Legislative

1. CPC Commentary: Congress Approves Spending Compromise

Summary

The Congress yesterday approved H.R. 112-1473, appropriating funds to operate the federal government through September 30, 2011. The vote confirmed last week's eleventh-hour compromise agreement between the Administration and Republican leaders.

Extended Summary

The vote in the House was 260 to 167, with only 81 Democrats voting in favor and 59 Republicans against. On separate votes to "correct the enrollment" of the spending bill, the House voted 240 to 185 to defund last year's health care reform legislation and 241 to 185 to prevent the payment of any federal funds to Planned Parenthood.

Both these amendments failed in the Senate, the first by a vote of 47 to 53, strictly along party lines, the second by a vote of 42 to 58, with five Republicans joining the Democrats to reject the amendment. The final vote in the Senate, where a 60-vote majority was required for passage, was 81 to 19, with three Democrats voting against.

2012 Budget Resolution

The House immediately began debate on a budget resolution for fiscal 2012 put forward by Budget Committee Chair Paul Ryan (R-WI) that would cut spending by $5.8 trillion over the next ten years, while reducing revenues by $4.2 trillion. The proposal projects a $1.6 trillion reduction in budget deficits over the ten-year period.

Components of the tax reduction elements of the Ryan proposal include:

- permanently extending the Bush-era tax cuts;
- indexing the alternative minimum tax for inflation;
- extending the estate, gift, and generation-skipping transfer taxes at existing levels; and
- reducing the top marginal income tax rates for individuals and corporations to 25%.

Spending cuts would be achieved through, among other measures:

- rolling back non-security spending to 2008 levels;
- repealing the Health Care Act;
- converting the federal contribution to Medicaid to state block grants, indexed for inflation; and
- transforming Medicare to a "premium support" program starting in 2022.

The proposal also projects a substantial decline in military spending as the wars in Afghanistan

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and Iraq "wind down."

A House vote on the Ryan budget resolution is expected today. An amendment offered by Rep. Chris Van Hollen (D-MD) as the Democrats' alternative budget resolution would repeal the Bush-era tax cuts and restore transfer taxes to their 2009 levels, and would open discussion on imposing higher marginal income tax rates on incomes over $1 million.

Obama's Fiscal Policy Statement

Speaking at George Washington University on Wednesday, President Obama took issue with the Ryan proposal, emphasizing, in particular, that he would "not allow Medicare to become a voucher program," nor Social Security to be privatized. He did suggest that some changes, which he did not specify, would have to be made to keep these programs sustainable. At several points in his remarks, the President cited, though he did not specifically endorse its recommendations.

President Obama asserted that he would "refuse" a further extension of the Bush-era tax cuts, and he reiterated his earlier proposal to limit the rate at which itemized deductions would reduce taxes in the top two rate brackets, singling out the mortgage interest deduction and the charitable contributions deduction.

CPC Commentary

Obviously, a number of proposals are on the table from various groups. There is nothing of substance to report now, but hopefully the President and the two political parties will give us specificity in the near future.

Id: 1820727, Issued: Apr 15, 2011

2. CPC Commentary: Other Items of Interest

Summary

In recent days:

1. President Obama signed into law H.R. 112-4, repealing the expanded 1099 reporting requirements enacted last year as part of the health care reform legislation.
2. The House Budget Committee cleared an amended version of H.R. 112-1249, a patent reform measure that includes provisions denying patent protection to tax planning strategies.
3. Following a hearing earlier this month before the Health and Oversight Subcommittees of the House Ways and Means Committee on the matter, the chairs of those two subcommittees sent a letter to IRS Commissioner Shulman asking his agency to investigate whether AARP should retain its tax exempt status.

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Extended Summary

1. Repeal of Expanded 1099 Reporting

Earlier, the Administration had expressed strong reservations about the revenue features of the House bill. These provisions proposed to increase the amount the government might recapture from an individual whose income disqualified him or her from receiving a subsidy for participating in a state-sponsored health exchange created under the Health Care Act. This concern was not mentioned in the President's signing statement.

2. Tax Strategy Patent Ban

The House bill differs slightly from a similar bill, S. 112-23, which passed the Senate in March.

Each bill would treat "any strategy for reducing, avoiding, or deferring tax liability" as "insufficient to differentiate a claimed invention from the prior art," and each would exclude from the scope of this provision tax return preparation software. The House bill would also exclude "financial management" software, provided it is "severable from any tax strategy or does not limit the use of any tax strategy by any taxpayer or tax advisor."

The conformed text of the amended bill is not yet available.

3. AARP Exempt Status Challenged

The letter was signed jointly by Rep. Wally Herger (R-CA), chair of the Subcommittee on Health and Rep. Charles W. Boustany, Jr. (R-LA), chair of the Subcommittee on Oversight, together with Rep. Dave Reichert (R-WA).

The letter summarized a report released by Reps. Herger and Reichert in advance of the hearing alleging that AARP stands to benefit substantially from increased demand for Medigap insurance because of cuts to Medicare Advantage in the health care reform legislation enacted last year, and that its lobbying in support of that legislation conflicted with its stated mission to advocate for the interests of seniors.

The letter also mentioned testimony at the hearing suggesting that payments received by AARP for its endorsement of insurance products marketed by United Health Group should be characterized -- not as royalties, exempt from unrelated business taxable income -- but instead as commissions, subject to tax.

CPC Commentary

The letter from Reps. Herger, Boustany, and Reichert to Commissioner Shulman cited testimony "questioning whether certain revenue categorized by AARP, Inc. as royalty payments . . . are in fact, flat commissions."

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Presumably, the reference was to the testimony of William Josephson, a retired partner with the DC law firm Fried Frank. Mr. Josephson did raise the question, but concluded that he could not see "a consistent basis for IRS rulings that a particular transaction is or is not a royalty," and suggested "[t]his lack of coherency is . . . another reason for further exercise of the Congress's legislative and the IRS rulemaking jurisdiction with respect to these issues."

The other expert witness at the hearing, Prof. Frances R. Hill of the University of Miami School of Law, similarly noted the unsettled state of the law on the question, noting that "Congress has considered many of these issues in the past and has chosen not to amend the statute."

Id: 1820735, Issued: Apr 15, 2011

3. CPC Commentary: Finance Committee Hears More Testimony on Tax Reform

Summary

In the second of a series of hearings on tax reform, the Senate Finance Committee yesterday heard testimony from three economists and a law professor on the relationship between tax policy and economic growth.

Extended Summary

Alan J. Auerbach, of the University of California at Berkeley, focused his remarks on "tax expenditures" and corporate taxation. Prof. Auerbach noted that the description of any tax benefit as an "expenditure" or an "incentive" is irrelevant to the question of whether the benefit should remain in the Code, or what limits should be placed on it. He suggested that the mortgage interest deduction, for example, and the exclusion of employer-provided health insurance, should be capped or recast as tax credits. Prof. Auerbach advocated moving toward a "destination-based cash flow" corporate tax, reducing or even eliminating incentives for debt financing (the deductibility of interest) and replacing these with stronger incentives for equity financing (accelerated depreciation deductions), and eliminating incentives to shift profits overseas.

Glenn Hubbard of Columbia University sounded similar themes, arguing that a pure income tax or a pure consumption tax:

"would reduce tax-planning opportunities because tax-minimizing strategies often involve combining transactions with different tax treatments (that is, part of the transaction receives pure income-tax treatment, while another part receives consumption-tax treatment) or by taking advantages of disparities in tax rates across investors."

James K. Galbraith of the University of Texas at Austin argued that the budget deficit is "an economic outcome, not a policy choice," and that "no combination of tax increases and spending cuts...can make it go away" while unemployment remains high. Prof. Galbraith

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suggested tax reform and spending policy should focus on "economic performance," not on deficit reduction:

"A tax policy aimed at supporting employment would shift the tax burden away from labor, and off of short term capital, and place it instead on long-term capital accumulations."

The Professor proposed not only a return to higher estate tax rates, but also taxing unrealized capital gains "after a certain amount of time has elapsed," subject to a full charitable deduction. He also suggested increasing the required payout rate for foundations, so that they "do not last in perpetuity, unless they find new donors."

Michael Graetz of the Columbia Law School argued that tweaking the current system was an exercise in futility. He proposed instead enacting a value added tax ("VAT") that would generate enough revenue

"to finance an income tax exemption of $100,000 of family income and to lower substantially the individual income tax rate on income above that amount," reducing the corporate income tax rate to 15% "or at most 20%," and replacing the earned income tax credit with some other form of targeted relief from the VAT for low and middle income families.

CPC Commentary

The next hearing in this series has not yet been scheduled.

Kallina's Korner: It will be interesting to see whether or not the SFC will only have individuals testifying who agree with the sentiments of committee members, or there is significant diversity of opinion. At the hearings in June, 2004 on charitable abuses, particularly abuses of DAFs and SOs, those testifying and even those permitted to attend were pre-determined. The make-up of the SFC for the 112th Congress is:

Democratic Members:

Baucus, Max (MT) , Chairman
Rockefeller, John D. (WV)
Conrad, Kent (ND)
Bingaman, Jeff (NM)
Kerry, John F. (MA)
Wyden, Ron (OR)
Schumer, Charles E. (NY)
Stabenow, Debbie (MI)
Cantwell, Maria (WA)
Nelson, Bill (FL)
Menendez, Robert (NJ)
Carper, Thomas R. (DE)
Cardin, Benjamin L. (MD)

Republican Members:

Hatch, Orrin G. (UT), Ranking Member
Grassley, Chuck (IA)
Snowe, Olympia J. (ME)
Kyl, Jon (AZ)
Crapo, Mike (ID)
Roberts, Pat (KS)
Ensign, John (NV)
Enzi, Michael B. (WY)
Cornyn, John (TX)
Coburn, Tom (OK)
Thune, John (SD)

Id: 1816149, Issued: Mar 9, 2011

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4. CPC Commentary: Senate Passes Ban on Tax Strategy Patents

Summary

By a vote of 95 to 5 on March 8, 2011, the Senate approved S. 112-23, the Patent Reform Act of 2011 ("Bill"), which includes provisions that would prevent the patenting of tax planning strategies.

Extended Summary

Under the Bill, "any strategy for reducing, avoiding, or deferring tax liability, whether known or unknown at the time of the invention or application for patent" would be deemed "insufficient to differentiate a claimed invention from the prior art."

There is no similar measure pending in the House, and there is no indication when the Bill might be taken up by the House.

Id: 1816150, Issued: Mar 9, 2011

5. CPC Commentary: Finance Committee Hears Testimony on Tax Reform

Summary

The Senate Finance Committee yesterday heard testimony from five former assistant secretaries of the Treasury for tax policy on how the Tax Reform Act of 1986 ("TRA 1986") has weathered globalization, technological advances, the growth of the financial services industry, and the current recession. The testimony also addressed what policies should inform tax reform efforts going forward.

Extended Summary

A recurring theme in the testimony was that TRA 86 was intended to broaden the individual income tax base and lower marginal rates; however, in the intervening 25 years, thousands of amendments added countless targeted tax incentives, while marginal rates crept up. More than one witness pointed out that even at its inception TRA 86 included very substantial tax expenditures, notably the exclusion of employer-provided health care and the home mortgage interest deduction, leaving much of the "base broadening" to leveling techniques such as phaseouts and the alternative minimum tax. Multiple witnesses also noted that several of these tax expenditures reflect broadly shared societal values, and/or that they are a more efficient mechanism for delivering the desired subsidies than direct spending programs.

All five witnesses acknowledged that the growing budget deficit cannot be controlled merely through reductions in discretionary spending, and that difficult political decisions concerning

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reform of the income tax system will have to be made.

In anticipation of the hearing, the Joint Committee on Taxation issued a report on tax expenditures, as defined in the Budget Act of 1974, and the methods by which the revenue losses attributable to various exclusions, exemptions, deductions, credits, preferential rates, or deferrals are calculated. The Joint Committee report also discussed questions of economic efficiency, equity between taxpayers, and administrability of various tax expenditures. While noting that the charitable contributions deduction, for example, provides a greater tax benefit to a taxpayer in a higher marginal rate bracket, the report also pointed out that since the taxpayer receives no economic benefit for an outright contribution of cash, it might be argued that the amount contributed should be excluded from the tax base.

CPC Commentary

We consider testimony and hearings surrounding the repeal/limitation of the charitable deduction to be sufficiently news worthy that we will report events on a frequent basis. Normally, we wait until a bill has passed at least one House of Congress to publish, but in this particular situation, we feel publishing commentary as events unfold is appropriate.

Id: 1815385, Issued: Mar 2, 2011

6. CPC Commentary: Fiscal 2012 Budget Proposal Released

Summary

The Administration released its budget proposal for fiscal year 2012 yesterday. The budget again includes a proposal to limit itemized deductions for high-income taxpayers, identified as a revenue offset for a three-year "patch" to the alternative minimum tax.

Extended Summary

Measured against a baseline that assumes that most of the Bush-era tax cuts remain in place, the budget would increase deficits slightly over the next two years, but cut the aggregate deficit over five years by $717 billion and over ten years by $2.182 trillion. This would reduce the federal deficit as a percentage of gross domestic product by about half. Roughly two-thirds of the projected deficit reduction would come from spending cuts. These figures assume growth in the economy of about 3.6% over five years, with inflation at less than two percent.

Details are posted to the website of the Office of Management and Budget. The Treasury also published its "Green Book," providing explanations of the various tax proposals and estimating their revenue effects.

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1. Limiting Itemized Deductions

As in the previous two budget proposals submitted by the Obama Administration, the 2012 budget includes a proposal to limit to 28% the marginal rate at which itemized deductions would reduce the tax liability of individual taxpayers with adjusted gross incomes over $200,000 (for married couples filing jointly, the AGI threshold would be $250,000). This proposal would take effect for tax years beginning after December 31, 2011.

The baseline assumes that the "Pease" limitation, which phased out itemized deductions by 3% of the amount by which adjusted gross income exceeded these thresholds, up to a limit of 80% of the amount otherwise deductible, would be reinstated in 2013. In outlying years, the proposed 28% limit on itemized deductions would be applied after the "Pease" limitation.

The proposal is projected to generate over $321 billion in additional revenue over ten years, offsetting only the first three years of anticipated inflation adjustments to the alternative minimum tax.

2. Transfer Tax Proposals

The budget includes several proposals that would affect transfer tax planning, specifically:

1. making permanent the "portability" of a decedent's unused transfer tax exemption by a surviving spouse;
2. requiring consistency in valuation for transfer tax and income tax purposes;
3. disregarding, for valuation discounting purposes, restrictions on liquidation or on acquisition of voting rights that are more restrictive than those set forth in regulations;
4. requiring a minimum ten-year term for grantor retained annuity trusts, with a level annuity payout and with no zeroing out of the remainder value; and
5. limiting to 90 years the exemption of a trust from the generation-skipping transfer tax.

These changes would become effective upon enactment, and are projected to increase revenue by about $7.5 billion over five years, and $19.5 billion over ten years.

3. Other Charitable Tax Measures

At least three other items in the budget proposal would directly affect tax-exempt entities:

a. A revision and simplification of the "fractions rule."

The rule presently requires that the share of partnership income allocated to a tax-exempt partner cannot be greater than the share of losses allocated to that partner in the year for which that partner's loss share will be the smallest. The Administration's proposal would simply require that partnership allocations have substantial economic effect and that no allocation have as its principal purpose the avoidance of tax. This change is projected to result in revenue losses of $242 million over ten years.

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b. A reform of the investment income excise tax on private foundations.

Existing law imposes an excise tax of 2% on the net income of a private foundation. The rate drops to 1% in a year in which the foundation distributes more than the sum of its average percentage payout over the preceding five years plus 1% of its investment income for the year. Although a distribution that is substantially larger than the five-year rolling average is taxed at a lower rate, it raises the foundation's average distributions going forward, increasing the likelihood that the foundation will be subject to the higher tax rate in subsequent years. As applied to a non-exempt foundation, such as a charitable lead trust, the tax is the excess of the excise tax that would have been imposed if the foundation were exempt, plus any unrelated business income tax, over the foundation's income tax liability.

The Administration's proposal would replace the two-tier tax with a single rate of 1.35%. Several legislative proposals put forward over the past two years would have set the rate for a simplified excise tax at 1.32%. This change is projected to result in revenue losses of $55 million over ten years.

c. Imposing a penalty on failure to comply with electronic filing requirements.

An exempt organization with $10 million or more in assets is required to file electronically if it files at least 250 returns in a calendar year; including income, excise, employment tax and information returns. A private foundations or a non-exempt charitable trust is required to file Form 990-PF electronically regardless of asset size, if it files at least 250 returns in a calendar year. The electronic filing requirement does not apply to Form 8868, the automatic three-month filing extension.

Notice 2010-13 provides a mechanism for requesting a waiver of the electronic filing requirement where the organization cannot meet the requirement due to "technology constraints," or where compliance would result in an "undue financial burden." Under current law, there is no monetary penalty for filing a paper return where an electronic return is required. The Administration's proposal would impose a penalty of $5,000 on a tax-exempt organization that failed to comply with electronic filing requirements. This change is projected to result in a modest increase in revenue.

CPC Commentary

In a separate volume titled Analytical Perspectives, the OMB provides detailed explanations of the economic assumptions underlying the budget projections, and of the conceptual framework underlying the baseline revenue assumptions and the concept of "tax expenditures" as measured against those baseline assumptions. Chapter 17 of this volume is especially instructive, as it quantifies the revenue loss attributable to various "tax expenditures," including the charitable income tax deduction.

For example, the deduction for contributions other than to educational or health-related charities is ranked 8th, and is projected to cost $43.11 billion in 2012, and $248.93 billion over five years, of which $240.50 billion is attributable to individual returns. The deduction for

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contributions to educational institutions is ranked 33rd, while the deduction for contributions to health-related charities is ranked 35th.

The home mortgage interest deduction is ranked 2nd, with a projected cost of $98.55 billion in 2012 and $609.18 billion over five years. The differential rate at which capital gains are taxed is ranked 7th, with a projected cost of $38.49 billion in 2012 and $256.28 billion over five years.

Id: 1810946, Issued: Feb 15, 2011

7. CPC Commentary: Tax Bill Creates Unique Year-End GST Tax Planning Opportunity

Summary

As noted on Forbes.com before the House voted on the measure, and as discussed in greater detail in two posts yesterday to Stephan R. Leimberg's website, the tax compromise act ("Act") signed into law on December 17, 2010 creates a unique opportunity for high net worth taxpayers to make large transfers in trust for multiple generations without incurring generation-skipping transfer taxes, either upon funding the trust or upon later distributions to skip persons.

Extended Summary

The opportunity arises from the fact that the Act reinstates the GST tax retroactively, but with a zero marginal rate through 2010. Until details of the compromise agreement were solidified in the Reid amendment to H.R. 111-4853, it was widely believed that the zero rate would apply only to outright transfers to skip persons, but in what Forbes blogger Janet Novack characterized as a "loophole," the legislative text extends this treatment to transfers in trust, provided there are no non-skip trust beneficiaries.

In an article posted to LeimbergServices.com, David Pratt and George D. Karibjanian, both partners in the Boca Raton office of Proskauer Rose LLP, mapped out the planning opportunity as follows:

1. The zero marginal rate. Although the gift tax exemption amount remains at $1.0 million through December 31 and will increase to $5 million on January 1, a generation-skipping transfer made in 2011 will be subject to both gift tax and GST tax, each at a marginal rate of 35%. A transfer made in the next few days will be subject only to the gift tax.

2. Transfer to trust benefiting only skip persons. As noted above, the zero rate applies only to outright transfers and to transfers in trust, provided there are no non-skip trust beneficiaries.

3. Election out of automatic allocation. The central feature of the strategy is to elect out of

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automatic allocation of GST exemption to the transfer.

4. Distributions not taxed. Distributions to skip persons from a trust that was already subject to GST tax upon funding (albeit at a zero marginal rate) are not treated as "taxable distributions," and thus will not be taxed.

In a separate article also posted to LeimbergServices.com, Jonathan G. Blattmachr, a principal in Eagle River Advisors, a New York wealth management firm, Diana S.C. Zeydel, a partner in the Miami office of Greenberg Traurig, and Mitchell Gans, a law professor at Hofstra University, take the logic several steps further.

They suggest, first, that a trust might be funded during 2010 that benefits only skip persons, as described above, but that non-skip beneficiaries might be added at some later point, with "prudence" dictating a "considerable" delay, maybe three to five years.

Second, they suggest that an existing non-exempt discretionary trust might be "decanted" during what remains of 2010 into a further trust for the benefit only of skip persons. Third, they suggest a similar strategy with respect to an existing exempt trust that would otherwise terminate soon, placing assets outright in the hands of an individual beneficiary and thereby exposing them to transfer taxation.

Because these latter two strategies have the effect of extending the perpetuities period of an existing irrevocable trust, they are dependent on state law. As noted in the article, only a handful of states permit the "decanting" of a discretionary trust into a further trust, rather than outright to the current beneficiary.

CPC Commentary

These strategies are designed for taxpayers for whom the $5 million exemption, coming into effect on January 1, 2011, is not sufficient to effect a zero tax result. The strategies proposed by Jonathan Blattmachr, et al., are well-thought out, but the first one (adding non-skip beneficiaries later) might be considered by some to be aggressive.

Id: 1795628, Issued: Dec 23, 2010

8. CPC Commentary: House Accedes to Tax Compromise after Delay

Summary

After a delay resulting from pushback by members of the Democratic caucus, the House voted 277 to 148 yesterday to accept the Senate amendment to H.R. 111-4853, the tax compromise bill ("Bill").

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Extended Summary

A procedural rule in the House floor would have permitted a separate vote only on a proposal to reinstate the estate tax at 2009 levels ("Pomeroy Amendment"), with no opportunity to offer further amendments. However, Floor Manager Rep. Jim McGovern (D-MA) withdrew the rule when it became clear the Bill would not pass in that form. A substantial number of Democrats wanted an opportunity to vote on amendments that would limit the extension of Bush-era income tax cuts to incomes under $1 million, replace the proposed payroll tax cut with a tax credit, and provide a cost-of-living adjustment for seniors already receiving Social Security benefits.

After a recess of several hours, debate resumed under a rule permitting an up-or-down vote on the Bill without the Pomeroy Amendment, even if the Pomeroy Amendment passed. Ultimately, the Pomeroy Amendment failed, with 60 Democrats voting against.

For details of the Bill, see our earlier commentary.

UPDATE: THE PRESIDENT DID IN FACT SIGN THIS BILL INTO LAW ON DECEMBER 17, 2010.

CPC Commentary

It is hard to believe that estate tax reform and the IRA charitable rollover will soon become law. It will be interesting, to say the least, to see how these changes and the other aspects of the Bill will impact charitable giving.

Id: 1795290, Issued: Dec 18, 2010

9. CPC Commentary: Election Causes Shifts on Taxwriting Committees

Summary

Although not every vote has been counted, some of the likely effects of Tuesday's election on the membership and leadership of the House Ways and Means Committee and the Senate Finance Committee can already be seen.

Extended Summary

House Ways and Means Committee

With Republicans capturing a solid majority in the House, not only will Rep. John A. Boehner (R-OH) ascend to the Speaker's chair, but control of the Ways and Means Committee will pass to ranking member Rep. Dave Camp (R-MI). Rep. Camp is credited with playing a key role in

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the enactment of the charitable IRA rollover and has supported the current effort to extend that tax incentive.

The interim chair of the committee, Rep. Sander Levin (D-MI), is among at least three candidates for the minority post, including Rep. Charles B. Rangel (D-NY), who stepped aside as chair pending investigation of ethics charges against him. Two incumbent committee members, Rep. Earl Pomeroy (D-ND) and Rep. Bob Etheridge (D-NC), lost their re-election bids, and with the shifting majority in the House, several other Democrats will lose their seats on the committee.

Senate Finance Committee

Though Democrats retained control of the upper chamber, they will hold a smaller majority in the next session and will give up one seat on the Senate Finance Committee, presumably that of Sen. Blanche L. Lincoln (D-AR), who was defeated for re-election by Rep. John Boozman (R-AR). The Republicans will have a second seat to fill as well, due to the retirement of Sen. Jim Bunning (R-KY).

While Sen. Max Baucus (D-MT) will continue to chair the committee, the role of ranking member will likely pass to Sen. Orrin Hatch (R-UT), as Republican caucus rules require that the incumbent, Sen. Chuck Grassley (R-IA), who has served a term each as ranking member and as committee chair, step aside. Though Sen. Grassley will remain on the committee, he will be less able to pursue high-profile investigations of university endowments, nonprofit hospitals, executive compensation, and churches. For his part, Sen. Hatch has already challenged a recent call by Sen. Baucus for an IRS investigation into possible improper political activity by major 501(c)(4), (c)(5), and (c)(6) organizations.

Senator Harry Reid (D-NV) was re-elected, and will continue to serve as Senate Majority Leader.

Id: 1791998, Issued: Nov 4, 2010

10. CPC Commentary: Estate Tax Reform in 2010 Is Unlikely

Summary

The House of Representatives adjourned on Wednesday, September 29, 2010, until after the mid-term elections. The Senate will continue to meet twice a week in "pro-forma" sessions through November 12, 2010, with no votes taken.

Extended Summary

Any action to extend the 2001 and 2003 income tax cuts or to modify the transfer tax provisions that will take effect January 1, 2011 as EGTRRA sunsets will be undertaken by a

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"lame duck" Congress or will await the seating of the 112th Congress in January.

The vote in the House on the adjournment resolution, H.Con.Res. 111-321, was 210 to 209, with 39 Democrats opposed and zero Republicans in favor. Speaker Nancy Pelosi (D-CA) cast the deciding vote. Some press reports indicated that many of the Democrats voting against adjournment are in close races for re-election. The vote in the Senate on H.Con.Res. 111-321 was 54 to 39, with two Democrats opposed (Michael F. Bennet of Colorado and Blanche L. Lincoln of Arkansas) and no Republicans in favor. Both chambers will reconvene at 2:00 p.m. Monday, November 15, 2010.

CPC Commentary

Under Senate rules, the scheduling of twice weekly "pro forma" sessions during the interval allows more than a hundred pending nominations to executive and judicial positions to remain active, while preventing the White House from making "emergency" recess appointments.

Before adjourning, Congress approved a continuing appropriations bill, H.R. 111-3081, to keep the government running through early December.

Kallina's Korner: When one speculates on what Congress will or will not do, one is open to a lesson in humility. That being said, we do not believe there will be any estate and GST tax reform this year. There is simply not much working time for Congress that is available following the elections, given the Thanksgiving and Christmas recesses. In fact, Congress will only be in session for about 3 weeks between now and the seating of the 112th Congress, scheduled for January 3rd.

The theory is that Congress could not agree on changes in the transfer tax area for approximately 10 years, and thus any significant legislation during a 3 week period by a lame duck session is remote.

Id: 1785930, Issued: Oct 1, 2010

11. CPC Commentary: Extenders, Carried Interests Back on Senate Calendar

Summary

On September 16, Senate Finance Committee Chair Max Baucus introduced S. 111-3793 ("Bill"), which would reinstate retroactively for 2010 roughly fifty expired and expiring tax incentives, including the charitable IRA "rollover."

Extended Summary

The Bill was initially part of the negotiations last week surrounding the enactment of the small business bill, H.R. 111-5297. Efforts to pass the Bill were rebuffed by Sen. Orrin Hatch (R-

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UT), who sought to make the research and development credit permanent, rather than extending it only for one year.

Among offsetting revenue measures are provisions that would tax as ordinary income 75% of compensation for investment management services paid in the form of "carried interests" in the investment fund. A "carried interest" does not represent a return on invested capital and is not held for at least five years. The language tracks prior legislation introduced by Sen. Baucus in June as part of H.R. 111-4213, which extended unemployment benefits.

Although the Finance Committee has provided a summary of the bill's provisions, including tax expenditure and revenue estimates, the Joint Committee on Taxation has yet to issue its report.

CPC Commentary

The Bill has been read twice and placed on the Senate calendar, but it is unclear when it will be taken up. The Senate has been occupied this week with the defense authorization bill, S. 111-3454. That bill includes provisions laying the groundwork for a repeal of "don't ask, don't tell," which would allow homosexuals to openly serve in the military. A motion for cloture failed on Tuesday, September 21, 2010.

Kallina's Korner: Both of the these provisions, namely the IRA rollover and the categorization of carried interests as ordinary income (rather than capital gain) assets, are important to the charitable planner, but for different reasons.

The first provision dealing with the IRA rollover is a good marketing technique that helps charities gain an audience with donors, although some experts have questioned the mathematical value of the rollover. If we recall correctly, our friend André Donikian of Pentera, Inc., spoke on this issue several years ago at PPP, and his materials should be available online with that organization, or you can contact André at http://www.pentera.com/contact.html.

With respect to carried interests and its relevance to charitable planners, we continue to feel that the higher the tax rate, the greater the incentive for some of our high net worth clients to move their tax dollars (through CRTs or other vehicles) over to charities they support, rather than giving tax dollars to the government.

Id: 1785505, Issued: Sep 23, 2010

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IRS Internal Developments

12. CPC Commentary: Government Files Rehearing Briefs in *Home Concrete*, *Beard*

Summary

Earlier this week, the Department of Justice filed a petition for rehearing in the 4th Circuit federal appeals court in *Home Concrete & Supply, LLC v. United States* and a brief in response to the taxpayer's petition for rehearing in the 7th Circuit in *Commissioner v. Beard*.

Extended Summary

Both decisions involve the question of whether an overstatement of basis is a failure to report income for purposes of Section 6501(e)(1)(A), thereby extending the statute of limitations for a deficiency assessment from three years to six. The 4th Circuit in *Home Concrete* ruled that it is not, while the 7th Circuit in *Beard* ruled that it is.

In each case, the Government argued that regulations proposed and finalized while the litigation was pending should control the interpretation of the statute. The 4th Circuit in *Home Concrete* rejected this argument, partly because Regs could not apply retroactively to extend a limitations period that expired before the Regs were proposed. The 7th Circuit in *Beard* expressed the view that the Regs were valid, but found it unnecessary to actually reach the question.

CPC Commentary

While the substantive issues in these cases are outside the scope of our usual focus, we have been following them because they represent an aggressive policy of the IRS to adopt new regulations, contrary to existing case law, to bolster its arguments in pending.

Obviously, the Government is setting the stage for the matter to be resolved by the Supreme Court by way of a writ of certiorari, since opposite conclusions have been reached by two circuit courts.

Id: 1818090, Issued: Mar 25, 2011

13. CPC Commentary: Federal Circuit Rules in *Grapevine*, Petition for Rehearing Filed in *Beard*

Summary

On Friday, March 11, 2011, the Federal Circuit appeals court issued its decision in *Grapevine Imports, Ltd. v. United States*, holding that an overstatement of basis is a failure to report income, thus extending the statute of limitation for assessment from three years to six.

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Meanwhile, the taxpayer in *Commissioner v. Beard* petitioned the 7th Circuit federal appeals court for a rehearing en banc of a similar decision of that court.

Extended Summary

As argued in the petition for rehearing, the result in *Beard* is contrary to decisions of at least two federal circuit appeals courts, the Tax Court, and the Federal Claims Court. In response to these adverse decisions, the IRS published temporary and proposed Regs in December, 2009, while the *Beard* and *Grapevine* appeals were pending. Those Regs were finalized in December, 2010, after notice and comment.

While the 7th Circuit panel in *Beard* did not rely on the Regs in reaching its decision, the Federal Circuit appeals court in *Grapevine* confronted the question of *Chevron* deference directly. The court concluded that the Regs are a reasonable interpretation of an ambiguous statute, overruling its own precedent in *Salman Ranch, Ltd. v. United States*.

CPC Commentary

Again, Alan Horowitz of Miller Chevalier provides an excellent analysis on his firm's blog covering tax appeals.

While the substantive issues in *Beard* and *Grapevine* are outside the scope of our usual focus, we have been following these cases because they represent an aggressive policy of the IRS to adopt new regulations, contrary to existing case law, which bolters its arguments in pending litigation.

Any charitable planner contesting the IRS' position in litigation should be aware of this technique. Further, anyone issuing an opinion letter to a client should highlight the danger that IRS can change the status of the law retroactively, despite prior favorable judicial interpretations.

Id: 1816668, Issued: Mar 14, 2011

14. CPC Commentary: Recommended Readings

Summary

In a recent column in Tax Notes, a publication of Tax Analysts, law professor Steve R. Johnson of the University of Nevada Las Vegas argued that the recent Supreme Court decision in *Mayo Foundation v. United States* "does not...fundamentally alter the litigating balance between taxpayers and the government" when the validity of a Treasury Regulation is at issue.

Extended Summary

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After summarizing the facts of the case, which addressed whether medical residents are students for purposes of an exception from FICA taxes, Prof. Johnson asserted that *Chevron* deference under *Mayo* is to be extended not only to Regs issued under "specific authority" granted in a particular section of the Code, but also to Regs issued under the "general authority" of Section 7805.

However, the decision left open the question of whether a court may consider legislative history in determining, at "step one" of the *Chevron* analysis, whether the statute in question is ambiguous. The Court made it clear that at "step two" of the *Chevron* analysis, in determining whether the Treasury's interpretation of an ambiguous statute is reasonable, a court may consider not only the "accuracy of meaning," but also "process values," *i.e.*, whether a less accurate rule is more easily administered. Additionally, the Court effectively put an end to the "tax exceptionalism" of *National Muffler*, which treated Treasury tax Regs with less deference than regulations issued by other agencies.

Prof. Johnson then went on to argue that *Mayo* did not "fundamentally alter the balance of power between taxpayers and the government in cases in which the validity of Treasury regulations is challenged." He argued for this conclusion because:

1. the trend in court decisions had already been away from *National Muffler* and toward *Chevron* deference;
2. the *Chevron* analysis still permits a court to find either that the statute is not ambiguous, or that the Treasury's interpretation is unreasonable; and
3. that properly understood, *National Muffler* was actually a less deferential standard than *Chevron*.

Prof. Johnson predicted that one of the "future battlegrounds" will center on the validity of Regs issued without notice or comment. Additionally, issues are likely to arise regarding the language in the relevant Code section by which authority to regulate is delegated and the credibility of the Treasury's explanation of its reasoning in adopting the regulation in question.

Finally, Prof. Johnson addressed "pronouncements of a lower level of dignity than regulations." He argued that revenue rulings, revenue procedures, notices, and announcements should be subjected to "the more probing *Skidmore* standard" and were not addressed in *Mayo*.

CPC Commentary

We find ourselves unable to share Prof. Johnson's view that *Mayo* did not "fundamentally" change the rules. For example, the *National Muffler* criteria would argue strongly against deferring to a regulation adopted years after the statute it purports to interpret, conflicts with prior court rulings, and is specifically designed to bolster the government's argument in pending litigation. At least one federal circuit court has ruled that such a regulation is entitled to *Chevron* deference after *Mayo*.

In addition, most statutes are general in nature, and rarely does legislative history clarify how a statute should be applied to a particular set of facts. This being the case, we would argue that

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the "step one" analysis will frequently result in a determination that the statute is ambiguous as applied to the facts. Thus, in most scenarios, only a "step two" analysis will be required, thus giving the Government a significant advantage and shifting the balance of power.

Even if the Supreme Court accepts certiorari from *Grapevine* and/or some of the other *Intermountain* decisions, we find it hard to believe, given a close reading of *Mayo* (an 8-0 decision), that the Court would find the Treasury's interpretation of the statute unreasonable.

Id: 1818455, Issued: Mar 30, 2011

15. CPC Commentary: Supreme Court Upholds IRS Regulations in *Mayo Foundation*

Summary

In *Mayo Foundation v. United States ("Mayo"),* the Supreme Court adopted a deferential standard for review of Treasury regulations when interpreting ambiguous provisions of the Code.

Extended Summary

In ruling that medical residents are not "students" exempt from FICA taxation, the Court:

- endorsed the standard of review set forth in *Chevron v. Natural Resources Defense Council*, a 1984 Supreme Court decision, which requires a court in considering the validity of an agency regulation to defer to a reasonable interpretation of the statute, where the statute is ambiguous; and
- rejected the analysis set forth in *National Muffler Dealers Association v. United States*, a 1979 Supreme Court decision, under which a court might invalidate a regulation where the agency's interpretation of the statute had been inconsistent over time, or where the regulation was promulgated long after the statute was enacted or specifically in response to contrary court decisions.

Chevron requires a two-fold analysis of a regulation in question: first, a court must ask if Congress directly addressed the precise question at issue. Assuming Congress failed to do so, as a second step the court must determine if the agency rule is "arbitrary or capricious in substance, or manifestly contrary to the statute." If not, the Court conclusively (8-0) held that the agency rule must be upheld.

The Court went even further, however, and stated that it made no difference whether "Congress's delegation of authority was general or specific." It held within the tax context that the authority granted by Section 7805(a) to "prescribe all needful rules and regulations for the enforcement" of the Code was adequate authority, and no greater specificity was required.

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CPC Commentary

Mayo is important to the charitable tax planner. First, it clearly stated the deference granted by the Supreme Court in *Chevron* to regulations of government agencies applies "with full force in the tax context." Second, the case made it clear that a Treasury regulation, which embodies a "reasonable" interpretation of an ambiguous statute, is to be given deference where it conflicts with prior court decisions or prior guidance from Treasury itself, **even where the regulation is adopted specifically to bootstrap the government's argument in pending litigation.**

It should be noted that the Court did state that such regulations are subject to notice-and-comment procedures, which it considered to be "a significant sign that a rule merits Chevron deference." Presumably, a public hearing that roundly criticized a regulation would be an important consideration for a court.

In short, this decision is likely to be very far-reaching, and may well have changed "interpretive" regulations into "legislative" regulations, that is, regulations that have the power and authority of a statute.

Update:

Tax Analysts reported Clarissa Potter, a deputy associate in the technical section of the Chief Counsel's office, spoke at a meeting of the ABA Taxation Section on January 21, 2011, commenting that *Mayo* would speed up the process of developing and issuing formal regulatory guidance. She highlighted the Court's statement that a simple "bright line" rule, though "not perfect," may often be a reasonable mechanism for interpreting complexities in the Code. As a result, Ms. Potter anticipated that the agency may be able to move more quickly in proposing and finalizing formal guidance. Ms. Potter noted the Court's emphasis on the importance of notice and comment in the regulatory process, but said it "may take some time" to integrate the policy implications of this aspect of the decision throughout the agency.

Reporting from another session at the same conference, Tax Analysts quoted acting deputy assistant attorney general Gilbert Rothenberg as saying legislative history is no longer relevant after *Mayo* to the threshold question whether the language of a Code provision is ambiguous. Mr. Rothenberg also asserted that Revenue Rulings should be accorded Chevron deference, even though they are not adopted through a process of notice and comment.

As of yet, we do not have access to a full text of Ms. Potter's or Mr. Rothenberg's remarks, but we suggest that *Mayo* entirely hinges on the fact that the regulations in question were adopted only after notice and comment, and we also suggest Mr. Rothenberg's extension of the scope of the Court's decision to revenue rulings is a significant reach. Under Mr. Rothenberg’s view, because legislative history is not relevant to ambiguous legislation, and because revenue rulings do not go through the process of public comment and scrutiny before becoming "law," the IRS has a blank check to do whatever it pleases. Is this what the Court meant in *Mayo*?!

National Taxpayer Advocate Nina Olson shares our concerns about the Service’s interpretation of *Mayo*. Tax Analysts reported, in a January 25 speech at the 2011 Tax Institute, Ms. Olsen

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opined the IRS should not be given “unfettered discretion,” and intends to address this with Congress in her next annual report. "People rue the day that Congress micromanages the IRS, but if it is not a responsible steward of the great authority and responsibility that it has, then it should be micromanaged," Ms. Olsen stated.

Id: 1802824, Issued: Jan 26, 2011

16. CPC Commentary: Tax Bar Comments on Economic Substance

Summary

The Taxation Section of the ABA and the Tax Section of the New York State Bar Association ("NYSBA") requested formal substantive guidance on the recent codification of the economic substance doctrine ("ESD"), submitting comments on January 18, 2011 and January 5, 2011, respectively.

Extended Summary

Background

A "conjunctive" form of the ESD was enacted as part of the Health Care Reconciliation Act, attached to the Health Care Act. Under the conjunctive form of the ESD, the burden of proof is placed upon the taxpayer to show both that:

1. the subject transaction affected the taxpayer's economic position "in a meaningful way" (apart from federal income tax consequences), and
2. the taxpayer had a "substantial" non-tax purpose for entering into the transaction.

Under the "disjunctive" form of the ESD, which had been applied by some courts, the taxpayer was required to satisfy only one of these criteria, not both.

The statute imposes a penalty of 20% on an underpayment attributable to a transaction lacking economic substance, negates the defense of "reasonable cause," and increases the penalty to 40% where the transaction is not adequately disclosed on a return.

Notice 2010-62

In Notice 2010-62, the Service provided interim guidance stating that while determinations under each prong of the analysis are to be made under existing common law principles, the Service will challenge taxpayers who continue to rely on a disjunctive form of the ESD. The Notice confirmed that the Treasury and IRS do not intend to issue guidance enumerating types of transactions to which the ESD does or does not apply (sometimes called an "angel list"), nor will the IRS rule privately on particular transactions.

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The Notice specified the manner in which disclosure is to be made, but offered no further substantive guidance. There was no indication in the Priority Guidance Plan issued in December, 2010 that further guidance is planned.

Comments

Although Notice 2010-62 requested comments only on the disclosure requirements, the ABA Taxation Section and the NYSBA Tax Section each submitted lengthy comments urging substantive guidance on certain matters.

While uncertainty whether the Service might assert lack of economic substance in a particular case has historically functioned as a brake on overly aggressive tax planning, the removal of the "reasonable cause" defense and the doubling of penalties for inadequate disclosure have changed the landscape. Absent some formal guidance on the threshold question of when the ESD is "relevant" to a transaction, each of the comments argued that examining agents might assert the doctrine routinely. The ABA pointed out that this "could have a significant chilling effect on a wide range of business transactions that the doctrine has historically been thought not to cover," and might on the other hand result in court rulings adverse to the Service, ultimately weakening the doctrine.

The ABA and NYSBA urged formal guidance to clarify that the ESD will not be asserted if:

- a narrower anti-abuse rule, such as business purpose, step transaction, or substance over form, already applies;
- courts or the Service itself have historically determined that the doctrine does not apply to similar transactions; or
- the claimed tax treatment literally conforms with the substantive provisions of the Code and Regs, or is consistent with the underlying policy expressed in those provisions.

Both comments cited interpretive difficulties with the statute arising from the fact that the House Budget Committee Report accompanying the legislation was prepared in connection with a different, earlier version of the ESD codification. The technical explanation prepared by the Joint Committee on Taxation, which does track the final language of the enactment, might not be considered "legislative history."

In particular, there is confusion between the two reports on the question of what constitutes a sufficient "profit potential" to support either prong of the ESD. Also, in paraphrasing the statute, the House Report appears to state that lack of business purpose in itself is an independent ground for finding economic substance does not exist.

Each of the comments also identified a number of ambiguous terms in the statute and suggested that formal guidance might lend some specificity to these terms. The word "transaction" itself is not defined in the statute, nor are the phrases "changes in a meaningful way," "economic position," or "substantial purpose."

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CPC Commentary

Tax Analysts reports that similar comments have been submitted by the AICPA, though these have not yet been posted to that organization's website.

It may be that these comments will be largely ignored. Not only have the Treasury and IRS indicated that no further substantive guidance will likely be forthcoming, but as we reported some months ago, a lawyer in the Chief Counsel's office indicated that the Service might take advantage of the codification of a "conjunctive" form of the ESD to relitigate issues that it had previously lost.

Id: 1805656, Issued: Jan 21, 2011

17. CPC Commentary: IRS May Take Harder Line on Economic Substance

Summary

According to Tax Analysts, a lawyer in the Chief Counsel's office stated that IRS might take advantage of the recent codification of a "conjunctive" form of the economic substance doctrine ("ESD") to relitigate issues that it previously lost.

Extended Summary

William D. Alexander, Associate Chief Counsel (corporate), made the remarks last week at a seminar in Boston co-sponsored by the Boston Bar Association and KPMG LLP. A "conjunctive" form of the ESD was enacted as part of the reconciliation measure accompanying the Health Care Act, placing the burden of proof on the taxpayer to show both (a) that the transaction under scrutiny affected the taxpayer's economic position in a meaningful way, apart from federal income tax consequences, and (b) that the taxpayer had a substantial non-tax purpose for entering into the transaction.

The codified ESD applies to transactions entered into on or after March 31, 2010. The "reasonable cause" exception for accuracy-related penalties is removed, and penalties on underpayments attributable to transactions not adequately disclosed on a return are doubled.

In Notice 2010-62, the Service provided interim guidance. The Service made it clear that it will challenge taxpayers who continue to rely on the "disjunctive" form of the ESD and confirmed that it does not intend to publish an "angel list" of exempted transactions, nor delineate safe harbors, nor will the IRS rule privately on particular transactions.

Mr. Alexander cited the 2008 decision of a federal district court in Texas in *Shell Petroleum v. United States* as an example of an issue that IRS might want to relitigate. In that case, the parent corporation transferred non-income producing properties with built-in losses to a new

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subsidiary in exchange for non-voting preferred stock, which it then sold to third-party investors at a loss. The court rejected IRS' attack on the transaction, applying a disjunctive form of the ESD and requiring only that the transaction produce a nontax economic effect, not that the taxpayer also had substantial nontax motives. The government contested the decision of the court, but later voluntarily dismissed its appeal.

CPC Commentary

As Tax Analysts and other sources have reported, this is not the first time Mr. Alexander has publicly stated that he would be willing to relitigate the issues in *Shell Petroleum*, even under the common law doctrine. With a conjunctive form of the doctrine now codified, the IRS' hand is strengthened.

We do not think the IRS will stop with this one case, and instead will expand its new-found weapon to many other scenarios. How this will impact charitable planners remains to be seen, but we do predict a chilling effect on future transactions.

Id: 1787142, Issued: Oct 8, 2010

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Tax Exempts

18. CPC Commentary: Two ABA Committees Consider Resolutions Opposing L3C Legislation

Summary

At its meeting in April, 2011, the Nonprofit Organizations Committee of the Business Law Section of the ABA will vote on a formal resolution urging state legislatures not to adopt legislation specifically enabling the so-called "low-profit limited liability company" or "L3C." A similar resolution was adopted by the Committee on LLCs, Partnerships, and Unincorporated Entities at its meeting in April, 2010. Neither resolution has been adopted by the Business Law Section as a whole, nor submitted to the ABA House of Delegates.

Extended Summary

The L3C is a form of limited liability company created under specific enabling legislation. The L3C does not have the production of income or the appreciation of property as a "substantial" purpose, but is instead engaged in furthering one or more charitable or educational purposes. No purpose of the L3C may be to further a political or legislative agenda. Eight states have enacted legislation closely tracking a model statute first enacted in Vermont. L3C enabling legislation is pending in ten other states.

The concept has been promoted by Robert Lang, CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation through a project of that foundation called Americans for Community Development. The premise is that a properly structured and operated L3C would qualify as a "program related investment" ("PRI"), so that a foundation's investment in the enterprise would count toward its annual distribution requirement and would not be treated as a jeopardizing investment.

The L3C may produce profits, and these may be distributed to its members. Typically, in order to attract investors, the distribution rights are arranged so that for-profit investors receive a higher rate of return on their investment, while the foundation receives a lower return. Assuming the L3C's income is related to the foundation's exempt function, distributions to the foundation would not be treated as UBTI.

The concept has been somewhat controversial. The resolution adopted in April, 2010 by the LLC Committee of the ABA Business Law Section noted, among other objections, that existing Regs expressly provide that state law cannot relieve foundation managers of their responsibilities with respect to jeopardizing investments.

Last week, *Tax Analysts* reported that Paul "Chip" L. Lion III, a lawyer with Morrison & Foerster and a member of the Council of the Business Law Section, spoke on L3Cs at a recent webinar co-sponsored by the American Law Institute and the ABA. Lion suggested that the Section would adopt the Committee's resolution, possibly at the meeting in April,

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2011 in Boston.

Several drafters of the resolution have published articles in various journals, expressing their opposition to the L3C concept. Among these are an article by Carter G. Bishop, a law professor at Suffolk University; an article by Daniel S. Kleinberger, a law professor at William Mitchell College of Law; and an article co-authored by J. William Callison of the Denver law firm of Faegre & Benson. This latter article appeared with several other papers discussing the concept from various perspectives, including a paper co-authored by Mr. Lang, in a recent symposium issue of the Vermont Law Review.

A proposal put forward by Mr. Lang's organization in 2008 to amend the Code to treat an L3C as presumptively qualifying as a PRI has not yet found any traction, though the Council on Foundations endorsed the proposal. In a letter to the leadership of the Senate Finance Committee in March, 2009, the National Association of State Charity Officials expressed apprehension that state L3C legislation:

"encourages the diversion of charitable assets away from the nonprofit sector and toward a new and untried corporate form that may lack the supervision state charity officials now exercise over true public charities."

The letter included a list of 20 specific concerns these state attorneys general shared.

Although the Exempt Organizations Committee of the Taxation Law Section of the ABA, in its 2009 recommendations to Treasury and IRS for priority guidance, included a request for "safe-harbor guidance for private foundation program related investments into [L3Cs] in states that have adopted the L3C form," this request was not repeated in its 2010 submission. In a letter dated March 3, 2010 to Commissioner Shulman proposing 17 updated examples to be added to the existing Regulation on PRIs, the Taxation Law Section expressed the view that L3Cs are merely a subset of regular LLCs, and that:

"if a particular loan to, or investment in, an ordinary LLC would qualify as a PRI, then, *a fortiori*, a loan to, or investment in, an L3C should also so qualify."

In each of the past two years, the Treasury and IRS have mentioned in their Priority Guidance Plans an intention to issue unspecified guidance on program-related investments. It is unclear whether this refers to L3Cs, and in any event, no guidance has been issued.

CPC Commentary

The debate surrounding L3Cs is surprisingly heated. We are not taking a position in favor of, or against, the vehicle, but certainly want to warn our readers to use L3Cs carefully, with a full awareness of potential concerns.

Id: 1818084, Issued: Mar 25, 2011

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19. CPC Commentary: Nevada Court: No Recourse for Jilted DAF Donor

Summary

Last month in *Styles v. Friends of Fiji*, the Nevada Supreme Court affirmed a trial court decision. The lower court had dismissed the complaint of a contributor to a donor advised fund who sought monetary damages and a rescission of his contribution, despite finding that Friends of Fiji ("Foundation") had breached an "implied covenant of good faith and fair dealing."

Extended Summary

The trial court held the plaintiff, Ray Styles, made an unrestricted gift to the Foundation, and retained no interest in or control over the contributed funds, concluding the donor was not damaged when the Foundation rejected his recommendations as to how to distribute the funds. The high court agreed.

The text of the Supreme Court opinion does not describe the nature of the alleged breach. In an opinion piece published last February in the Chronicle of Philanthropy, Richard L. Fox, the lawyer who represented Mr. Styles on appeal, claimed the Foundation not only ignored his client's wishes, but used the donor's gifts "instead to pay the charity's directors substantial salaries, sponsor celebrity golf tournaments at lavish resorts, and transfer funds to another entity controlled by the directors." Mr. Fox provided much more detail, including excerpts from deposition testimony, in a lengthy post on Stephan Leimberg's subscription website last March.

In its initial Form 990 filing for calendar 2002, the Foundation reported Mr. Styles' contribution of $2.5 million, and essentially no other activity. The IRS reclassified the organization as a private foundation in 2003. In 2003 and again in 2004, the Foundation spent more than $100,000 to sponsor celebrity golf tournaments, though these expenditures accounted for less than half the amounts distributed in each of those years. Mr. Styles filed his lawsuit in August, 2004.

Starting in 2005, the Foundation greatly scaled back the amounts it was distributing and began making all of its distributions to a controlled charity, the World Health and Education Foundation, which then redistributed the funds to other charities. In calendar 2008, the Foundation made no distributions at all. Through 2008, the most recent filing available, the Foundation incurred nearly half a million dollars in legal fees defending the Styles lawsuit.

In his posting to leimbergservices.com, Mr. Fox described his client as "the owner of a local barbeque restaurant [in] Wichita Falls, Texas," who won $8 million at a slot machine in Lake Tahoe, Nevada. Allegedly, the donor was persuaded to make the $2.5 million contribution to the Foundation by Jerome Schneider, who later pled guilty to unrelated charges of conspiring to defeat and obstruct the lawful functions of the IRS by promoting

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the transfer of funds to decontrolled offshore entities.

CPC Commentary

In the world of donor advised funds, this is an important decision, as is the case of the National Heritage Foundation, which we reported on a number of times.

Donors should be aware that gifts to DAFs are irrevocable, and there is little one can do, based upon *Friends of Fiji* and *National Heritage Foundation*, to change the nature of an irrevocable gift that is "advisory" in nature.

Given this risk, charitable planners should consider using a supporting organization, private foundation, or a donor directed fund as alternatives, especially when the amount of the gift is substantial.

Update:

We should mention the larger DAFs run by commercial brokerage houses (e.g., Fidelity, Schwab, and Morgan Stanley Smith Barney) and those run by conventional charitable institutions (e.g., National Christian Foundation, Associated Jewish Charities, Cornell, and Wharton) have no reported history of abuse or misuse of donor funds. The danger seems to lie mostly with small or family run DAFs.

Id: 1815541, Issued: Mar 9, 2011

20. CPC Commentary: IRS Interprets *Mayo* Broadly

Summary

According to recent speeches, the IRS is interpreting *Mayo Foundation v. United States* ("*Mayo*") to give the Service broad authority to interpret ambiguous *Code* provisions.

Extended Summary

Please see the updates to our earlier commentary on *Mayo.*

Id: 1807045, Issued: Jan 26, 2011

21. CPC Commentary: Grassley Concludes Investigation of Mega-Churches

Summary

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Senator Charles E. Grassley (R-IA), Ranking Member of the Senate Finance Committee, released a staff memo summarizing his three-year investigation of six media-based ministries.

Extended Summary

The 61-page memo notes that a number of informants had insisted on complete anonymity, fearing retaliation, and that staff had concluded that issuing "friendly" subpoenas to informants would be counterproductive. Due to competing demands on Committee staff and Senate legal counsel, staff did not seek subpoenas for the churches themselves, which likely would have been resisted.

The memo makes reference to separate summaries of staff investigations of each of the six churches, which are posted to Sen. Grassley's section of the Finance Committee website. The memo notes that "there are multiple for-profit and non-profit entities related to each church," and that while some of these are likely "integrated auxiliaries," others may not be, and that staff were "unable to determine whether and the extent to which [the churches] are reporting and paying taxes on income earned in those entities."

Appendix C to the memo is given over to legislative and other recommendations, including proposals to:

1. create an IRS-sponsored advisory committee focused on issued relating to churches and religious organizations. The committee would include not only representatives of churches and religious organizations, but also representatives of various other federal agencies that have "significant interaction" with these entities;
2. limit the parsonage allowance to a single residence or to a stated dollar amount;
3. impose an initial and/or an annual information return filing requirement for churches; and
4. remove the restrictions on church tax inquiries as they relate to investigation of excess benefit transactions with a disqualified person.

Appendix D extends the discussion to exempt organizations more generally, including proposals to:

1. extend to entities other than private foundations the requirement that the entity's governing instrument forbid excess benefit transactions;
2. ease the standard for imposing an excise tax on a manager who participates in an excess benefit transaction from actual knowledge to "reason to know";
3. impose an entity-level excise tax on excess benefit transactions, replacing the "rebuttable presumption" standard with a "minimum due diligence" standard; and
4. require public disclosure of the comparability data on which executive compensation decisions are based.

Appendix E discusses the existing statutory prohibition on electioneering, noting that it is difficult to enforce, that the only available sanction -- revocation -- is often excessive, and

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that at least as applied to churches it is of questionable constitutionality. The memo proposes that the prohibition might be replaced with a limitation similar to that imposed on lobbying, based on expenditures.

Senator Grassley forwarded this memo to Evangelical Council for Financial Accountability, seeking its input.

CPC Commentary

Sen. Grassley has been investigating these churches for quite some time.

Id: 1797017, Issued: Jan 7, 2011

22. CPC Commentary: Boston's PILOT Task Force Issues Final Report

Summary

A task force appointed nearly two years ago by Mayor Thomas M. Menino to review Boston's system of negotiating with nonprofit institutions for payments in lieu of taxes ("PILOTs") issued its final report and recommendations.

Extended Summary

The nine-member task force included appointees from several of the city's hospitals, colleges, and community organizations, as well as from the private sector and from the city council. Throughout 2009, the task force met five times behind closed doors and once in a public forum. An executive summary of the final report was issued in April.

Boston is home to a number of large research hospitals, colleges, and universities. In fiscal year 2009, the city faced a current budget deficit of about $140 million. It was estimated that if educational and medical properties that are exempt from property taxation had been taxed at commercial rates, they would have generated about $347 million.

In its final report, the task force recommended that:

1. the PILOT program remain voluntary, i.e., that state law not be changed to make payments in lieu of taxes mandatory;
2. the program apply to all nonprofits, with an exemption of $15 million in property value;
3. contributions be calculated at 25% of what the tax payment on the excess would be, were the property taxable;
4. credit be given, up to 50% of the full PILOT payment amount, for community benefits offered by the institution (for example, public health initiatives, targeted scholarships, etc.);

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5. credit be given for real estate taxes actually paid on properties that would ordinarily qualify for exemption; and
6. the formula be phased in over not less than five years, to allow a smooth transition.

CPC Commentary

We are not aware of many recent PILOT studies of this nature, certainly not by a major city. The recommendations of this task force may have broad-reaching significance, and should be reviewed by all charities (not just those holding over $15 million in property value).

Id: 1796357, Issued: Dec 30, 2010

23. CPC Commentary: Bartels: Margin Account Generates UBTI

Summary

In *Henry E. and Nancy Horton Bartels Trust for the Benefit of Cornell University v. United States*, the Federal Circuit Court of Appeals affirmed a summary judgment of the federal Court of Claims, holding that income from securities bought on margin is UBTI.

Extended Summary

The trust is one of at least six similar SOs established about twenty years ago by Henry E. and Nancy Horton Bartels for the benefit of a number of educational institutions, including Cornell University. The trust reported and paid UBTI on timely filed Forms 990-T in 1999 and 2000 and then filed a refund claim for both years. The IRS denied the claim, and the present action followed.

One of the related *trusts*, for the benefit of the University of New Haven, litigated an identical claim in the federal district court in Connecticut in *Henry E. and Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States*. The trial court in that case granted the government's motion for summary judgment, the 2nd Circuit Court of Appeals affirmed, and the Supreme Court denied *certiorari*.

Although the 2nd Circuit decision was not binding on the parties in the present case, it was cited repeatedly by both the Claims Court and the Federal Circuit appeals court in support of the rulings that:

1. securities bought on margin are "debt financed" within the meaning of Section 514(b)(1);
2. investment activity was not "substantially related" to the trust's exempt purposes, so as to bring it within the exception at Section 514(b)(1)(A)(i); and
3. incurring margin debt was not "inherent" to the trust's exempt function, so as to

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bring it within the exception at Section 514(c)(4).

Both courts also rejected, as did the 2nd Circuit, the trust's argument that investing in securities is not a "trade or business" within the statute, because it does not involve unfair competition with for-profit enterprises. Both courts ruled that Section 514 by its literal terms defines "debt financed income" to constitute an "unrelated business," without reference to the question of "unfair competition."

CPC Commentary

There is now no question that a margin account generates UBIT, though the legislative history of Section514 (part of the Tax Reform Act of 1969) suggests Congress may have intended a more narrow construction. Arguably, Congress wanted to counter an abusive transaction in which an exempt entity would buy corporate assets as part of a liquidation, leasing the assets back to a related purchaser, and turning the rents back to that purchaser in the form of payments on a non-interest bearing note.

In a report submitted to the leadership of the tax writing committees in Congress, the Tax Section of the New York state bar urged legislators to revisit the policy considerations underlying the treatment of debt-financed income to nonprofits as unrelated business taxable income.

Id: 1783819, Issued: Sep 8, 2010

24. CPC Commentary: PLR 201108037 - No UBTI Incurred on Sale of Office Building Subject to Mortgage

Summary

In PLR 201108037, the Service ruled that the proposed sale by an exempt organization of an office building would not generate unrelated business taxable income. The organization leased space in the building to commercial tenants, and the building was subject to a refinanced purchase money mortgage.

Extended Summary

The organization was initially granted exempt status as a publicly supported charity, but was later granted reclassification as an educational institution.

The property was encumbered by a deed of trust that secured a note representing the refinancing of earlier loans, including the initial purchase money mortgage. Proceeds of some of the refinancings exceeded the then-outstanding balances on existing loans, and were used for improvements to the building and for operational expenses.

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The ruling noted that gains or losses incurred in the disposition of property not held as inventory are excluded from the definition of UBTI, except that in the case of debt-financed property. A percentage of the proceeds from the sale of real property is treated as UBTI, equal to the fraction obtained by dividing "acquisition debt" by the charity's adjusted basis in the asset. Where the refinancing increases the outstanding principal amount of the existing debt, the excess is treated as a separate indebtedness. However, as the ruling noted, educational institutions are excluded from the "acquisition debt" rules, along with a handful of exceptions. Thus, gain on the sale of the building was not UBTI.

CPC Commentary

This ruling is a helpful reminder of the UBIT and debt-financed rules, and how the educational exception comes into play to salvage taxes. It also causes the charitable planner to consider whether to recommend to donors that they give debt-financed property to an educational institution, rather than another type of charity, in order to maximize the total charitable gift. Remember that the bargain-sale rules come into play with a gift of an encumbered asset to charity, regardless of the educational exception.

Although not mentioned in the ruling, the same rules apply to rents received from the commercial tenants.

The ruling does not mention whether the building was acquired, and the purchase money mortgage incurred, whether before or after the organization was reclassified as an educational institution. This is an interesting question, and perhaps a crucial consideration.

Id: 1815036, Issued: Feb 28, 2011

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CRT Matters

25. CPC Commentary: PLR 201115003 - Nonqualified Trust Is Reformed into a CLAT and a CRUT

Summary

In PLR 201115003, the Service ruled that the proposed reformation of a split interest trust under a decedent's will would qualify the charitable interests for the estate tax charitable deduction.

Extended Summary

The trust, which was to be funded from the residue of the decedent's estate, was to pay income to each of two named individuals ("A" and "B") or the survivor, while also paying a fixed annuity to each of two named charities ("Charity 1" and "Charity 2"). At the death of the survivor of A and B, the trust would terminate and specified amounts would be distributed from the remainder to two other charities ("Charity 3" and "Charity 4") and five individuals ("D" through "G"). The remaining balance was to be divided equally among yet another individual ("H") and two charities, Charity 2 and a foundation supporting Charity 1.

As thus structured, none of the charitable interests qualified for an estate tax charitable deduction, because:

1. the charitable annuities were measured by the lives of individuals who were not ancestors of any of the remaindermen; and
2. the charitable remainders did not follow a fixed annuity or unitrust payout.

Within 90 days after the last date for filing an estate tax return, with extensions, the executor brought an action in state court to reform the trust. Under the proposed reformation, the trust would be divided into two trusts, a charitable lead annuity trust and a charitable remainder unitrust.

The CLAT would pay the annuity amount to Charities 1 and 2 for a term of 22 years, which was equivalent to the actuarial life expectancy of A and B. At the expiration of the term, specified amounts would be paid from the remainder to individuals D through G, and the remaining balance would be distributed to individual H.

The CRUT would pay a straight unitrust amount to A and B for their joint lives. At the death of the survivor, specified amounts would be paid to Charities 3 and 4, and the remaining balance would be distributed in equal shares to Charity 1 and Charity 2.

The Service determined that a state court judgment implementing this proposed reformation would be effective to qualify the residuary bequest for a charitable deduction,

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because:

1. there would be no more than a 5% difference between the actuarial values of each of the charitable interests, as of the decedent's death, before and after the reformation;
2. the lead interests in the CLAT were for the same period and the nonremainder interests in the CRUT would terminate at the same time as in the trust prior to reformation; and
3. the reformation would be made effective as of the decedent's death.

CPC Commentary

This ruling illustrates the importance of making a timely assessment of whether a testamentary split interest trust qualifies for the estate tax charitable deduction and making a timely intervention if it does not.

The design of the proposed reformation in this case is straightforward and elegant. However, even though the values of the charitable interest before and after the reformation would not differ by more than 5%, it is likely that there would be greater variance in the noncharitable interests, specifically, the income interests of A and B and the remainder interest to H. Execution of post-mortem planning of this nature requires the cooperation of all interested parties.

Id: 1820925, Issued: Apr 18, 2011

26. CPC Commentary: PLR 201048031 - Reformation of CRUT to Correct Scrivener's Error

Summary

In PLR 201048031, the Service ruled that a judicial reformation of a CRUT to add a second non-charitable beneficiary would not disqualify the trust or constitute an act of self-dealing.

Extended Summary

The ruling appears to be a copy of PLR 201042012, released in October.

The ruling recited that "[n]o parties objected to the proposed reformation," but did not state whether notice of the court proceeding was given to the remainder charities or to the state attorney general. The state court approved the reformation, subject to a favorable ruling from the Service.

The ruling was conditioned upon the settlor and the second beneficiary (apparently a

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spouse) filing "any necessary [amended] income or gift tax returns consistent with [treating the trust as] a two-life CRUT."

Id: 1794035, Issued: Dec 6, 2010

27. CPC Commentary: PLR 201043041 - Wholly-Owned Blocker Enables CRUT to Invest in Hedge Funds

Summary

In PLR 201043041, the Service ruled that dividends paid to a CRUT by a foreign corporation would not be treated as unrelated business taxable income. The trustee created the corporation to enable the CRUT to invest in debt-financed investments of domestic and overseas hedge funds.

Extended Summary

The trustee of the CRUT, who was also the donor and unitrust beneficiary, created the corporation. The CRUT owned all of the stock of the corporation, but had no liability for the debts of the corporation, and was not required to make further capital contributions to it. The trustee made no representations whether other investors might become additional shareholders in the corporation.

The Service ruled that income and gains realized by the controlled foreign corporation would not constitute UBTI to the CRUT, whether retained at the corporate level or distributed as dividends to the CRUT. Crucially, the Service also ruled that the creation and operation of the corporation as a "blocker" entity would not constitute self-dealing, because the corporation was not itself a disqualified person with respect to the CRUT.

The ruling was issued more than four years after the initial request.

CPC Commentary

In some respects, the issues are similar to those that have received favorable treatment from the Service in dozens of rulings approving "Harvard CRT" arrangements, in which a college or university foundation issues contract rights in its endowment fund to CRTs of which it is the trustee and sole remainderman. In those rulings, the Service determined that the contract rights did not constitute direct ownership of the underlying fund assets, and that the CRTs would not be required to recognize any portion of UBTI incurred within the endowment fund. The endowment fund would make distributions to the CRTs in accordance with its established spending rate, and these would be treated as ordinary income regardless of the character of earnings within the endowment fund.

A somewhat similar arrangement was approved several years ago

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in PLRs 200251016, 200251017, and200251018. In that group of rulings, the CRT was a limited partner in a partnership that proposed to create a foreign corporation to serve as a blocker. And again, in PLR 200623069, the Service approved an arrangement under which a CRT proposed to invest in a limited liability company, which in turn invested nearly all its assets in a foreign blocker corporation. However, the present ruling takes the discussion a step further, approving a scenario in which the trustee of the CRT creates and funds the "blocker" entity directly, using trust assets.

In none of these rulings, incidentally, is it indicated who is paying the legal fees to design these strategies or to pursue the (sometimes lengthy) private letter ruling process. Query whether and to what extent these fees would be a proper expense of the CRT itself.

Obviously, not every CRT is in a position to take advantage of this kind of planning, a point that was underscored recently in a report submitted by the Tax Section of the New York State Bar Association urging the leadership of the tax writing committees in Congress to revisit the threshold question whether borrowing to invest in marketable securities or unrelated use real property should trigger exposure to UBIT. Three years ago, Rep. Sander Levin (D-MI), now the chair of the House Ways and Means Committee, introduced H.R. 110-3501, which provided that indebtedness incurred by a domestic partnership in acquiring investment assets would not be treated as acquisition indebtedness incurred by the limited partners. The bill died in committee.

It is also interesting to note that no representation was made regarding additional investors, a fact that is usually thought to be a critical element of the process of creating and operating a "blocker entity."

Id: 1791761, Issued: Nov 1, 2010

28. CPC Commentary: PLR 201040021 - Rescission of Nonqualified CRAT

Summary

In PLR 201040021, the Service issued favorable rulings on the rescission of a charitable remainder annuity trust, which failed the statutory requirement that the present value of the remainder to charity be at least 10%.

Extended Summary

Husband and wife created the trust to pay an annuity for their joint lives, calculated at 7% of the initial fair market value of the stock contributed to the CRAT. The settlors claimed a charitable contributions deduction on their joint income tax return.

Several years later, the CRAT paid only a portion of the annuity amount, and the state taxing authority asked the trustee to provide a computation of the then-present value of

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the remainder. The present value of the remainder was negative using the stated annuity amount and using an annuity amount of 5% of the then-current fair market value of the trust corpus. Further, the present value of the remainder interest was less than 10% at the outset, meaning that the trust did not qualify as a charitable remainder trust and the charitable contributions deductions claimed were not allowable.

With the consent of the remainder charity and the state attorney general, the parties agreed to rescind the trust and return the remaining corpus to the settlors. The settlors amended the returns on which the contributions deductions had been claimed and paid the additional income taxes owed, together with interest and penalties. The trustee proposed to amend the trust returns, consistent with the requested rulings.

The trustee requested, and the Service granted, rulings that the return of the remaining trust corpus to the settlors would not:

1. be treated as an act of self-dealing;
2. constitute a taxable expenditure; and
3. subject the trustee to an excise tax on termination of private foundation status.

In arriving at these conclusions, the Service noted that each of these excise tax provisions -- self-dealing, taxable expenditures, and termination of private foundation status -- is premised on a charitable contributions deduction having been allowed in the first instance. Since the trust was not qualified from the outset, a rescission and a return of trust assets to the settlors did not trigger any of these excise taxes.

CPC Commentary

Although the ruling did not recite the ages of the settlors and the 7520 rate at the time the CRAT was funded, it is likely that the trust would also have failed the probability of exhaustion test of Rev. Rul. 77-374.

If the trust had qualified on the 10% test at the outset, a rescission still may not have triggered excise taxes on self-dealing, taxable expenditures, or termination of foundation status. The amounts returned to the trust settlors, which would total less than the present value of the stated annuity payout, would not, by definition, be "amounts for which a deduction [had been] allowed."

Id: 1787412, Issued: Oct 11, 2010

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CLT Matters

29. CPC Commentary: PLR 201042005 - Late Election Out of Automatic Allocation of GST Tax Exemption (a warning for CLATs!)

Summary

In PLR 201042005, the Service granted an extension of time to elect out of the automatic allocation of GST tax exemption to a GRAT.

Extended Summary

With respect to transfers occurring on or after January 1, 2001, any remaining GST tax exemption is allocated automatically to an indirect skip, unless the settlor affirmatively elects not to allocate exemption to the transfer. This includes a transfer to a trust from which distributions to skip persons are possible.

In the case of a transfer, such as to a GRAT, that would be includible in the settlor's estate for estate tax purposes, the allocation is not made until the close of the estate tax inclusion period ("ETIP"). A separate gift tax return filing is then necessary to make the election out of automatic allocation.

In the present case, apparently, no filing was made at the close of the ETIP. The accountant who had filed the initial gift tax return, on behalf of a husband and wife who had elected to split the gift, discovered this omission some years later. The Service exercised its discretion to permit the late election, finding that the taxpayer had relied reasonably on the advice of a qualified tax professional.

CPC Commentary

Proposed Regs issued more than two years ago would subject late GST exemption allocation elections (both in and out), to a more stringent set of criteria than those that apply under current Regs for granting extensions of "regulatory" deadlines. These Regs would require documentation in the form of sworn affidavits, not only from return preparers, but from advisors to the underlying transaction. The present ruling does not indicate who provided evidence concerning any advice that was given to the taxpayers, or whether that evidence was verified.

The Proposed Regs have not yet been finalized, and the Code provision automatically allocating unused GST exemption to transfers to trusts with GST potential is among those set to expire on December 31, 2010.

Charitable planners should pay attention to this ruling, and remember the similar concerns apply to a CLAT, to which the GST exemption is not allocated until the lead annuity terminates.

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Id: 1791154, Issued: Oct 25, 2010

30. CPC Commentary: Tax Court: Interest on Loan to Pay Estate Tax Not Deductible

Summary

In *Estate of Stick v. Commissioner*, the Tax Court ruled that interest on a loan taken out by a testamentary trust, which was the residuary legatee of a decedent's estate, to pay estate taxes was not deductible for estate tax purposes as an administrative expense where there was no evidence the loan was necessary.

Extended Summary

The gross estate was over $3 million, with cash and marketable securities comprising slightly less than $2 million of the total. Claimed deductions for expenses of administration were $818,990, of which $656,250 was interest on the loan. The principal loan balance was $1.5 million. After disallowance of the interest deduction, the federal estate tax liability was about $1.3 million, and the executor in his brief indicated that the state estate tax liability was $193,198.

The court concluded that the estate had liquid assets on hand sufficient to pay the expenses of administration, including state and federal estate taxes, and the executor had failed to show tha the loan was necessary.

The court rejected the Commissioner's alternative argument that the deduction should be denied, because the trust also claimed the interest deductions on at least three income tax returns, for which the limitations periods had expired. Section 642(g) of the Code denies a deduction for expenses of administration for income tax purposes unless the executor in writin waives the right to claim the same expenses for estate tax purposes. Here no waivers were filec However, in Rev. Rul. 81-287, cited by the court, the IRS acknowledged that where the limitations periods for the income tax returns had expired, the Commissioner would be limited to equitable recoupment, offsetting any overpayment of the estate tax by deficiencies and interest on the closed years' returns.

CPC Commentary

On the deductibility of interest on loans taken to pay estate taxes, see also *Estate of Black v. Commissioner*, a 2009 Tax Court decision, reaching a similar conclusion. Compare these two decisions with *Estate of Murphy v. United States*, a 2009 decision of a federal district court in Arkansas, where the court held the executor "is not required to set aside good business judgment" and sell closely held stock to raise cash for tax payments.

Id: 1779358, Issued: Sep 2, 2010

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Supporting Organizations

31. CPC Commentary: PLR 201115030 - Supporting Organization Reclassified as Private Foundation

Summary

In PLR 201115030, the Service reclassified a Type I supporting organization as a private foundation, because it was not organized for the exclusive benefit of one or more designated charities, and the donors retained control over its operations.

Extended Summary

The organization was created as a trust, and was initially funded by a husband and a wife. The organizational document required that the trust distribute 35% of its net income to a designated primary charity, and another 50% of its net income to one or more from a list of 112 charities, or the primary charity, as the trustees might determine.

Although three of the five trustees were to be appointed by the primary charity, the trust document provided that the two trustees appointed by the donors or their descendants could change the primary charity. If the trust were to be dissolved because the trustees determined that it had become too small to administer economically, the remaining assets would be distributed to one or more public charities selected by the trustees.

The trust was initially granted exempt status as a supporting organization. An examination determined that the trust made no distributions to the primary charity in its first four years of operation. The entire contribution to the trust was invested in a limited liability company that did not distribute any income to the trust. The relationship, if any, of the LLC to the donors is not mentioned in the ruling.

The trustees did not file information returns for those years, as there were no gross receipts to report. In the fifth year, when the LLC made distributions to the trust, the trustees neglected to file an information return.

The Service acknowledged that the trust satisfied the "relationship test," because three of the five trustees were appointed by the primary charity. However, the Service cited two grounds for its determination that the trust should be reclassified as a private foundation:

1. Organizational Test

In the event of dissolution, the trust document permitted distributions to organizations other than the primary charity. Citing Quarrie Charitable Fund v. Commissioner, a 1979 decision of the 7th

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Circuit federal appeals court, the Service concluded that the trust, therefore, was not "operated exclusively for the benefit of...one or more specified organizations."

2. Control by a Disqualified Person

The facts and circumstances suggested that the three trustees appointed by the primary charity had no practical input into the operations of the trust. No minutes were kept of trustee meetings, no distributions were made, and all paperwork was signed by one of the donors alone.

Since trustees appointed by the donors' family could replace the primary charity, thereby unseating its appointees, and could therefore, dissolve the trust and distribute its assets to any charity they might select, the Service concluded that they had direct or indirect control of the supporting organization.

CPC Commentary

In order to be classified as a supporting organization under the Code, an entity must pass: (a) the Organized and Operated Test, (2) the Relationship Test, and (c) the Control Test. Initially, in 2002 the Service determined the organization was qualified as a Type I SO, and passed all 3 of these tests. However, upon reflection, the IRS determined that it was not properly organized because it could benefit charities other than those which were specified as supported charities, and it failed the Control Test because the creators of the organization (who were disqualified persons) had the ability alone to change the primary charity.

The ability to benefit additional charities and to change the prime charity existed at the outset, and so one must ask why these issues are arising years later. Obviously, the Service did not do its homework on the initial submission.

Today, all SO requests for a favorable determination letter go to the Cincinnati field office, which is in frequent communication with the National Office of IRS at 1111 Constitution Ave, Washington, D.C. regarding any "grey areas." The level of expertise in this area is much improved.

The reclassification of the tax exempt status of the trust in this case as a private foundation was retroactive to the date it was created. We question whether or not the decision should have been retroactive, given the fact that nothing really changed between the date of approval and the date of reclassification.

That being said, this ruling is a helpful warning that, although once approved, the IRS can and will take a second look at organizational documents. In short, do not take comfort in an initial approval by the IRS if they made a mistake.

Id: 1820929, Issued: Apr 18, 2011

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32. CPC Commentary: Polm Family Foundation: Government's Brief and Foundation's Reply Brief Filed

Summary

The Government filed its appellate brief, and the Polm Family Foundation ("Foundation") filed its reply brief in the U.S. Circuit Court for the District of Columbia.

Extended Summary

In September, 2009, the United States District Court for the District of Columbia held that the Foundation did not qualify as a Type II SO. The Foundation appealed this ruling to the U.S. Circuit Court for the District of Columbia.

In its lengthy appellate brief, the Government argued that the Foundation failed the Relationship Test, the Control Test, and the Organizational Test. The Relationship Test arguments centered on (1) whether a Type II SO may support a class of charitable beneficiaries and (2) what constitutes common supervision or control between the SO and its supported organizations. The Control Test issue primarily dealt with whether the founder of the SO may appoint the Foundation's trustees every year. The Organization Test arguments were largely procedural, being raised in-depth for the first time in the Government's brief.

Regarding the Relationship Test, the Foundation argued that the Government misconstrued the language in Reg. Sec. 1.509(a)-4(f)(4), which reads:

"[i]n the case of supporting organizations which are supervised or controlled in connection with one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors, as described in paragraph (h) of this section."

The Foundation argued that Reg. Sec. 1.509(a)-4(h) sets forth more specific requirements for Type II SOs, and does not require that all supported organizations individually must control the Type II SO (which would be administratively impossible in the case of a class of supported organizations). Example 3 of Reg Sec. 1.509(a)-4(h) supports this reading of the Regs.

As to the Control Test, the Foundation argued that the Government has no authority to deny SO status, merely because the founder appointed the independent directors. The Foundation contended the clear language of the regulations under Reg. Sec. 1.509(a)-4(j) makes it clear that the test for direct and indirect control is based upon majority vote - i.e., do the independent directors have majority vote.

The case is set for oral argument on January 18, 2011.

CPC Commentary

Kallina's Korner: As we has mentioned in our earlier commentary, we have a vested interest in

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this matter, since Kallina & Associates, *LLC* is legal counsel for the Foundation.

Id: 1794881, Issued: Dec 13, 2010

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Estate Planning

33. CPC Commentary: Linton: 9th Circuit Remands Indirect Gift Case

Summary

In *Linton v. United States*, the 9th Circuit federal appeals court reversed a summary judgment and remanded the case for further consideration. The lower court had held steps in a transaction, whereby the donors made gifts of interests in a limited liability company to trusts for children, could be collapsed under the step transaction doctrine, thereby eliminating valuation discounts.

Extended Summary

The IRS recharacterized the transfers as indirect gifts of the underlying assets, denying discounts for lack of control and restrictions on transferability. All of the documents effecting the transfers were signed on January 22, 2003, including:

1. a quitclaim deed of certain real property to the LLC,
2. stock and bond powers authorizing the transfer of various securities to the LLC,
3. documents creating irrevocable trusts for each of the transferors' four children, and
4. documents transferring interest in the LLC to each of the trusts.

The trust instruments and the documents affecting the gifts to the trusts were left undated in the hands of the transferors' lawyer, to be completed at a later date. Several months later, after communicating with the transferors' accountant, the lawyer inserted a date in the trust instruments and the deeds of gift.

The date he inserted was the date the documents were actually signed, not a later date intended to reflect a lapse of time between the two halves of the transaction. The lawyer testified that this was an error on his part, and that he should instead have inserted the date January 31, 2003. There was no testimony that the transferors themselves had communicated to the lawyer a later date that the documents were to be treated as having been signed.

The trial court ruled that parol evidence, including the lawyer's testimony, would be admissible, but nonetheless concluded that the transfers had in fact occurred on January 22. The court applied the "step transaction" doctrine to treat the transaction as an indirect gift of the underlying assets to the trusts for the children at fair market value, rather than a transfer of minority interests in the LLC at a discount.

The appeals court reversed, holding that the evidence before the trial court on cross motions for summary judgment did not clearly establish the date on which the trust instruments and deeds of gift were delivered to the trustee in a manner that put the documents "beyond retrieval" by the transferors, thereby clearly manifesting an intent that the transfers should take effect. The fact that the trustee of the four trusts was present at the document signing on January 22 and signed the trust instruments and acknowledgments of the deeds of gift was not

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conclusive, because the documents remained in the possession of the transferors' lawyer.

The appeals court also ruled that the fact that the transferors did not specifically instruct the lawyer on the date to be inserted into the documents indicated that January 31 was not the actual date of delivery, either, but that the transaction took place over the course of several weeks or months. The matter was remanded to the trial court to determine when exactly delivery "beyond retrieval" occurred.

CPC Commentary

The ruling seems to leave open the possibility that the trial court might find that the transfers to the trusts occurred before the LLC was fully funded, but it is difficult to see how the government can prevail on remand, since the appeals court specifically ruled that the step transaction doctrine did not apply to the situation.

Unfortunately, the 9th Circuit did not determine that the step transaction doctrine only applies to income tax matters, and not gift tax. Perhaps the taxpayer should argue this point on remand, if it was not previously raised.

Id: 1808545, Issued: Feb 2, 2011

34. CPC Commentary: Fisher: No Discount for Gifts of LLC Units

Summary

In *Fisher v. United States*, an Indiana federal district court ruled that transfer restrictions on membership units in an LLC, which owned only undeveloped land, could not be considered in valuing the units for gift tax purposes.

Extended Summary

A husband and wife transferred 4.762% of their voting units in the LLC to each of their seven children, aggregating 33.34%. The taxpayers retained control of the LLC, including decisions about distributions of income. The operating agreement permitted members to unilaterally transfer only their distribution rights, subject to the LLC's right of first refusal.

In March, 2010, the court ruled that because members could not force income distributions, the gifts were of future interests and not eligible for the gift tax annual exclusion. The present ruling, that the value of the membership units could not be discounted, resulted in a dismissal of the taxpayers' refund claim for taxes paid after an audit of their gift tax returns.

In support of its ruling, the court cited the recent decision of the 8th Circuit federal Court of Appeals court in *Holman v. Commissioner*, which involved a limited partnership funded entirely with publicly traded stock. The Tax Court ruled that the transfer restrictions

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in Holman were not a "bona fide business arrangement" for purposes of a Code provision, which disregards such restrictions for transfer tax valuation purposes, and a divided appeals court affirmed.

CPC Commentary

This ruling is consistent with recent court decisions valuing gifts of LLC units or limited partnership interests. Tax planners need to establish a strong business purpose for the use of these vehicles, or endure successful IRS challenges.

Id: 1780265, Issued: Sep 3, 2010

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35. CPC Commentary: Winter 2011 SOI Bulletin Released

Summary

The IRS released the Winter 2011 Statistics of Income Bulletin, including reports on 2009 individual filing data, 2008 noncash contributions, 2009 split interest trust filings, and 2007 UBTI filings.

Extended Summary

2009 Individual Returns

The total number of individual income tax returns was slightly down from 2008, and aggregate adjusted gross income declined 6.9%, to $7.6 trillion. This is the second consecutive year these numbers have fallen.

Average reported AGI was about $54,500, down from a little over $58,000 in 2008. Though marginal rates remained constant, brackets were widened due to inflation indexing, and total income tax fell 15.0% to $910 billion, the second consecutive decrease after four years of increases. Unemployment compensation as a component of AGI increased another 91.5% to $84.1 billion, while net capital gains fell another 46.1% to approximately $240.5 billion.

The number of returns showing alternative minimum tax liability decreased slightly to just under 3.9 million, or about 2.75% of all returns filed. However, the aggregate amount of AMT paid fell 9.1% to nearly $20.2 billion, the first decrease since 2001.

Slightly more than one-third of all filers (roughly 45.6 million) itemized deductions, down 4.9% from 2008. Of these, about 37.3 million claimed charitable contributions, also down 4.9% from 2008. Contributions aggregated $148.5 billion, down 8.2%. The average charitable contributions deduction per return was about $39,831.

2008 Noncash Contributions

Although about 23.0 million individuals itemized noncash charitable contributions on their 2008 tax returns, the report analyzed data for the 7.0 million who filed a Form 8283, reporting noncash contributions in excess of $500. The aggregate amount claimed for these contributions was $34.6 billion. While this figure was down 34.5% from $52.8 billion in 2007 that number itself appeared to be an anomaly (see our earlier commentary).

Contributions of corporate stock declined 48.0% to $12.3 billion. Although only 1.76% of returns claimed deductions for contributions of corporate stock, this constituted the largest single item in terms of dollar value, at about 32.0% of all amounts claimed. Clothing and

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household items were claimed on the largest number of returns, 77.4% and 34.7%, respectively, with dollar values constituting 22.9% and 9.1%, respectively, of all amounts claimed.

Contributions of land declined 63.2% to $1.49 billion, while contributions of conservation and facade easements fell 44.1% to just over $1.2 billion. Less than 0.02% of returns claimed deductions for these contributions, but in terms of dollar value, these comprised 7.8% of all amounts claimed.

Deductions claimed by individuals with AGI of $10 million or above declined 47.6% to $9.23 billion, but still represented 26.6% of all amounts claimed.

2009 Split Interest Trust Filings

Statistics relating to information returns, Form 5227, filed with respect to split interest trusts show the following:

1. returns were filed for 18,572 CRATs holding in the aggregate about $8.2 billion in assets;
2. returns were filed for 95,922 CRUTs holding in the aggregate about $86.5 billion in net assets book value, about $92.1 billion fair market value;
3. more than 80.8% of CRAT returns and nearly 69.4% of CRUT returns reflect assets of less than $500,000;
4. nearly 86.4% of CRUTs had payout rates of less than 10.0%;
5. nearly all undistributed income accumulated from prior years in both CRATs and CRUTs is long-term gain;
6. after corporate stocks, which constitute roughly half the value of the portfolios of both CRATs and CRUTs, the largest single category of investment -- ahead of government obligations and corporate bonds, and far ahead of real property -- is "other," presumably including commercial annuity contracts;
7. returns were filed for 6,626 CLTs holding in the aggregate about $18.2 billion in assets (the statistics do not distinguish between CLATs and CLUTs);
8. more than half of CLT returns reflect assets of more than $500,000;
9. 2009 returns were filed for only about 1,415 PIFs, again confirming the widespread perception that this device is in decline as a planned giving vehicle.

2007 UBTI Filings

The report showed a 3.6% increase over 2006 in the number of Forms 990-T filed, but a 4.1% decrease in the number of returns showing net positive UBTI. Aggregate UBTI, net of deficits, was over $1.4 billion, up 11.3% from 2006, yielding revenues of just over $594 million, up about 6.8% from 2006.

About 31.8% of all UBIT returns were filed by 501(c)(3) charities. The next largest categories were traditional IRAs at 17.6%, Section 501(c)(7) social clubs at 14.6%, and Section 501(c)(6) business leagues at 12.7%. Nearly 20,000 returns, 44.2% of the total, reflected gross UBTI of $10,000 or less, while 52.8% of all returns showed either zero or negative net UBTI.

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CPC Commentary

From the perspective of the charitable planner, some of the most telling statistics are that total giving is down 8.2% (for those itemizing deductions), with gifts of corporate stock down by 50%.

When the economy is bad, it is much more difficult to obtain cash gifts, especially large cash gifts. When the stock market is down, stock gifts are 50% less likely. These statistics should encourage charitable planners to look to other sources of gifts, such as (a) boats, coin and stamp collections, and other tangible personal property; (b) remainder interests in homes and farms; (c) nursing home deposits; (d) life insurance, etc.

In short, charitable planners need to look to any noncash asset on the balance sheet, which is not income producing. These are the items donors are most likely to consider giving during tough times. Remember, noncash assets constitute approximately 90% of all the assets of the average donor!

Id: 1819794, Issued: Apr 8, 2011

36. CPC Commentary: PPP Posts Info on Charitable IRA "Rollover"

Summary

The *Partnership for Philanthropic Planning* posted a collection of resources to its website to regarding the details of the tax compromise *act* ("Act"), with particular emphasis on the two-year, retroactive extension of the charitable IRA "rollover."

Extended Summary

The full text of the Act is linked, together with a 13-page summary of the tax provisions of the Act, including the charitable IRA "rollover," the extension for two years of existing marginal income tax rates, the retroactive reinstatement of the estate tax and generation-skipping transfer tax, with transitional rules permitting executors to elect carryover basis, and the zero marginal rate for the GST in 2010. In addition, PPP links to other legislative resources and to IRS guidance issued in connection with the initial enactment of the charitable IRA rollover.

PPP also links two of its surveys, one covering the initial two-year period through December 31, 2007, when the charitable IRA "rollover" provisions first expired, and the second covering the period from October 6, 2008, when the provisions were first extended, through December 31, 2009. Both surveys suggest that the rollover provision has primarily benefited colleges and universities, yielding mostly smaller gifts in the neighborhood of $5,000. Data for the earlier survey were based on 8,677 responses, while data for the later survey were based on only 171 responses. PPP is conducting a third survey, gathering information about gifts made under the current extension of the charitable IRS "rollover" provisions.

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Id: 1795772, Issued: Dec 22, 2010

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AFR & 7520 Rates

37. CPC Commentary: Rising 7520 Rates Stall at 3.0%

Summary

In Rev. Rul. 2011-10, the Service announced the Section 7520 rate for April, 2011 will hold steady at 3.0%

Extended Summary

After climbing unsteadily from a low of 2.0% in February, 2009, the rate peaked at 3.4% in May, 2010 before starting a downward slide, losing at least twenty basis points each month until bottoming out at 1.8% in December, 2010, an historic low.

The rate bounced back to 2.4% in January and 2.8% in February of 2011, arriving at the 3.0% mark in March, where it will remain for a second month.

Gift Annuities

The ACGA adopted slightly higher recommended gift annuity rates in April, 2010, which took effect in July. These rates assume an investment return of 5.5%.

As long as 7520 rates do not fall below 3.2%, annuities paid at the ACGA recommended rates to an annuitant of any age would qualify under the acquisition indebtedness rules, which require that the present value of the remainder to charity must be at least 10% in order to avoid incurring UBIT. However, 7520 rates have been consistently below that level since the newer rates came into effect.

In a recent newsletter and on its home page, the ACGA posted a statement acknowledging this difficulty and suggesting that charities lower their gift annuity rates with respect to younger annuitants and many deferred annuities. With the 7520 rate at 3.0%, a gift annuity (payable quarterly, at the end of the period) for an individual aged 51 or younger at the ACGA recommended rates will fail to qualify.

Although a lower 7520 rate will yield a lower charitable income tax deduction for a gift annuity, it yields a higher exclusion ratio, assigning a larger portion of each annuity payment to return of principal. Thus, planners should compare results under both available rates.

Charitable Remainder Annuity Trusts

Using the February 7520 rate of 2.8%, a CRAT with a minimum 5% annuity payable annually at the end of the period over the life of the annuitant would fail the 5% probability of exhaustion test set forth in Rev. Rul. 70-452 and Rev. Rul. 77-374 if the annuitant were younger than age 69. A similar CRAT for an annuitant as young as 68 would satisfy the test

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using the 3.0% rate for March or April, 2011.

A 5% CRAT for a 69-year-old donor would yield a deduction of 42.457% under the February rate. However, it would yield a deduction of 43.437% under the March or April rate -- a spread of 0.98%. Planners who have been waiting until the April rate was announced to close on a CRAT may want to wait another month to see whether the May rate may be higher.

Lead Trust Planning

Lower 7520 rates are advantageous for lead annuity trust planning, including both CLATs and GRATs, and to a lesser extent, retained life estates and QPRTs. Planners wishing to take advantage of lower 7520 rates for CLATs or retained life estate gifts would have to close these transactions in March to take advantage of the 2.4% rate from January.

Unitrusts, whether lead or remainder, are only marginally affected by changes in the 7520 rate, depending on the frequency of the payout.

Id: 1817518, Issued: Mar 21, 2011

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Investment Fees

38. CPC Commentary: IRS Extends Interim Guidance on Bundled Fees

Summary

In Notice 2011-37, the Service delayed for a fourth time implementation of proposed Regs that would subject investment management fees paid by nongrantor trusts and probate estates to the 2% floor for miscellaneous itemized deductions.

Extended Summary

The proposed Regs were issued in July, 2007, while certiorari to the Supreme Court was pending from a 2nd Circuit federal appeals court ruling that investment management fees not "unique" to fiduciary administration were subject to the 2% floor for miscellaneous itemized deductions (see our earlier commentary). The Court ultimately ruled that fees not "ordinarily" incurred by nonfiduciaries are fully deductible.

The present Notice supersedes Notice 2010-32, which applied only to tax years beginning prior to January 1, 2010. The filing deadline for fiduciary income tax returns for the 2010 calendar year is Monday, April 18, 2011.

Unlike previous interim guidance on the matter, the present Notice applies to returns for any tax year beginning before the Regs are finalized. Final Regs are among the items listed in the IRS's Priority Guidance Plan for 2010-2011.

Id: 1820626, Issued: Apr 14, 2011

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Miscellaneous

39. CPC Commentary: CCA 201105010 - Transferable State Charitable Tax Credit Not a Quid Pro Quo

Summary

In CCA 201105010, Chief Counsel's Office issued detailed rulings on the federal tax treatment of transferable state tax credits, which were incentives for contributions to selected charities and which were applied against the taxpayer's state income tax liability.

Extended Summary

The ruling considered four separate state income tax credits, which were granted to the taxpayers for two reporting years. One of the credits was transferable, and all four could be carried forward. Contributions made in the first year included appreciated property.

Taxpayers applied a portion of the credits granted in the first year against their current state income tax liability, sold a portion of the transferable credit, and carried the balance forward. In the second year, the taxpayers were granted additional credits, which they applied against that year's state income tax liability, together with the credits carried forward from the previous year.

Chief Counsel first considered whether the grant of a state tax credit should be treated as a *quid pro quo*, reducing the charitable contributions deduction, or caused the contribution of appreciated property to be treated as a bargain sale. Citing a number of older court decisions to the effect that a state income tax deduction was not a quid pro quo, Chief Counsel concluded the tax credit should be treated no differently. Chief Counsel also noted Rev. Rul. 79-315, stating that an across the board state income tax rebate was neither includible in income nor deductible as a tax payment.

Chief Counsel also concluded, however, that the amount realized by the taxpayers on the sale of the transferable credit was taxable as an exchange, and that their basis in the credit was zero. Express authority for this ruling was not cited.

CPC Commentary

When the IRS decides it does not want to rule on a matter, it has several "outs," many of which are not legitimate. In this particular case, the memo noted that Chief Counsel previously declined to rule on the contribution of cash or property to a state agency or to a 501(c)(3) organization in exchange for refundable or transferable credits, reasoning that the matter might be addressed in formal guidance. Explaining the change in position here, the memo stated that "[a]t this time, published guidance on the issue is not contemplated."

The IRS will also attempt to side-step issuing a ruling by claiming that it does not issue rulings on "questions of fact." This, of course, is patently absurd since the almost every PLR is issued

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based on a specific set of facts. The Service has frequently done this with rulings involving the grantor's ability to replace assets in a trust with assets of substantially similar value under Section 675(4)(C). If and when the Service attempts this ploy, the charitable planner should challenge their reasoning.

Another ploy of the Service that should be challenged is when it argues that the law is "unclear" in the area, and thus it cannot rule. Once again, this is patently absurd since the ruling is being requested, as with many other rulings, precisely because the law is not clear in a particular area. In fact, to the other extreme, the Service frequently will not issue a ruling because the law is clear (e.g., the tax exempt status of a garden-variety CRT, CLT, or PIF).

One additional "out" the Service uses, which may truly be the basis for the first three excuses, is when a ruling is not "in the best interest of sound tax administration," at least according to the IRS. See section 2.01 (first paragraph) of Rev. Proc. 2011-3. For example, the Service responded in this fashion to a request in the mid-1990s for a PLR on charitable split dollar, where the charity was guaranteed a priority rate of return of 6% on all charitable dollars invested in the plan before the donor or the donor's family received any benefit. The IRS refused to rule, not wanting to establish precedent for "all charitable split dollar plans." Arguments that such a ruling could be prefaced in a fashion that established a strict standard or requirement of minimum charitable benefit (e.g., a rate of return equal to at least the 7520 rate), which would be good for the charitable community and also for the Treasury, were ignored. The passage of Section 170(f)(10) eliminating all charitable split dollar programs in 1999, even those plans beneficial to charity, ended the discourse, but this was years after the PLR request had been refused for "administrative" reasons.

In short, the Service reserves the right to rule or not to rule, and its position can only be contested by resort to litigation, frustrating the very purpose of the private letter ruling process, which is to bring advance certainty to taxpayer planning on matters that are not clear. The only non-litigious alternatives available to taxpayers, if the Service refuses to rule, probably lie with Congress or the National Taxpayer Advocate.

Id: 1809068, Issued: Feb 7, 2011

40. CPC Commentary: Center on Philanthropy Releases Study on High Net Worth Philanthropy

Summary

The Center on Philanthropy at Indiana University issued its biannual study ("Study") analyzing trends in charitable giving by high net worth individuals; including which nonprofit sectors they supported, where the largest gifts were directed, and what motivated these behaviors. In short, giving is down significantly.

Extended Summary

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The Study combined data from IRS statistics with survey responses from more than 800 households in "high net worth neighborhoods" across the country. Surveys were mailed to households with income greater than $200,000 and/or net worth of at least $1 million. Those responding had an average net worth of $10 million. Fewer than fifty respondents reported income over $2 million or net worth in excess of $20 million, rendering data in those ranges statistically insignificant.

Citing IRS data, the Study found that:

- high net worth households gave an average of 9.1% of their income to charity in 2009, down from 11.1% in 2007;
- the average amount of charitable giving per household dropped 34.9% from $83,034 in 2007 to $54,016 in 2009, adjusted for inflation;
- meanwhile, average amounts given to private foundations, donor advised funds, trusts, and other "giving vehicles" increased more than 21%, from $62,680 in 2007 to $75,867 in 2009, with 20.9% of all respondents maintaining an endowment fund with a charity and 17.5% giving through donor advised funds;
- more than 46 percent of wealthy households today have a will with a specific charitable provision and another 12 percent would consider establishing a charitable provision in their will in the next three years;
- average amounts given outright to health related charities dropped 63.7% from $12,430 in 2007 to $4,511 in 2009, with this sector dropping from 10.4% to 6% as a share of all high net worth giving;
- average giving to education declined 55%, giving to combined purpose charities fell 44%, and giving to religious organizations fell 43.4%;
- however, giving in other sectors increased, with gifts to arts organizations, for example, increasing 11.5%, and gifts to environmental charities increasing 3.9%, though average dollar amounts were modest.

Based on responses to the survey, the Study found that:

- 55% of the surveyed households made their largest single gift in 2009 unrestricted, to fund general operations;
- another 36.2% made their largest single gift to fund a particular program; and
- only 14.2% made their largest gift to fund capital expenditures.

The Study also indicated that the number of high net worth individuals volunteering more than 200 hours a year to charitable activities increased significantly, from 26.7% in 2007 to 39.3% in 2009, with the average number of hours volunteered by all respondents increasing from 241 in 2007 to 307 in 2009. The 21.3% of respondents who did no volunteer work at all gave $46,414 on average in 2009, while those who volunteered more than 200 hours gave $75,662.

The survey asked a number of less quantifiable questions, focusing on donor motivations. High net worth individuals were more likely to give:

- when they believe the gift will "make a difference" (72.4%);

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- when they themselves feel financially secure (71.2%);
- when they believe the organization is "efficient" in its use of funds (71.0%); and
- from a desire to "give back" to the community (64.7%, down from 81.2% in 2007).

More than half of respondents stated that they gave because of political or philosophical beliefs, while somewhat more than a third cited religious beliefs, and slightly less than a third gave "because they were asked."

About 35.4% of respondents stopped giving to at least one organization they gave to in the past, because:

- solicitations were too frequent and/or the organization asked for inappropriate amounts (58.9%);
- the respondent had moved on to other causes (34.2%);
- the household had experienced a change in financial circumstances, had relocated, etc. (29.4%); and
- the organization had changed leadership or direction (29.1%).

CPC Commentary

Kallina's Korner: It is interesting to note that giving to health related charities (-63.7%), educational institutions (-55%), and religious organizations (-43.4%) was down significantly. It is difficult to determine how much criticism by the SFC over the past 2 years impacted giving to these sectors. We can only hope, going forward with the new Congress, that it will be more circumspect when attacking charity, and will do so on the basis of study and analysis, not anecdotal evidence.

The glass, however, is half-full, as well as being half-empty. Note the willingness of high net worth individuals to provide for charities in their wills, and their increased use of private foundations and trusts. This certainly should encourage charities to focus on bequest programs and to increase their interface with professional advisers.

CPC is committed to educating the professional adviser, whether that person be a lawyer, accountant, financial adviser, insurance professional, trust officer, or charitable giving officer. We believe CPC is a valuable resource for the adviser, and allows a charity to provide the professional with educational content, while at the same time allowing the charity to develop a relationship of trust and mutual professional respect.

We know our beliefs are self-serving, but would urge our readers to review this important Study, and determine for themselves whether or not a close relationship between charity and the professional adviser is becoming even more critical to the future of charitable giving.

Id: 1793349, Issued: Nov 26, 2010

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41. CPC Commentary: SOI Report Includes 2009 Estate Tax Filings

Summary

IRS posted the quarterly SO Report, including data on estate tax returns filed during 2009.

Extended Summary

Most of the filings were with respect to decedents who died in 2008. Due to extensions, the data also included returns filed with respect to decedents who died in prior years when the exemption equivalent was lower than $2 million.

Of 33,515 returns filed, fewer than one in five claimed deductions for contributions to charity, and slightly more than half of these deductions were claimed by estates that remained taxable after all deductions. Estates claimed charitable contributions deductions aggregating over $16 billion, or about $2.5 million per return.

According to a similar report from a year ago, fewer than one in five estates claimed charitable contributions deductions, and again somewhat more than half of these estate remained taxable after deductions. However, estates claimed deductions aggregating over $28 billion, or about $3.9 million per return.

CPC Commentary

These data omit estates for which no return was filed, because the gross estate was below the filing threshold.

Id: 1790680, Issued: Oct 18, 2010

42. CPC Commentary: IRS: No Income Recognition on IRA Rollover to Fulfill Charitable Pledge

Summary

In an information letter to Prof. Harvey P. Dale, director of the National Center on Philanthropy and the Law, the Chief Counsel advised that a taxpayer who satisfied an enforceable pledge with a distribution from an IRA under the charitable IRA "rollover" provisions, since expired, would not recognize income.

Extended Summary

The letter cited:

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1. Rev. Rul. 55-410, stating that a taxpayer who satisfied a pledge with appreciated or depreciated property would not recognize gain or loss on the transaction;
2. Rev. Rul. 64-240, stating that an irrevocable trust whose income is applied to discharge the settlor's pledge would not be treated as a grantor trust for income tax purposes; and
3. Rev. Rul. 57-506, stating that (a) amounts paid from income of a pre-1969 charitable remainder trust created for the benefit of the settlor's former spouse as part of a divorce settlement, though taxable to her as alimony, are not included in the settlor's income nor deductible by him, and (b) the transfer of appreciated stock to the trust does not trigger recognition of gain.

CPC Commentary

Rev. Rul. 55-410 states:

"[i]t would be inconsistent to treat such payment or transfer as a 'contribution or gift' and at the same time as a satisfaction of a debt with the tax consequences [gain or loss] which would ordinarily follow from the use of appreciated property or depreciated to pay a debt,"

However, the Rev. Rul. does not explain why this would be inconsistent.

In PLR 200920031 ("PLR"), the taxpayer requested a ruling that the distribution of appreciated property in lieu of cash to satisfy the annuity payout requirement would not trigger gain or loss, citing Rev. Rul.55-410. The Service disagreed, citing as authority:

1. *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940), in which the court ruled that the distribution of appreciated securities in partial satisfaction of a pecuniary gift should have no different tax consequence from the trustee first selling the securities and then distributing the proceeds; and
2. Rev. Rul. 83-75, which adopted the reasoning of *Kenan* in the context of a non-grantor CLAT, though noting that the gain recognition would be to some extent offset by a charitable contributions deduction.

The Service asserted Rev. Rul. 55-410 involved distributions in satisfaction of an unenforceable pledge, for which the taxpayer could not claim a deduction until the pledge was paid. In the PLR, the deduction was already claimed upon funding of the CLAT, and the payment of the annuity was a legally enforceable obligation of the trust.

While the logic of Rev. Rul. 83-75 and the PLR appears sound, nowhere is it stated in Rev. Rul. 55-410 that the pledge was unenforceable. That ruling seems to hinge entirely on the perceived "inconsistency" in treating the transfer as a recognition event, on the one hand, and allowing a charitable contributions deduction on the other. Perhaps the perceived inconsistency between the various rulings can be reconciled by saying that Rev. Rul. 55-410 stands for the proposition that a charitable pledge, whether or not enforceable under state law, is treated for income tax purposes as not enforceable.

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The information letter to Prof. Dale also does not address the point that the unrecognized appreciation in a charitable IRA "rollover" would have been ordinary income, rather than capital gain. Outside the context of the charitable IRA rollover, the income tax deduction for a gift of ordinary income property would be limited to the taxpayer's basis, which in this case would be zero. In short, the letter's reliance on Rev. Rul. 55-410 is a bit thin.

According to section 2.04 of Rev. Proc. 2010-1, an information letter "calls attention to a well-established interpretation or principle of tax law[,] without applying it to a specific set of facts." It is "advisory only and has no binding effect on the Service," and it is "not a substitute for a letter ruling."

We would adviser our readers not to rely too heavily on this informal letter.

Id: 1784595, Issued: Sep 17, 2010

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