life rates are 0.2% higher for age combinations 70 and 70 through 82 and 82. They are 0.1% higher for age combinations 83 and 83 through 91 and 92. They are unchanged for all joint annuitant ages older than 91 and 93. As with the single-life rates, the new joint life rates increase 0.4% - 0.5% at young annuitant ages, such as 50 and 50 or 40 and 40.

Deferred gift annuity rates increase also. The ACGA has increased the compound interest factor for deferred gift annuity rates from 4.25% to 4.5% for all deferral periods.

Reality: The new gift annuity rates have changed little, if at all, for the range of ages into which almost all gift annuitants fall. Immediate payment gift annuities will remain an attractive option for supporters in their 70s and older who are interested in making a charitable gift and receiving fixed payments in return. The increase in deferred gift annuity rates may be enough to attract a few additional donors, but probably no more than a few. Most importantly, gift annuities will continue to be good gifts for charities.

Consult the new rate schedule from the ACGA which is available on the ACGA website (www.acga-web.org).

[The ACGA continues to be conservative and recommend rates based on a careful analysis of all the relevant factors. Charities are well-served and protected by following the recommended rates. So – is it responsible for a major charity to offer rates significantly higher than the recommended rates? It is legal, but not recommended. Their investment earnings must be significantly higher than projected by the ACGA.]

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That's it for issue #14. Please feel free to comment, send tips, or provide questions.