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MEMORANDUM

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TO: CLIENTS AND FRIENDS
FROM: MICHAEL SCHLEY
RE: PRESENTATION OUTLINE: PENSION PROTECTION ACT
DATE: SEPTEMBER 14, 2006

The Pension Protection Act of 2006:

Consequences for Planned Givers

(and Planned Receivers)

by

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Introduction: The federal Pension Protection Act of 2006 (“PPA”) was signed into law on August 17, 2006 . This outline summarizes the provisions of the PPA that may have the most effect on exempt organizations, with special attention to planned giving activities.

This outline is for informational purposes only and is not intended to be a substitute for professional legal or tax advice based on the facts of your situation.

1. Qualified Charitable Distributions from IRAs

- **1.1. Old law:** In order to donate from a traditional IRA to a charity, a taxpayer would have to take the distribution into income and then claim a charitable deduction for the gift.
 - **A. Problem:** Taxpayers who do not itemize could not claim the deduction.
 - **B. Problem:** Taxpayers at the 50% AGI limit could not claim a deduction for the excess.
 - **C. Problem:** Taxpayers with “tax friction” could still end up paying net tax on the gifted amount (because of the effect of increased AGI on certain deductions).
 - **D. Problem:** Some states (unlike CA) do not allow itemized deductions. In those states, a taxpayer making a donation from an IRA would be subject to state income tax on the amount.
- **1.2. New law:** The new law permits (in 2006 and 2007 only) taxpayers age 70-1/2 or over to exclude from gross income charitable gift distributions of up to \$100,000 per year from a traditional individual retirement account (IRA) or Roth IRA which would otherwise be included in income.
- **1.3. Does this work in California ?**

A: Yes. California ’s tax laws conform to federal tax law on the issue of inclusion or exclusion of distributions from IRAs.

Beware: A California charity should not assume that all donors are subject only to CA rules. Some states may tax charitable IRA distributions.

- **1.4. The details:**
 - **A. Effective for 2006 and 2007.**
 - . The new law took effect on August 17, 2006 , but is retroactive on this issue. Specifically, new §408(d)(8)(A) of the Code applies to any qualified distributions made between 12/31/2005 and 1/1/2008 . This may affect tax planning done for gifts already made earlier in 2006.
 - . Unless IRS regulations provide otherwise, the timing would depend upon the date of delivery of the gift – when actually delivered (or postmarked).
 - **B. Lifetime transfers only.** The exclusion provided by the new law applies only to distributions during the life of the taxpayer. Rules relating to testamentary transfers remain unchanged.
 - **C. Age 70-1/2 or older.** Though this requirement seems straightforward, there is potential for confusion because almost all

taxpayers are aware of a different rule requiring them to begin receiving minimum required distributions *in the year that they attain age 70-1/2*.

- **D. Traditional and Roth IRAs only.**
 - · The new law applies only to traditional and Roth IRAs.
 - · It does not apply to SEP, SAR-SEP, SIMPLE, MSA or HSA accounts, or to 401(k) or other qualified pension plan accounts.
 - · However, the taxpayer may be able to roll over the ineligible account into a traditional IRA, to enable a qualified charitable distribution under the new rule.
 - · Does the provision apply to inherited IRAs?
- **E. Up to \$100,000 per year per taxpayer.**
 - · The \$100,000 annual limit is based on the aggregate amount of a taxpayer's qualified charitable distributions in a year. Thus, an individual's tax-free IRA donations may consist of one or more distributions, from one or more IRAs, donated to one or more charitable organizations, as long as the aggregate amount does not exceed \$100,000 in a year.
 - · Note that a married couple could donate \$200,000, if they each have the IRA resources to do so.
 - · There is no carryover provision – i.e., if charitable IRA distributions exceed the \$100,000 limit, there is no ability to apply the excess to a future year's exclusion.
 - · The IRS will adopt rules that exclude qualified charitable distributions from withholding requirements.
- **F. Qualified charitable distributions count toward minimum distribution requirements for IRAs.**
 - **1.5. What are eligible charities?**
 - **A. Charities described in §170(b)(1)(A)**
 - · These are generally known as “50% charities” because taxpayers may give up to 50% of AGI to them in deductible contributions. These generally include:

(1) churches (or church conventions or associations);

(2) tax-exempt educational organizations;

(3) tax-exempt hospitals and certain medical research organizations;

(4) certain organizations holding property for state and local colleges and universities;

(5) a U.S. state or possession, or any political subdivision of any of these, or the U.S. or the District of Columbia, if the contribution is for exclusively public purposes;

(6) organizations organized and operated exclusively for charitable, religious, educational, scientific or literary purposes, or for the prevention of cruelty to children or animals, or to foster

national or international amateur sports competition if they normally get a substantial part of their support from the government or general public;

(7) private operating foundations;

(8) certain membership organizations more than one-third of whose support comes from the public.

- **B.** The law excludes §509(a)(3) **supporting organizations** and §4966(d)(2) **donor-advised funds**.
- **C. Problem:** The exclusion of donor-advised funds and most private foundations means that the money is truly “out the door” once given. This effect can be mitigated by gifts to:
 - · Field of interest funds.
 - · Scholarships.
 - · Restricted or general endowments (provided that the donor has no advisory rights).
- **1.6. Other mechanical issues**
 - **A. Custodians’ responsibilities.** IRA custodians must adopt new policies and procedures to implement this new law, and must address:
 - · Must the custodian verify the eligibility of the receiving charity?
 - · What are the procedures for withholding exemption?
 - · Will there be a separate 1099-R reason code for reporting?
 - · Will the custodian have a duty to report the identity of the donor to the charity?
 - · Can the distribution be made in securities, or must it be cash?
 - **B. Distribution cannot be made to taxpayer.** If the taxpayer requests a distributions directly to him or her, planning to then contribute it, the old rules will apply.
 - · Perhaps a taxpayer could request a check payable to the charity, which the taxpayer would deliver; but custodians might feel this is too risky.
 - **C. Gift receipts are required.**
 - · The committee technical explanation states that “sufficient substantiation” is required. This means a written receipt in compliance with IRS donation acknowledgement requirements (Treas. Reg. §1.170A-13(f)).
 - · **Warning:** If the donor receives any thing of value in consideration for the gift, the entire exclusion will be jeopardized. Charities must therefore be especially cautious regarding the types of recognition they give to these donors.
- **1.7. What if the IRA contains mixed pre-tax and after-tax contributions?**

- **A.** The new law provides special rules for counting taxable distributions as distributed first. Example:
 - · Donor has \$120,000 IRA, consisting of \$75,000 in pre-tax contributions and earnings and \$45,000 in after-tax contributions and earnings.
 - · Donor distributes \$100,000 to charity.
 - · Treatment:
- (1) \$75,000 is excluded from income under the new rules.
- (2) \$25,000 is included in income (to the extent of untaxed earnings or appreciation) but available for deduction (if the taxpayer itemizes deductions) under the old rules.
 - **B.** The new law provides for “morphing,” where multiple accounts are involved:
 - · Donor has two \$100,000 IRAs, each consisting of \$50,000 pre-tax and \$50,000 after-tax contributions (including earnings and appreciation).
 - · Donor gives all of the funds in one account to an eligible charity.
 - · Treatment:
- (1) The first \$100,000 given to the charity is treated as paid from pre-tax dollars, and is excluded from income under the new rules.
- (2) The remaining IRA morphs into an IRA consisting entirely of after-tax contributions (and their earnings/appreciation).
 - **C.** Issue: How will the custodian know how to characterize the distributions? Given the portability of IRAs, custodians generally do not track pre-tax and after-tax contributions. Yet, they will apparently have a duty to report the nature of the distribution to the IRS.
- **2. NEW RULES FOR CHARITABLE CONTRIBUTIONS**

The following changes are effective for tax years beginning after 8/17/06 , unless otherwise noted:

- **2.1.** The Act disallows any charitable deduction for any contribution of a **cash, check, or other monetary gift** unless the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. There is no longer a \$250 de minimis exception.

Comment: Unless a charity issues receipt letters for every donation, this will require donors to keep copies of cancelled checks (or perhaps credit or debit card statements showing the payee, amount and date).

- **2.2.** Donated **clothing and household items** must be in “good used condition or better” to permit a fair-market value donation.
 - **A.** Exception: The IRS may further exclude from deductibility donated items of minimal value, such as used socks or underwear.

- **B.** Exception: The “condition condition” does not apply to a donation of >\$500 where there is a substantiating qualified appraisal.
- **C.** “Household items” include furniture, furnishings, electronics, appliances, linens and similar items.
 - · They do not include food, paintings, antiques and other art objects, jewelry, gems, or collections.
- **2.3.** Special rules allowing above-basis **book inventory** donations to schools, and donations of “**apparently wholesome food**” to charities serving food to the needy, have been retroactively revived for 2006 and 2007.
- **2.4.** **Effective 9/1/06** , **tangible personal property** gifts exceeding \$5,000 trigger new requirements:
 - **A.** Prior rules required (i) a limitation of the deduction for tangible personal property to the taxpayer’s basis *if* the property is not used by the charity for its exempt purposes, and (ii) a report from the charity to IRS of any disposition of exempt-purpose property within 2 years of the gift.
 - **B.** New rules relating to premature dispositions:
 - · If the property is sold within the year of gift, the deduction must be reduced to basis.
 - · If the property is sold within the following tax years and prior to the third anniversary of the gift, the taxpayer must recognize *ordinary income* equal to the excess of the deduction amount over the taxpayer’s basis in the item.
 - **C.** However, these effects can be avoided if the charity certifies to the IRS, with a copy to the donor, that either:
 - · The property was used, before disposition, for exempt purposes; or
 - · The charity intended to so use the property, but the intended use became impossible or infeasible.
 - **D.** Comments:
 - · The certificate requirement leaves the taxpayer at some jeopardy. Query whether IRS regulations will permit the issuance of a contemporaneous certificate, at the time of donation, where the property is to be immediately used for an exempt purpose.
 - · Donors may be inclined to place limits on the sale of gifted property. However, such limits will reduce the appraised value of the property.
- **2.5.** **Fractional interest gifts** (eff. for gifts after 8/17/06)
 - **A.** Prior law generally permitted a deduction for a gift of an undivided fractional interest in the donor’s entire interest in property.
 - **B.** New requirements:
 - · All interests in the items must be owned by the donor (or the donor and donee) immediately prior to the gift.
 - · Gifts of additional fractional interests in the same property must be valued at the lesser of FMV at the time of donation or FMV at the time of the initial fractional interest donation.

(Remember that FMV is appropriate only for property used for exempt purposes.)

- · The same lesser-value rule applies even if the subsequent interest gift is a bequest.
- · The gift deduction(s) will be recaptured if the charity does not have substantial possession and use of the property and the balance of the interests are not contributed before the earlier of (i) donor's death or (ii) 10th anniversary of the initial fractional interest gift. Furthermore, the new law imposes a penalty equal to 10% of the recaptured deduction.

Comment: Fractional interest gifts of artwork have been a popular way of getting a deduction while being able to enjoy the art for certain periods during the balance of the donor's life. The 10-year restriction will probably curtail many such gifts.

- **2.6. Gifts by S Corporations (in 2006 & 2007) of appreciated property will reduce shareholder "outside" basis only by the corporation's adjusted basis in the property** (thus bringing S corporations into parity with partnerships).
- **3. QUALIFIED CONSERVATION DONATIONS**
 - **3.1. Conservation easements increased to 50% of AGI.** Effective for tax years 2006 and 2007, Section 1206 of the Pension Protection Act of 2006 amends Section 170 of the Code to allow a 50% deduction (increased from 30%) for capital gain property that constitutes a qualified conservation contribution donated by an individual to a Code Section 170(b)(1)(A) organization.
 - **3.2. Qualified farmers and ranchers: Up to 100% of adjusted taxable income.** If the donor is a qualified farmer or rancher, he/she is allowed a deduction up to 100% of the excess of his/her contribution base over all other allowable charitable contributions.
 - **A.** This applies to a nonpublicly traded farming or ranching corporation, except that the contribution base is taxable income, as adjusted.
 - **B.** A qualified rancher or farmer realizes more than 50% of his/her income from farming or ranching.
 - **C.** The land must be "generally available" for farming or ranching – but need not actually be used for those purposes.
 - **3.3. Carryforward for 15 years.** Any excess allowable deduction may be carried forward for fifteen years (formerly 5 years).
 - **3.4. Preservation easements are limited.** Preservation donations in registered historic districts will qualify now only if they preserve the entire exterior of the building. Former law allowed a deduction for façade preservation or raw land in a historic district.
- **4. APPRAISERS AND MISVALUATION PENALTIES**
 - **4.1.** Any donated property valued in excess of \$5,000 must be appraised by a "qualified appraiser":
 - · Appraisal designation from a recognized appraiser organization; or

- . Meets education and experience standards in new regulations to be published by the IRS.
 - **4.2.** Note: As before, the “qualified appraisal” substantiating the value must be:
 - **A.** Made within 60 days before the date of the donation.
 - **B.** Summarized in an attachment to the taxpayer’s return.
 - **C.** Misvaluation penalties have been strengthened:
 - **4.3.** New standards for penalties on misvaluations:

	Old Rule	New Rule
“substantial” misvaluation (income tax returns)	200%	150%
“gross” misvaluation (income tax returns)	400%	200%
“substantial” misvaluation (estate/gift tax returns)	50%	65%
“gross” misvaluation (estate/gift tax returns)	25%	40%

- **4.4.** The 2006 Pension Act also eliminates the **reasonable cause exception** for gross valuation misstatements with respect to charitable deduction property. The exception continues to apply, as under pre-2006 Pension Act law, to substantial valuation overstatements with respect to charitable deduction property, i.e., it applies if the appraisal and investigation requirements are met.
 - **4.5.** Appraisers are now subject to a new penalty, for appraisers only, that can be assessed for substantial or gross misvaluations: generally, the greater of 10% of the tax underpayment or 125% of the appraisal fee.
- **5. NEW RESTRICTIONS ON DONOR-ADVISED FUNDS**
 - **5.1. Excise taxes.** These new excise taxes treat donor-advised funds in a manner similar to private foundations:
 - **A.** Taxes on the sponsoring organization and fund managers who make “taxable distributions.”
 - **B.** More-than-incidental benefits to a donor or fund-related person now trigger special excise taxes.
 - **C.** Excise taxes are imposed on excess business holdings.
 - **D.** Donors and investment advisers are deemed “disqualified persons” for excess benefit transaction taxes.
 - **E.** Grants, loans or similar payments to a donor or a related person are automatically deemed excess benefit transactions on a dollar-for-dollar basis.

- **5.2. Reporting.** Sponsoring organizations must now file information returns reporting the total number of donor advised funds held, their aggregate value, aggregate contributions, and aggregate grants.
 - **A.** Comment: This is still much more lenient than the detailed reporting requirements imposed on private foundations.
- **5.3. Supporting organizations:** Similar rules have also been adopted for certain types of supporting organizations.
- **5.4. Studies:** The Act requires the Secretary of the Treasury to study donor-advised funds and supporting organizations, and to report on various issues, including whether contributions to these organizations should be deductible.
- **6. NEW RULES FOR PRIVATE FOUNDATIONS**
 - **6.1.** Congress addressed challenges to IRS regulations by codifying these capital gain/loss rules for purposes of the excise tax on investment income:
 - **A.** Capital gains and losses subject to the excise tax on net investment income include capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used *to further an exempt purpose* – unless the property is exchanged under new rules similar to those governing §1031 like-kind exchanges.
 - **B.** Capital loss carrybacks are not permitted.
 - **6.2.** Distributions to certain supporting organizations are not qualifying distributions.
 - **6.3.** Taxed investment income includes income from annuities and similar instruments.
- **7. EXEMPT ORGANIZATION TAX RETURNS AND FILINGS**
 - **7.1. Unrelated Business Income Tax (“UBIT”) Returns** (Form 990-T), previously confidential, must now be made publicly available if filed after 8/17/06 . This rule applies only to 501(c)(3) organizations.
 - **A.** However, as with exemption applications and other 990 returns, the taxpayer may ask for confidentiality of trade secrets, patents and similar information.
 - **7.2. IRS Reports to State Officials**
 - **A.** Former law *required* the IRS to report to state officials (in CA, the attorney general and the FTB) an adverse exemption determination, a revocation of exemption, or a notice of deficiency against a charity. In connection therewith, the IRS must provide related file information on the charity.
 - **B.** The new law *permits* the IRS to disclose to the same state officials a *proposed* adverse determination, revocation or tax deficiency notice, and to provide related file information.
 - **C.** The new law also strengthens limits on the improper disclosure by IRS or a state official of any of the information so provided, and provides criminal sanctions and civil remedies.
 - **7.3. Information Filings Now Required of ALL Charities**
 - **A.** Prior law and IRS regulations exempted organizations with gross revenue normally under \$25,000 from filing returns.

- **B.** The new law requires every charity exempted from the return requirement to file electronically an annual information return stating:
 - · Legal name
 - · Any fictitious business name(s)
 - · Mailing address
 - · Website URL (if any)
 - · Name and address of principal officer
 - · Evidence of continuing exemption from return requirements.
- **C.** A nonprofit may have its exemption revoked if it fails to file for three consecutive years.
- **D.** The IRS is required to publicize this new requirement.
- **E.** Effective: For annual periods beginning after 2006.
- **7.4. Charities must now report dispositions of tangible personal property made within 3 years of the gift** (see 2.4 above).
- **7.5. Information returns of parent tax-exempt organizations must now include information about transactions with controlled entities** (eff. for returns due after 8/17/06).
- **7.6. Charities that acquire interests in life insurance contracts within two years of 8/17/06 must file special returns reporting this information.**
 - **A.** IRS must conduct a study, and report to Congress, on whether charities are improperly sharing their insurable interests in donors with investors.
- **7.7. The new law increases the penalty on split-interest-trusts (e.g. charitable remainder annuity and unitrusts and pooled income funds) for failure to file a return and failure to properly report required information.**
 - **A.** The penalty is \$20 for each day the failure continues up to \$10,000. For trusts with gross income in excess of \$250,000, the penalty is \$100 per day up to \$50,000.
 - **B.** If any officer, director, trustee or other individual under a duty to file or include required information, knowingly fails to file the return or include required information, such person is personally liable for such penalty, in addition to the penalty imposed upon the entity. This provision is effective for taxable years after December 31, 2006 .
- **8. PENALTY EXCISE TAXES ON CHARITIES AND PRIVATE FOUNDATIONS ARE GENERALLY DOUBLED**
 - **8.1.** For acts of self-dealing, the initial tax on the self-dealer is increased from 5% to 10% of the amount involved.
 - **8.2.** The initial tax on foundation managers for acts of self-dealing is increased from 2.5% to 5% of the amount involved.
 - **8.3.** The dollar limitation is increased from \$10,000 per act to \$20,000 per act.
 - **8.4.** The initial tax on a private foundation for failure to distribute income is increased from 15% to 30% of the undistributed amount.
 - **8.5.** The initial tax on excess business holdings is increased from 5% to 10% of the value of the holdings.

- **8.6.** For jeopardizing investments, the initial tax imposed on the foundation and foundation managers is increased from 5% to 10% of the amount of the investment.
- **8.7.** The dollar limitation on the initial tax on foundation managers is increased from \$5,000 to \$10,000 per investment. The dollar limitation on the additional tax on foundation managers is increased from \$10,000 to \$20,000 per investment.
- **8.8.** For taxable expenditures, the initial tax on the foundation is increased from 10% to 20% of the amount of the expenditure.
- **8.9.** The initial tax on the foundation manager is increased from 2.5% to 5% of the amount of the expenditure.
- **8.10.** The dollar limitation on the initial tax on foundation managers is increased from \$5,000 to \$10,000. The dollar limitation on the additional tax on foundation managers is increased from \$10,000 to \$20,000.
- **8.11.** The dollar limitation on the tax imposed on organization managers of public charities and social welfare organizations for participation in excess benefit transactions is increased from \$10,000 to \$20,000 per transaction.
- **9. OTHER TOPICS IN THE NEW LAW**
 - **9.1.** Charitable contributions of taxidermy property.
 - **9.2.** Certain transactions between parent and controlled entities.
 - **9.3.** Debt management plan services and credit counseling organizations.
 - **9.4.** Tax exempt employers of proctors for college entrance and placement exams.
 - **9.5.** Conventions or associations of churches.
 - **9.6.** Qualified blood collector organizations.