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Diana S.C. Zeydel

Mitchell M. Gans
Maurice A. Deane School of Law at Hofstra University

Jonathan G. Blattmachr

EDITED BY JOHN B. HUFFAKER, LL.B., AND MICHAEL D. MULLIGAN, J.D.

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The breadth and depth of the complex new legislation and its principal focus on pension reform may cause some taxpayers to overlook the significant effects on estate planning, particularly in the area of charitable gifts. The new rules significantly affect gifts of fractional interests in tangible personalty and allow for charitable distributions from IRAs. Many of the changes have varying effective dates or apply during a limited window, which calls for careful study.

DIANA S.C. ZEYDEL is a shareholder in the law firm of Greenberg Traurig, P.A., in Miami. MITCHELL M. GANS is a professor at Hofstra University School of Law in Hempstead, New York. JONATHAN G. BLATTMACHR is a partner in Milbank, Tweed, Hadley & McCloy, LLP, in New York City. All three authors have previously written for The Journal, *and Professor Gans and Mr. Blattmachr are co-authors of* The Circular 230 Deskbook *(PLI, 2006).*

The Pension Protection Act of 2006 (PPA), P.L. 109-280, 8/17/06, has many provisions that are effective immediately. Although most of the legislation deals with technical pension plan issues,[1] some provisions will be of more direct concern to estate planners. As discussed below, these include:

1. New rules for charitable gifts of fractional interests in tangibles.
2. Recapture of the charitable deduction if the donee charity ceases related use of tangible personal property.
3. New underpayment penalty provisions for taxpayers and appraisers.
4. New reporting requirements for charities owning an interest in an insurance contract.
5. Changes with respect to charitable easements.
6. Increased private foundation and similar penalties.
7. New exemption for charitable distributions from IRAs.
8. New rules permitting rollover to an inherited IRA for nonspouse beneficiaries of qualified plans.

CHARITABLE GIFTS OF FRACTIONAL INTERESTS IN TANGIBLES

The PPA radically changes the rules applicable to charitable gifts of fractional interests in tangible personal property. The new rules are exceptionally onerous and therefore, unless modified, are likely to discourage donors from making fractional interest contributions.

Background

In general, the Code does not allow a deduction for income, gift or estate tax purposes for a donation to charity of an interest in property that consists of less than the taxpayer's entire interest in the property.[2] Nevertheless, a deduction is permitted for a contribution of an interest in property that consists of a "vertical slice" of the taxpayer's interest, such as an undivided interest (e.g., 40%) of the taxpayer's interest in the property.[3]

For example, if an individual gives a museum a 25% interest in a painting she owns, and the charity will use its interest in furtherance of its exempt function (e.g., will display it for viewing by the public),[4] the taxpayer will be entitled, subject to other rules, to an income tax deduction for the value of that 25% interest. And the IRS has indicated that the amount deductible is equal to the FMV of the entire property multiplied by the fraction or percentage donated—no "fractionalization" discount need be taken into account. Thus, if the painting is worth $1 million, the taxpayer's deduction is $250,000.[5]

Taxpayers sometimes make gifts of such undivided interests for at least one of two reasons. One is that a deduction for the value of the entire property may not be available because it exceeds the limits permitted, the general rule being that charitable deductions may not exceed 50% of the taxpayer's contribution base (which is adjusted gross income, as specially computed[6]). For capital gain property, the total amount deductible may not exceed 30% of

the taxpayer's contribution base, unless the taxpayer elects to limit the deduction to the taxpayer's basis.[7] Although charitable contributions in excess of the percentage limitations may be carried forward (in most circumstances, for the five years after the year of the gift[8]), a contribution of the entire item might still exceed the limitations for the whole six-year term.

A second reason a taxpayer may wish to make a gift of only a fractional interest is that the taxpayer wishes to retain the item for part of the year. For example, assume a taxpayer lives half the year in New York and the other half in Florida. She owns a valuable painting that she leaves in New York while she is in Florida. She might give a one-half interest in the painting to a museum, and she and the museum agree that she will retain possession of the painting for the six months she is in New York and the museum will possess and display it for the six months she is in Florida. Prior to the PPA, the museum's entitlement to possession of the painting for half the year would, without more, give the taxpayer a charitable deduction for income and gift tax purposes of 50% of its value.

Under the Tax Court's decision in *Winokur*, 90 TC 733 (1988), a charity's legal entitlement to possession for a portion of the year would be sufficient to secure the deduction, even if the charity did not take actual physical possession. That is, under *Winokur* the charity's failure to take actual possession did not adversely affect the charitable deduction. Based on *Winokur*, some taxpayers have presumably claimed a deduction for fractional-interest gifts while continuing to enjoy possession throughout the year.

The fractional interest retained by the taxpayer usually is subsequently given to the charity, either at one time or in a series of gifts during the donor's lifetime, or entirely at death. Taxpayers are entitled to a deduction each time a fractional (or percentage) interest is contributed. Prior to the PPA, the deduction was determined for each portion of the gift based on the value at the time of the gift. For example, a gift of a 25% interest in a painting worth $1 million would generate a $250,000 deduction for income and gift tax purposes. And if the taxpayer later contributed the remaining 75% interest when the value of the painting was $2 million, the second gift would generate a deduction of $1.5 million for income and/or transfer tax purposes.[9]

The New Rules

The PPA makes significant changes to the rules on deductions for gifts of fractional interests in tangible personal property. (The new rules do not apply to gifts of real estate or intangibles.) As noted above, they are so onerous that they are certain to eliminate virtually all gifts of such interests.

Precontribution ownership. First, new Section 170(o)(1)(A) permits a deduction only if the taxpayer owns 100% of the item of tangible personal property immediately before the contribution or the only owners at that time are the taxpayer and the charitable donee. The PPA authorizes Treasury to issue Regulations that would permit the deduction if others also own an interest in the item, if they all give a proportionate share of their interests to charity at the same time. (Of course, no such Regulation has yet been issued.[10]) Hence, if a sister and brother own a painting and the sister gives one-half of her interest to charity but her brother does not give one-half of his interest, no income tax deduction will be allowed to the sister—apparently even if Regulations *are* issued.[11]

Recapture. Second, the PPA forces a taxpayer to recapture the income and gift tax deductions for a contribution of a fractional interest in property if the taxpayer has not transferred his or her remaining interest to the same donee before the earlier of (1) ten years after the date of the initial contribution or (2) the taxpayer's death.[12] For example, if a taxpayer owns a painting worth $1 million and gives an undivided 25% interest (worth $250,000) to a museum on 1/15/07 and does not transfer the balance to the same museum before 1/15/17,[13], the taxpayer will be required to include the $250,000 amount deducted in 2007 in income and as a taxable gift in 2017. If the museum is no longer in existence, recapture can be avoided if the remaining interest is timely given to another person described in Section 170(c).[14]

Amount recaptured. The PPA provides that the amount recaptured equals any deduction allowed "plus interest." In addition, the tax imposed in the year of recapture is increased by 10% of the amount recaptured.[15] Although not specified, it would seem that the Regulations would require interest to accrue

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1 See generally Baum, "Sweeping Changes for Pension Plan Funding and Other Rules, Part 1—Defined Benefit Plans," page 208, this issue.

2 See Sections 170(f), Section 2522(c), and Section 2055(e). For income tax purposes, the denial of a deduction for a gift of a partial interest also applies if the property was divided in order to avoid the prohibition on deduction; see Reg. 1.170A-7(a)(2)(i). As a general rule, a taxpayer may not deduct more than the taxpayer's basis in the property unless any inherent appreciation would be taxed as long-term capital gain; see Section 170(e)(1).

3 See Reg. 1.170A-7(b)(1).

4 In order to take a deduction for more than the taxpayer's basis in an item of tangible personal property donated to charity, the charity must use the item in connection with its exempt function, such as a museum putting on public view an appreciated work of art donated by a taxpayer. See Section 170(e)(1)(B)(i).

5 See Rev. Rul. 57-293, 1957-2 CB 153.

6 See Section 170(b)(1)(F).

7 Section 170(b)(1)(C)(i).

8 See, e.g., Sections 170(b)(1)(C)(ii) and 170(d)(1).

9 See note 4, *supra.*

10 See Gall, "Phantom Tax Regulations: The Curse of Spurned Delegations," 56 Tax Lawyer 413 (Winter 2003) (discussing the effect of Treasury's failure to issue Regulations where the Code anticipates that they will be issued).

11 It may be that this rule was adopted to prevent taxpayers from avoiding the "forced" subsequent donation of any retained interest. In other words, if one owner contributes a fractional interest of what she owns, she will be compelled, as a practical matter, to transfer the balance to charity (discussed in more detail in the text, below). Absent the PPA, however, the other owner would not be subject to the same compulsion.

12 As a technical matter, the PPA requires the Treasury to provide for this recapture.

13 The "within ten years" phrasing might make the deadline 1/14/17.

14 Section 170(o)(3)(A)(i).

15 Sections 170(o)(3)(B) and 2522(e)(3)(B).

from the date a tax payment would have been due in respect of the income and gift tax returns, respectively, claiming the deductions.[16]

Timing issues. If it is the taxpayer's death that triggers recapture, it would seem that recapture would be deemed to occur for both income and gift tax purposes the moment before the taxpayer's death.[17] Thus, the amount deducted (plus interest) would be includable on the decedent's final income and gift tax returns. What if, at the taxpayer's death, the remaining fractional interest is bequeathed to the same charity that received the initial gift?

The new law radically changes the rules applicable to charitable gifts of fractional interests in tangible personal property.

For example, assume a taxpayer gives a 25% interest in a painting to a museum in 2007. At her death in 2011, she bequeaths the remaining interest to the same museum. It would seem that as a matter of policy recapture should not occur in this context. After all, Section 2055, as amended, permits an estate tax charitable deduction for the bequest. It would strain credulity to read Congress as having intended to deny the earlier gift tax deduction via recapture while permitting an estate tax deduction. Nonetheless, read literally the PPA does seem to call for this rather unusual outcome: It applies the recapture rule in any case where the gift of the remaining interest fails to occur *before* death. One would hope that this glitch in the statutory language will be cured by technical corrections, or perhaps by Regulation.

Substantial physical possession. Recapture also occurs if the charity does not take "substantial physical possession" of the item or does not use it in connection with its exempt function within the ten-year/before-death timeframe.[18] Thus, in the example above if, after the 25% interest in the painting is donated, the museum fails to take possession of the painting or fails to use it in connection with its exempt function before 1/15/17 or before the taxpayer's death, recapture will occur, presumably even if the balance of the taxpayer's interest is timely contributed.[19]

There seems to be no minimum time exception. For example, assume a taxpayer donates a fractional interest in a painting in September 2006, donates the remaining interest in the painting in September 2007, and dies in October 2007 before the charity takes possession of the painting. Recapture of the charitable deduction for both income and gift tax purposes apparently occurs. Perhaps Regulations will provide a reasonable time exception, but there is none in the statute. Therefore, any taxpayer who makes a contribution of a fractional share of her interest in tangible personal property should arrange for immediate possession by the charity and its immediate use in connection with the charity's exempt purpose for some specified period.

Although the committee report cites the Tax Court decision in *Winokur* and presumably contemplates that it would no longer be viable, the PPA surprisingly fails to overrule the decision. As indicated, because the donee had legal entitlement to possession, the donor in *Winokur* was permitted a deduction for a fractional interest even though the donee did not in fact take actual possession.[20] Although the PPA requires that the donee take "substantial physical possession" within the statutory timeframe, there is no requirement that the donee's possession correspond to the fractional interest given. To illustrate, if the donor gives a 25% interest in a painting to charity, the deduction will presumably be permitted and recapture will not occur even if the charity does not take actual possession or use it in connection with its exempt purpose until the tenth year. Thus, ironically, a taxpayer's ability under *Winokur* to retain possession while claiming a deduction remains intact as long as the donee is provided with "substantial physical possession" within the statutory timeframe.[21]

"Forced" subsequent gifts. The PPA also imposes a limit (the "lesser-of rule") on the amount of the deduction for any subsequent contribution of an interest in tangible property where a taxpayer has previously made a fractional interest gift. The amount the taxpayer may deduct for a subsequent gift is limited to the lower of the (1) value of the interest later transferred or

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16 If the charity that received the initial fractional gift is no longer in existence, the taxpayer may make the subsequent transfer under the "within ten years or death" rule to another charity; see Section 170(o)(3)(A)(i).

17 *Cf.* Reg. 1.684-3 (deeming a sale to occur before death in certain contexts for Section 684 purposes); Frane, 98 TC 341 (1992), *rev'd* 998 F.2d 567, 72 AFTR2d 93-5268 (CA-8, 1993) (the Tax Court required that the tax on the gain from a self-cancelling installment note be reported on the decedent's final income tax return but the Eighth Circuit reversed on this point and treated the gain as income in respect of a decedent).

18 A deduction for the full FMV of an item of tangible personal property (as opposed to limiting the deduction to the taxpayer's income tax basis in the item) is permitted only if the item is to be used in connection with the charity's exempt function (e.g., displaying a donated painting for viewing by the public). As discussed further in the text, below, the PPA also provides for recapture if the exempt use ceases unless, among other things, the charity files a report with the IRS explaining why the use became impossible or infeasible to implement. See Section 170(e)(7).

19 The effect of recapture could be worse than indicated. For example, the benefit of the deduction may have been limited because it offset long-term capital gain income or because the taxpayer was subject to the alternative minimum tax and may have to pay full ordinary income tax (times 110%) on the amount recaptured.

20 Reg. 1.170A-5(a)(2) states that if a donor contributes an undivided interest in a painting to charity, the period of initial possession may not be deferred for more than one year. The Tax Court construed this Regulation as referring to an entitlement to possession, not actual physical possession.

21 Perhaps it could be argued that "substantial physical possession" should be construed as requiring possession that is commensurate with the donated interest. Under such a construction, in the example posited in text, recapture would occur at some point before the tenth year on the rationale that the charity did not enjoy actual possession for 25% of the time. The difficulty with this construction, however, is that it results in uncertainty concerning the triggering event for the recapture rule. It therefore seems more likely that Congress contemplated that recapture would occur at the end of the tenth year if "substantial physical possession" did not occur by that point.

(2) the value of such interest at the time of the initial gift. For example, assume the painting given to charity on 1/15/07 is then worth $1 million, entitling the taxpayer to a deduction of $250,000 for the 25% fractional interest. If the taxpayer gives the balance of the interest (75%) to the museum on 8/1/12 when the painting is worth $3 million, the taxpayer's deduction in connection with the later gift is limited to $750,000 (75% of the lesser of (1) $1 million, which is what the painting was worth when the first fractional interest was given, or (2) $3 million, which is what the painting is worth when the second gift is made).

The limitation on the income tax deduction for the essentially "forced" subsequent donation ("forced" because of the threat of recapture) may not be the worst tax effect the taxpayer faces. When the subsequent donation is made, this limitation applies for gift and estate tax purposes as well. Thus, if the item has appreciated in value between the time of the initial and subsequent gifts, the excess "actual" value of the subsequent gift over the limited amount deductible under this new provision will be subject to gift or estate tax. For instance, in the foregoing example, the subsequent gift to the charity of the 75% interest will generate a taxable gift of $1.5 million (the value of the gift is $2.25 million, or 75% of the $3 million current value, but the deduction for gift tax purposes under Section 2522 is reduced to $750,000). In short, a transfer of property to charity is subject to gift or estate tax except to the extent it qualifies for the charitable deduction, and under this new provision the charitable deduction could easily be less than the value of the property transferred.

Perhaps the taxpayer could successfully argue, notwithstanding the apparent position of the IRS to the contrary,[22] that the amount of the subsequent gift (or the amount included in her estate) is not equal to the percentage then transferred times the value of the item at that time but a lower value on account of a "fractionalization" discount.[23] But even if the argument is successful, it will not necessarily eliminate the adverse consequence at the time of the later gift or bequest.

For example, assume that the value of the painting is subject to a fractionalization discount of 30% for estate tax purposes. The decedent's remaining 75% interest would have a date-of-death value of $1,575,000 (75% of $3 million, the painting's value at the time of death, reduced by 30% to reflect the discount). But the estate tax charitable deduction will be limited to 75% of $1 million—$1 million being the painting's value at the time of the initial gift—or $750,000. Hence, estate tax will be due on (or unified credit will be applied against) the $825,000 excess of the $1,575,000 included in the gross estate over the $750,000 charitable deduction. That seems to be the case even if the taxpayer's entire estate passes to charity.

It should be conceded, however, that the language of the section does not seem to support the use of a fractionalization discount in this context. Rather, it seems that the lesser-of analysis is to be made with reference to the value of the entire donated item. That construction is also supported by the Technical Explanation prepared by the Staff of the Joint Committee on Taxation.[24]

Effective dates. The new provisions are effective for contributions, bequests, and gifts made after 8/17/06, the date of enactment.[25] It would seem, therefore, that the gift and income tax charitable deductions for prior gifts of fractional interests are not subject to recapture.

Perhaps not quite as certain, it also would seem that the valuation-limitation rule discussed above (i.e., the lesser-of rule) would not apply to a post-PPA transfer if the initial gift was made prior to enactment. Such an interpretation would require construing "initial fractional contribution" defined in the PPA to refer only to a post-PPA contribution. In any event, if a fractional share were donated before the law became effective, and a second fractional share (but not all) is donated after the law is in effect, the deduction for this second fractional gift would seem to be subject to the new recapture provision and any further fractional gift would be subject to the lesser-of rule.

As suggested, the possible application of the recapture and lesser-of rules will likely lead well-informed taxpayers to avoid making partial-interest gifts of tangible personal property. The bottom line is that Congress may have overreacted. It simply should have denied any deduction for a gift of less than the taxpayer's entire interest in tangibles, given its concern about possible abuse. As it stands now, new Section 170(o) is a potential trap for the uninformed.

RECAPTURE IF CHARITY CEASES RELATED USE

A taxpayer is entitled to an income tax deduction for the long-term capital gain inherent in an item of tangible personal property only if it is to be used in connection with the charity's exempt function. The PPA amends Section 170(e)(1)(B)(i) to reduce the deduction to the taxpayer's basis not only if the charity uses the property in a manner that is unrelated to its exempt purposes (e.g., a museum rents a donated painting to an individual for the individual's possession and use)[26]

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22 Rev. Rul. 57-293, *supra* note 5.

23 *Cf.* Mooneyham, TCM 1991-178; LeFrak, TCM 1993-526.

24 The report refers to "the lesser of: (1) the value *used for purposes of determining* the charitable deduction for the fractional contribution; or (2) the *fair market value of the item* at the time of the subsequent contribution." (Emphasis added.) See Staff of the Joint Committee on Taxation, "Technical Explanation of H.R. 4, The 'Pension Protection Act of 2006,' as Passed by the House on July 28, 2006 and as Considered by the Senate on August 3, 2006" (JCX-38-06, 8/3/06) (the "Staff Report"), page 307.

25 PPA section 1218(d).

26 See Reg. 1.170A-4(b)(3)(ii), indicating that a taxpayer will be entitled to a deduction on the grounds that the property will not be put to an unrelated use if at the time of the contribution it is reasonable to anticipate that the property will not be put to an unrelated use and the taxpayer has no actual knowledge to the contrary. See also Reg. 1.170A-1(e), indicating that if the possibility that the charity will not use the property for its exempt purpose is so remote as to be negligible, the taxpayer will be entitled to a deduction.

but also if the charity disposes of the item of tangible personal property prior to the close of the tax year of the gift.

If the charity sells, exchanges, or otherwise disposes of the item of tangible property after the year of the donation, and before the end of the third year after the donation, the excess of the deduction over the taxpayer's basis in the item is recaptured and included in the taxpayer's gross income. There is an exception if, among other things, the charity certifies to the IRS under penalties of perjury that the intended use of the item has become "impossible or infeasible to implement."[27] The term "disposition" obviously is broad and presumably would include an exchange with another charity that will use the item in connection with its exempt purposes. Although a taxpayer might try to secure protection from recapture by having the charity contract to use the item in connection with its exempt purposes for at least three years, the use of such a provision could possibly affect the amount of the charitable deduction.[28]

The foregoing provisions apply to contributions after 9/1/06.[29]

NEW PENALTY PROVISIONS FOR TAXPAYERS AND APPRAISERS

Taxpayers are compelled in certain cases to have property appraised and to attach a copy of the appraisal to the tax return. In some situations, failure to obtain the appraisal results in denial of a tax benefit.[30] In addition, taxpayers may avoid penalties for valuation misstatements for reasonable cause if the taxpayer acted in good faith. A showing of reasonable cause and good faith could include reliance on a qualified appraisal by a qualified appraiser to establish the value of property subject to tax or for which a deduction is sought.[31]

Prior to the PPA, a taxpayer faced a penalty equal to 20% of the underpayment attributable to a substantial valuation misstatement.[32] A substantial valuation misstatement was deemed to occur for income tax purposes if the value used (e.g., the value claimed for a painting donated to charity) was 200% (or more) of the correct value. It was deemed to occur for estate or gift tax purposes if the value used was 50% (or less) of the correct value. And the taxpayer instead faced a penalty equal to 40% if the underpayment was attributable to a *gross* valuation misstatement. A gross valuation misstatement was deemed to occur for income tax purpose if the value used was 400% (or more) of the correct value. A gross valuation understatement was deemed to occur for gift or estate tax purposes if the value used (e.g., the value of an asset includable in the taxable estate) was 25% or less of the correct value.

The PPA changes these percentages so that the penalties will become applicable in a greater number of cases. A substantial valuation misstatement will be deemed to occur for income tax purposes if the value used is 150% (or more) of the correct value. And it will be deemed to occur for estate or gift tax purposes if the value used to determine the amount of such tax is 65% (or less) of the correct value. A gross valuation misstatement will be deemed to occur for income tax purposes if the value used is 200% (or more) of the correct value. A gross valuation misstatement will be deemed to occur for gift or estate tax purposes if the value used is 40% (or less) of the correct value.

As noted above, before the PPA taxpayers could avoid, under Section 6664(c), the misstatement of value (and other) penalties imposed by Section 6662 if the taxpayer acted in good faith and had a reasonable basis to use the value reported.[33] The PPA eliminated the defense in the case of a gross valuation misstatement with respect to an income tax charitable deduction.[34] (Perhaps Regulations will provide some other protection from the 40% penalty in the case of a charitable income tax deduction, such as where the taxpayer believed it was more likely than not that the value claimed as a charitable contribution was correct.) The defense was not, however, eliminated with respect to substantial valuation misstatements with respect to an income tax charitable deduction. The PPA also does not alter the defense in the case of an estate or gift tax underpayment or an income tax underpayment not attributable to a charitable deduction.

In addition, the PPA imposes a nearly automatic penalty on appraisers in some situations under new Section 6695A. With respect to a substantial income tax valuation misstatement or a gross estate or gift tax valuation misstatement in an appraisal that the appraiser knows (or has reason to know) will be used "in connection with a tax return or claim for tax refund," the penalty is the greater of $1,000 or 10% of the amount of tax underpaid by reason of the incorrect valuation (but in no event more than 125% of the gross income received by the appraiser for preparing the appraisal).

For example, an appraiser who has been engaged to value property for an estate tax return and values it at $400,000 will be subject to the penalty if the correct value of the property is $1 million or more. The appraiser's only defense would be to prove, to the

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27 Section 170(e)(7)(D).

28 See Rev. Rul. 2003-28, 2003-1 CB 594 (situation 3).

29 PPA section 1215(d).

30 For example, under Section 170(f)(11) and the Regulations thereunder, a taxpayer who fails to obtain an appraisal and attach a qualified appraisal summary to the taxpayer's income return relating to a gift of certain property to charity is denied the deduction in its entirety.

31 See, e.g., Section 6664(c)(2).

32 Section 6662.

33 With respect to a substantial or gross valuation overstatement for income tax purposes in the context of a charitable contribution, the Section 6664 defense was not available unless the taxpayer had obtained an appraisal from a qualified appraiser and, in addition, the taxpayer had made a good faith investigation concerning value. See Section 6664(c)(2) as in effect prior to the PPA.

34 Although the Staff Report does not state that the good faith/reasonable cause defense for gross valuation misstatement is eliminated only for the income tax charitable deduction, the statutory language is operative only in that instance. See Staff Report, *supra* note 24, page 309.

Treasury's satisfaction, that the appraised value was more likely than not the correct value.[35]

The determination of whether the appraised value was more likely than not the correct value is to be made by Treasury (the IRS) and not a court. Presumably, if a court were to find that the IRS abused its discretion in refusing to grant a waiver, the court could direct the IRS to grant it.[36] Nonetheless, it will be difficult for appraisers to meet the burden where the court has made a determination on the merits that the appraised value was grossly understated (i.e., equal to 40% or less of the correct value). An unfortunate aspect of the new provision is that appraisers may feel coerced to "back off" during an audit in order to avoid the penalty—even if they sincerely believe that their appraisal accurately reflects value.

The penalty imposed by Section 6695A may be imposed on anyone who prepares an appraisal for tax purposes, whether or not the person who prepares the appraisal is a professional appraiser. For example, an executor who estimates value for purposes of the estate tax return conceivably could be subject to the penalty (although it would be difficult to apply given that the statute limits the penalty to 125% of the appraisal fee). The new appraisal penalty is applied only against, in essence, appraisers hired by taxpayers. Appraisers hired by the IRS apparently are not subject to the penalty. Whether that distinction was intentional or not, it is unfair and creates the opportunity for appraisers hired by the government to understate, with impunity, the value of property for which a deduction is claimed for income tax purposes and overstate it if it is taxable for estate and gift tax purposes.[37]

The PPA also may hand another critical weapon to Treasury: the threat of "blacklisting" the appraiser. Circular 230, section 10.50(b), permits Treasury, in essence, to blacklist appraisers—that is, to rule that the appraiser is barred from presenting evidence or testimony in any administrative proceeding before Treasury or the IRS and that any appraisal made by that appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before Treasury or the IRS. Before the PPA, Treasury could effect a blacklisting only if the penalty under Section 6701 had been imposed on the appraiser. That section permits a penalty to be imposed only if, among other conditions, the appraiser knew the appraisal would result in an underpayment of tax.

The reference to Section 6701 has been removed from Circular 230 by the PPA, thus raising the question whether an appraiser could be disciplined or blacklisted on the basis of an unintentional error. And with Section 6695A, the PPA now provides for the imposition of a penalty on appraisers even if the appraiser did not know at the time of the appraisal that it would result in an underpayment of tax. It is uncertain what effect the new penalty might have on Treasury's authority to blacklist appraisers under the Circular. The PPA does not direct Treasury to adopt Regulations (by amendment to the Circular or otherwise) to specify a course of conduct that could result in such discipline.[38] It may be, however, that an appraiser's being subjected to the new Section 6695A penalty will be used by Treasury as a basis for blacklisting.

As indicated above, an appraiser cannot avoid the new Section 6695A penalty by limiting appraisals to claims for refund. It applies where the appraisal is prepared "in connection with" a return or a claim for refund, perhaps even after the fact. For example, assume a taxpayer files a claim for refund of gift tax without submitting any appraisal, contending that the value reflected on the return was overstated. If an appraiser submits a valuation report in the court proceeding to obtain the refund, it may be that the appraiser could be subject to the penalty, as the court proceeding may be deemed to be "in connection with" the refund claim.

The Section 6695A penalty does not deal exclusively with the determination of minority, marketability, or other discounts. For example, an appraiser might use a methodology that the court finds inappropriate in the circumstances (e.g., the appraiser might use a "net asset value" approach when the court determines the "discounted cash flow" approach is more appropriate). Thus, appraisers will not be able to assume that the penalty can be avoided through the simple expedient of taking limited discounts.

What if an appraiser includes in the valuation analysis minority and marketability discounts in determining the value of a decedent's limited partnership interest in a family limited partnership and the court disallows the discounts by invoking Section 2036? In that event, the appraiser will have evaluated one asset, a limited partnership interest, but the assets ultimately included in the gross estate are the underlying partnership property. Since the applicability of Section 2036 is a legal question, rather than a valuation question, the penalty presumably would not be applied in this context.

Whether the penalty will apply to an appraiser who relies on another appraisal is also unclear. For example, assume that one appraiser determines the value of an entity's real estate assets and that a second appraiser relies on that appraisal in determining the value of the decedent's interest in the entity. If the real estate appraisal

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35 Some argue that the penalty is inapplicable in the estate and gift tax context because of the use of the words "under chapter 1" in Section 6695A(a)(2). The authors believe, however, that a more conservative interpretation of the statute would construe it to apply to gross valuation misstatements in both the income and the estate and gift tax contexts. This interpretation is supported not only by the placement of a comma after the cross-reference to Section 6662(e), which relates only to chapter 1, but also by the cross-reference to Section 6662(h) after the comma, which applies to gross valuation misstatements for both income and estate and gift tax purposes. In addition, the words "under chapter 1" follow, and do not precede, the words "substantial valuation misstatement" and are not repeated after the words "gross valuation misstatement," indicating that they modify only the former and not the latter phrase. A senior member of the Staff with whom the authors had an informal conversation agreed with the authors' interpretation.

36 *Cf.* Baldwin, TCM 2002-162 (applying an abuse of discretion standard under an analogous provision that has since been repealed).

37 *Cf.* McCord, 98 AFTR2d 2006-6147 (CA-5, 2006), fn. 5 ("This exemplifies a practice of the IRS that we see with disturbingly increased frequency, e.g., a grossly exaggerated amount asserted in a notice of deficiency").

38 See generally Blattmachr, Gans, and Rios, *Circular 230 Deskbook* (PLI, 2006).

proves to be grossly inaccurate, will the penalty apply to the appraiser who performed the second appraisal? Regulations will have to clarify how to apply the penalty in such a case. Until clarification is provided, appraisers will need to remain cautious.

Appraisers may consider contractual provisions that shift the burden of the penalty to the taxpayer. If the taxpayer agrees to hold the appraiser harmless in the event the IRS invokes the penalty, several issues arise:

1. The agreement may not be valid as a matter of state law in that it may violate public policy to permit the burden of a penalty to be shifted from the person targeted by Congress.[39]

2. Assuming no public policy impediment—or, in the alternative, that the taxpayer voluntarily agrees to reimburse the appraiser in accordance with the hold-harmless obligation and that, as a consequence, there is no litigation about the public policy question—the appraiser would presumably be required to include the reimbursed amount in gross income.[40]

3. The appraiser would not be entitled to deduct the cost of the penalty.[41] The deduction would appear to be unavailable even though the client's reimbursement is included in the appraiser's gross income. Given the tax effects of a hold-harmless agreement, appraisers may insist that it be drafted to include a "gross up" (requiring the taxpayer to pay not only the cost of the penalty but also any income tax cost that the appraiser incurs by reason of the indemnification). But a gross-up, like the hold-harmless for the penalty itself, may be unenforceable as a matter of public policy.

It would not be surprising if, faced with these uncertainties, appraisers increase their fees in order to compensate for the increased risk.

The effective date of Section 6695A also seems harsh. It applies to any appraisal that supports a tax position with respect to a return or submissions after 8/17/06, even if the appraisal was completed before that date. For example, assume an estate tax return is due to be filed on 10/1/06 and that the executor had obtained the appraisal to value property in the taxable estate in February of 2006. Because the estate tax return will be filed after August 17th, the appraiser could be penalized under the section even though the appraiser did not foresee the risk of the penalty at the time the appraisal was provided.

Similarly, the new blacklisting rules (no longer requiring the imposition of a penalty under Section 6701) apply with respect to returns and submissions after 8/17/06.

Treasury's expanded ability to blacklist an appraiser, as well as the new Section 6695A penalty, will radically alter the settlement and litigation dynamic in valuation cases. With appraisers made to feel more vulnerable by these provisions, the taxpayer's ability to support her valuation position in settlement and in litigation will necessarily be undercut.

CHARITIES OWNING AN INTEREST IN AN INSURANCE CONTRACT

Arrangements involving tax exempt entities (such as charitable organizations) acquiring interests in insurance contracts on the lives of individuals under which others (such as an investor group) provide funding to pay all or part of the premiums have been proposed by certain agents in the life insurance industry. The PPA, by adding new Section 6050V, mandates reporting by the exempt organization with respect to certain of these arrangements.

The PPA does not impose tax or contemplate loss of tax-exempt status as a result of these arrangements. Penalties for failure to report may apply, however. Exceptions to reporting apply in any of the following circumstances:

1. If all persons (other than the exempt organization) holding an interest in the contract have an insurable interest in the insured under the contract.

2. If the sole interest in the contract of the exempt organization, or each person other than the exempt organization, is as a named beneficiary.

3. If the sole interest of each person (other than the exempt organization) is as a gratuitous beneficiary of a trust or as a trustee of a trust solely for the benefit of persons described in items 1 and 2, above (i.e., exempt organizations, persons with an insurable interest, gratuitous beneficiaries, etc.).

Whether the arrangement falls within an exception may be difficult to analyze. For example, it may be unclear which insurable interest law applies—that of the state in which the insured resides or that of the state selected to govern the arrangement. If the insurable interest law is that of a state which grants any person, with the insured's consent, an insurable interest in the insured, it would appear that no reporting would be required regardless of the nature of the arrangement.

The reporting obligation ends two years after the date of enactment of the section. Treasury is directed to study the information received and to report the results of its study to the Senate Finance Committee and the House Ways and Means Committee within 30 months of 8/17/06, including, according to the Staff Report,[42] whether the activities of sharing the benefits of the exempt organization's insurable interest in insured individuals with investors are consistent with the tax-exempt status of the organizations involved, whether the arrangements are used improperly to shelter income from tax, and whether these arrangements should be reportable transactions under Reg. 1.6011-4(b)(2).[43]

The possibility (or, perhaps, foreshadowing) that the acquisition of an interest in such a policy could be a reportable transaction may inhibit the acquisition of such interests. In this regard, Treasury has required that reportable transactions be disclosed to the

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39 See Mortenson v. National Union Fire Ins. Co. of Pittsburgh, Pa., 249 F.3d 667 (CA-7, 2001) (indicating in dicta that a taxpayer subject to the penalty under Section 6672 would, in all likelihood, be precluded as a matter of public policy from seeking reimbursement under an insurance policy). See also Logue, "Tax Law Uncertainty and the Role of Tax Insurance," 25 Va. Tax Rev. 339 (2005), page 405. Surprisingly, as Mortenson suggests, the public-policy question may turn on state rather than federal law.

40 See Ltr. Rul. 7749029 (requiring the taxpayer to include in gross income the estimated-tax penalty recovered from the accountant).

41 See Reg. 1.162-21(b)(1)(ii).

42 Note 24, *supra*, page 286.

43 See generally *Circular 230 Deskbook, supra* note 38, "Reportable Transactions."

IRS even if the transaction was entered into before it was labeled as reportable.[44]

CHARITABLE EASEMENTS

A taxpayer is entitled to a charitable deduction for income and gift and/or estate tax purposes for a contribution of a qualified real property interest to a qualified charitable organization. In order to qualify, the contribution must be made exclusively for a conservation purpose,[45] which includes (1) the preservation of a historically important land area or a certified historic structure and (2) the preservation of open space (including farmland and forest land) where such preservation yields a significant public benefit and (a) is for the scenic enjoyment of the general public or (b) is pursuant to a clearly delineated federal, state, or local governmental environmental policy.

The PPA provides an opportunity for enhanced tax benefits for certain easements granted prior to 2008. It also restricts the availability of a deduction for the grant of an easement under certain circumstances.

Under the PPA, a contribution of an interest in real property for preservation purposes will not qualify for a charitable deduction merely because it is located within a registered historic district. The deduction continues to be permitted with respect to certified historic buildings, but now the entire exterior must be preserved under the easement restriction. Additional reporting requirements, including certain photographs, must be submitted to permit the deduction. Moreover, the charitable deduction must be reduced, in some instances, by any rehabilitation credit allowed under Section 47.

Although, as a general rule, a taxpayer may not deduct in any one year more than 30% of his or her contribution base for donations to charity of capital gain property,[46] the PPA allows taxpayers a charitable deduction for a qualified conservation contribution, made before 2008, of up to 50% of the taxpayer's contribution base. Any excess deduction is carried over for the 15 succeeding tax years.

The PPA is even more generous with respect to "qualified" ranchers and farmers. Such taxpayers (including corporations that qualify) may deduct charitable contributions consisting of qualified conservation contributions of up to 100% of the taxpayer's contribution base if made before 2008 (and carry over any excess for the succeeding 15 years). If, however, the property is being used for agricultural or livestock production, the donation must contain a restriction providing for the property to remain available for such production in order for the contribution to be eligible for the 100% threshold. A qualified rancher or farmer is a taxpayer 50% or more of whose income consists of income from the trade or business of farming.[47]

There are several incentives for taxpayers to grant easements such as to preserve open space (including farmland and forest land) (1) for the scenic enjoyment of the general public or (2) pursuant to a clearly delineated federal, state, or local governmental environmental policy.[48] First, because the easement is in the form of a restriction on the future use of the property, rather than a transfer of an interest in the property, as a general rule the taxpayer may continue to enjoy the property essentially as the taxpayer had prior to the grant of the easement (such as for a home, for farming, and/or for recreation). Second, public access is not required. Third, local real estate taxes may be reduced. Fourth, the property is preserved in its current condition in perpetuity, which generally is a goal of the taxpayer. Fifth, the taxpayer obtains an income, gift, and/or estate tax benefit. And now, under the PPA for easements granted before 2008, the income tax benefit may be greater.

Accordingly, it is appropriate for planners to explore with clients, who have property worthy of preservation, the granting of an easement that will qualify under Section 170(h) before the end of 2007. It is important to consider obtaining a private letter ruling from the IRS "approving" the easement before it is granted. Otherwise, the easement may not qualify for any tax benefit on the ground that it does not produce a significant public benefit or for other technical reasons.

PRIVATE FOUNDATION AND SIMILAR PENALTIES

The PPA essentially doubles the private foundation excise taxes under Chapter 42 (as well as the taxes on excess benefit transactions under Section 4958). These higher taxes (which are in the nature of penalties) are important for estate planners to consider not just because private foundations are often an important part of planning, especially for wealthy clients and corporations, but because several of these taxes (such as the tax under Section 4941 on acts of self-dealing) apply to split-interest arrangements, such as charitable remainder trusts and charitable lead trusts.[49]

CHARITABLE DISTRIBUTIONS FROM IRAs

As a general rule, distributions from an IRA must be made to the owner (or, on death, to beneficiaries who succeed to the ownership of the IRA). For 2006 and 2007, however, the PPA permits the owner of an IRA who has attained age 70½ to direct that up to $100,000 each year be distributed from one or more of her IRAs directly to charity. The direct distribution to charity is not included in the taxpayer's gross income, and the PPA denies the taxpayer a charitable deduction with respect to the distribution.[50]

The Staff Report nonetheless indicates that a qualified charitable distribution is taken into account for purposes of the minimum distribution

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44 *Id.*

45 See Sections 170(h), 2522(d), and 2055(f). In addition, an exclusion from the gross estate is permitted under Section 2031(c) for certain grants of conservation easements. See generally Jordan, "Charitable Contributions of Preservation Easements—A Primer," 101 JTAX 236 (October 2004).

46 See Section 170(b)(1)(C).

47 For this purpose, farming has the same meaning as it does for purposes of the special valuation for federal estate tax under Section 2032A.

48 See Section 170(h)(4)(A)(iii).

49 Section 4947(a)(2).

50 Section 408(d)(8)(E).

rules.[51] Failure to take the minimum required distributions will subject the taxpayer to penalties.[52] Thus, by making a qualified charitable distribution, the taxpayer can offset or eliminate entirely what needs to be distributed to avoid the penalties, and avoid income tax on the amount distributed.

This 2006/2007 distribution option does not apply to distributions to a private foundation, a supporting organization or a donor-advised fund.

The distribution-to-charity option may be of interest to taxpayers who do not need the distribution or who face limitations on the amount deductible (e.g., a partial or total disallowance of charitable deductions under Section 68 or state or local tax systems that do not permit the full benefit of a charitable contribution deduction). If the IRA owner does not face any such limitations or disallowance, she may be better off taking the distribution into income and contributing assets (perhaps, such as long-term capital gain property) to charity in lieu of a direct distribution from the IRA to charity. The taxpayer will avoid the possibility of having to pay capital gains tax on the property contributed and could repurchase similar or identical property with the cash received from the IRA, thereby effecting a tax-free basis step-up.

Charities might use the opportunity granted by the PPA to encourage their donors to accelerate the funding of more substantial pledges. For smaller donations, as suggested, it may be more beneficial for the taxpayer to recognize the income and claim the offsetting charitable deduction.

Practice Notes

Partial-interest contributions of tangible personal property have become a trap for the uninformed. If, for example, a partial-interest gift is made and the donor dies before the charity takes possession, a new recapture rule may apply even if the donor's will bequeaths the remaining interest to the same charity. In addition, the gift or estate tax deduction for a contribution of the remaining interest will be limited to the lower of FMV at the time of the initial fractional interest gift or FMV at death. In short, practitioners must carefully consider the PPA before advising clients about the consequences of such partial-interest gifts.

ROLLOVER TO INHERITED IRA BY NONSPOUSE BENEFICIARY

The PPA added new Section 402(c)(11), which permits a nonspouse beneficiary to roll over to an IRA any portion of a distribution from an "eligible retirement plan"[53] received on the death of the employee. The rollover must be accomplished by a direct trustee-to-trustee transfer to an individual retirement account or an individual retirement annuity established for the purposes of receiving the distribution on behalf of the individual who is a designated beneficiary.[54]

The individual retirement plan receiving the rollover is treated as an "inherited" IRA or individual retirement annuity, which means that the beneficiary cannot roll over any distributions, but may only effect further rollovers by a trustee-to-trustee transfer.[55] Although the designated beneficiary may exercise investment control over an inherited IRA, an inherited IRA is treated essentially as an IRA of the decedent. Hence, the beneficiary must take distributions in accordance with the required minimum distribution rules applicable to designated beneficiaries of plans and IRAs—and, unlike a spousal rollover, may not defer distributions until the beneficiary attains age 70½.

This new provision, notwithstanding the restrictions, can provide a designated beneficiary with significant tax benefits. In addition to giving the designated beneficiary more investment control, rolling over to an inherited IRA may provide for a payout under the required minimum distribution rules over the beneficiary's life expectancy. Because some plans do not permit anything but a lump-sum payout when the plan participant dies, the rollover option may provide the beneficiary, particularly one who is much younger than the participant, with significant tax deferral.

Under the PPA, Treasury may prescribe rules that would extend the foregoing rules to a trust for the benefit of one or more designated beneficiaries.[56]

CONCLUSION

The Pension Protection Act of 2006 adds both beneficial and limiting provisions to the Code in several areas that affect estate planning. In many instances the meaning of the PPA will remain unsettled until Regulations are issued. In addition to the provisions analyzed above, the PPA contains additional provisions, particularly in the charitable area, that can affect estate planning. Estate planners should study the entire PPA with care, and should be especially cautious about those provisions with uncertain application as well as those provisions conferring tax benefits that will be available for only a short period. ■

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51 Staff Report, *supra* note 24, page 266. Under Section 401(a)(9)(C), the required beginning date for minimum distributions is April 1 of the calendar year following the calendar year in which the taxpayer attains the age of 70½. Under Section 408(d)(8), however, the taxpayer may take advantage of the qualified charitable distribution provision after the taxpayer attains age 70½. If the taxpayer does so, the qualified charitable distribution will count for purposes of satisfying the taxpayer's obligation to commence taking minimum distributions. Thus, under Reg. 1.401(a)(9)-5(b), because the first distribution year is the year the taxpayer attains age 70½, the taxpayer could make a qualified charitable distribution in that year and perhaps avoid or reduce the double distribution that would otherwise occur in the subsequent year if the taxpayer were to wait to take any distribution until April 1 of the year after the taxpayer attains age 70½.

52 Section 4974.

53 Defined in Section 402(c)(8)(B); includes individual retirement accounts, individual retirement annuities, qualified plans, qualified annuities, tax-sheltered annuities, and governmental plans under Section 457.

54 See Section 401(a)(9)(E).

55 See Section 408(d)(3)(C).

56 Where an IRA owner anticipates that her beneficiary may want to do a rollover, consideration should be given to avoiding the use of a trust. Although the PPA gives Treasury authority to draft Regulations permitting a rollover where the beneficiary is a trust, until such Regulations are promulgated caution suggests that a trust not be used in this context. See Gall, *supra* note 10.