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**WHAT THE ESTATE PLANNER NEEDS TO KNOW ABOUT THE
PENSION PROTECTION ACT OF 2006**

Estate planners have focused their legislative attention on the wrangling over the estate tax, but attention should also be paid to the Pension Protection Act of 2006, which the House and Senate have both passed and the President has promised to sign. Pub. L. 109-280, 109th Cong, 2nd Sess. (August 17, 2006), 120 Stat. 780.

Estate planners are not expected to have a complete knowledge of the tax rules governing pension and retirement plans, but this new law includes a substantial number of provisions that directly affect common estate planning situations. This article examines the key provisions of the Pension Protection Act that will affect typical estate planning transactions.

TAX-FREE IRA DISTRIBUTIONS TO CHARITIES

The Pension Protection Act excludes from the gross income of an IRA participant who has already reached 70 ½ years of age, annual distributions of up to \$100,000 from a regular or Roth IRA to a qualified charity. This rule applies to distributions made in taxable years beginning in 2006 or 2008, but it does not apply to distributions from a simplified employee pension (SEP), a simplified retirement account (SIMPLE), or any

qualified pension or profit-sharing plan. Int. Rev. Code § 408(d)(8)(A), 408(d)(8)(B), 408(d)(8)(F).

This rule applies only to distributions made directly to public charities and private foundations the contributions to which are deductible subject to the 50 percent of adjusted gross income limitation. No exclusion is allowed for distributions to certain donor advised funds and supporting organizations. Int. Rev. Code § 408(d)(8)(B).

The new exclusion is allowed only if an income tax deduction would have been allowed under Section 170 for the “entire distribution.” Thus, no exclusion is allowed for contributions to charitable remainder trusts, pooled income funds, or other split-interest charitable trusts. Int. Rev. Code § 408(d)(8)(C). See discussions of contrary provisions in prior bills in the October, 2003 and December, 2005 issues of this Reporter.

Qualified charitable distributions from an IRA count towards the minimum distribution requirements. Thus, a participant who, in 2006, was required to withdraw four percent of the plan assets under a plan of substantially equal periodic payments over the participant’s lifetime, can instead distribute three percent of the plan assets to a qualifying charity and withdraw one percent personally. Int. Rev. Code § 408(d)(8)(D).

Editors’ Comments

Retirement plan benefits have long been a good source for testamentary charitable gifts, because such dispositions yield both income and estate tax deductions. Charitably-minded clients can now, for two years, avoid both income and gift taxes (and future estate taxes) by lifetime charitable distributions.

The creation of an exclusion, rather than a deduction, makes the charitable IRA distribution particularly useful to donors who do not itemize income tax deductions, who live in states that do not provide an income tax deduction for charitable gifts, whose other gifts already have already exhausted their percentage of modified adjusted gross income limitations, or whose charitable deductions would otherwise be lost because of the phase-out rules as the taxpayer's income increases above \$150,000.

The new law applies only if the IRA distribution is made "directly" to the charity. The IRA custodian cannot distribute funds to a beneficiary who then contributes them to charity. The IRA custodian should make out a check or document of assignment directly to the charity.

The new charitable exclusion applies only to distributions made after the donor actually reaches age 70 ½. This differs from the rule that credits towards the required minimum distribution any distribution made during the year in which the participant reaches age 70 ½. Charitable distributions made before the actual date on which the participant reaches

70 ½, but in that year, will count towards the required minimum, but not be excludible from gross income.

NONSPOUSAL ROLLOVER OF INHERITED QUALIFIED PLANS

The surviving spouse of a deceased participant in a qualified plan or IRA can avoid current recognition of the income on a distribution by rolling-over the distribution into an IRA, within 60 days of the distribution. Int. Rev. Code § 402(c). The Pension Protection Act permits a beneficiary other than the participant's surviving spouse to transfer a distribution made after December 31, 2006, directly to an IRA without current recognition of income.

The Pension Protection Act treats the IRA to which the nonspousal beneficiary has transferred a distribution as an inherited IRA of the beneficiary. Int. Rev. Code § 402(c)(11). Distributions from the inherited IRA are, for example, subject to the distribution rules generally applicable to IRA beneficiaries.

Editors' Comments

The beneficiary is permitted to make this by a direct transfer, rather than a roll-over. Thus, the funds must be transferred directly from one plan trustee or custodian to another, without an intervening distribution to the nonspousal beneficiary. This arrangement will give children and other nonspousal beneficiaries, including same-sex partners, a new means of deferring the tax on qualified plan benefits and IRAs.

TAXABILITY OF CERTAIN COMPANY-OWNED LIFE INSURANCE

The Pension Protection Act taxes as ordinary income certain life insurance proceeds received by a company on insurance policies owned on the lives of certain of its employees. Int. Rev. Code § 101(j). The new rule applies to any policy issued after the date of enactment, that is owned by and names as beneficiary (directly or indirectly) a person engaged in a trade or business, and that insures the life of an employee, officer, or director of the business. Int. Rev. Code § 101(j)(3)(A).

The new law does not apply in two situations. First, the beneficiary's gross income continues to exclude any amount received because of the death of the insured, that is paid to a member of the family of the insured, to an individual designated beneficiary of the insured under the contract (other than the applicable policyholder), or to a trust created for the benefit of any member of the family of the insured or any individual who is the designated beneficiary under the contract (other than the applicable policyholder). Int. Rev. Code § 101(j)(2)(B)(i).

Second, the beneficiary's gross income continues to exclude any amount received because of the death of the insured, if the insured was employed by the policyholder within the year ending on the date of death, or was, when the contract was issued, a director, highly-compensated employee, or highly-compensated individual with respect to

the policyholder. Int. Rev. Code § 101(j)(4). This exception applies only if, before the contract is issued, the insured:

- (a) is notified in writing that the applicable policyholder intends to insure the insured's life;
- (b) is notified in writing of the maximum face amount for which the insured's life can be insured;
- (c) is notified in writing that an applicable policyholder will be the beneficiary of the death benefits; and
- (d) consents in writing to being insured on such terms and that such coverage may continue after the insured's employment terminates.

Int. Rev. Code § 101(j)(4).

Editors' Comments

This new rule is designed to discourage corporations from buying a large number of policies of insurance on the lives of rank-and-file employees, without their notice, and retaining these policies after the employment relationship had terminated. It may, however, create serious problems for certain insurance-funded corporate buy-sell agreements.

A corporate redemption buy-sell agreement is often funded by having the corporation buy insurance on the lives of the stockholders to whom the agreement applies. The insured business owners are most often also employees, officers, or directors of the corporation.

The policies on their lives will produce ordinary income under this rule, however, unless the notice and consent requirements have also been met.

Many corporations whose insurance is used to fund a redemption buy-sell agreement will not routinely meet the notice and consent rules. The business owners are likely to know before the policy is bought that it will be bought, that it will insure their lives, and that it will be payable to the corporation. They may even have this information in writing, though often they receive no formal notification and sometimes the documents that provide that notice are executed after the policies have been bought.

Often, however, the insured will not know the maximum face amount for which his or her life can be insured, because no such maximum is known by the corporation. The insurance coverage is often adjusted to reflect the increased values of the stockholdings of the insureds, and the corporation may not know in advance how high these values may reach.

Also, many insureds will not have consented in writing to being insured on these terms or to the continuation of the coverage after the insured's employment terminates.

Practitioners should now include such notice and consent provisions as part of their buy-sell agreement forms.

CHARITABLE GIFTS OF PARTIAL INTERESTS IN TANGIBLE PROPERTY

The Pension Protection Act denies an income, estate, or gift tax charitable deduction for a contribution of a partial interest in tangible real or personal property unless, immediately before the gift, all of the interests in the property are owned by the donor or the charity or both. The act also calculates the income, estate and gift tax deduction for charitable contributions for partial interests in tangible personal property, where the donor has already made one or more contributions of interests in the same property, at the lesser of the value used for purposes of the first contribution or the fair market value of the later contributed interest. Int. Rev. Code §§ 170(o)(1), 170(o)(2), 2055(g)(1), 2055(g)(2), 2522(e)(1), 2522(e)(2).

The law also recaptures these deductions unless the donor contributes all of the donor's interests in the property to the same charity within ten years after the first contribution. Int. Rev. Code §§ 170(o)(3), 2055(g)(3), 2522(e)(3). The law treats the first contribution after the date of enactment as the initial contribution. Int. Rev. Code §§ 170(o)(4), 2055(g)(4), 2522(e)(4).

These changes are effective for all transfers after the date of enactment.

Editors' Comments

Charitable gifts of tenancy-in-common interests can provide a useful way to schedule charitable gifts of tangible assets, to permit use of the income tax deductions over a

longer period of time, and to make gifts of interests in tangible property that the donor does not use during the entire year. The appeal of such gifts was increased by the decision of the Tax Court in *Winokur v. Commissioner*, 90 TC 733 (1988), acq. 1989-1 CB 2, in which the court upheld a donor's gift to the Carnegie Institute of a ten-percent undivided interest in his art collection. The donor's agreement allowed the Institute to possess and display the artworks for one tenth of each year. The IRS contended that the gift was not a deductible gift of a fractional interest in the artwork, but the Tax Court found nothing in the Code that precluded fractionalization based on the number of days in a year, rather than on the number of items in the collection. The IRS acquiesced.

The new rules limit the usefulness of such gifts, but it does not eliminate them entirely. In particular, it will continue to afford benefits where the donor uses tenancy-in-common make a series of charitable gifts intended eventually to transfer 100 percent of the ownership from the donor to the charity.

OTHER CHARITABLE GIVING PROVISIONS

The Pension Protection Act also makes the following more narrow changes in the taxation of charities and charitable contributions. These provisions are important in certain limited situations, but will not apply to a great many everyday estate planning clients.

- (a) The act raises the deduction limit from 30% of adjusted gross income to 50% of adjusted gross income, for qualified conservation contributions, and allows a 15-year carryover of unused deductions. This provision applies only to contributions made in taxable years beginning in 2006 or 2007;
- (b) The act imposes a temporary reporting requirement for certain exempt organizations with respect to the acquisition of interests in certain life insurance policies (where interests are acquired by both charitable and noncharitable persons), and requires the Secretary of Treasury to issue a report within 30 months after the date of enactment, examining whether acquisitions of applicable insurance contracts is consistent with tax-exempt purposes of charitable organizations. This provision applies to contracts acquired after the date of enactment;
- (c) The act tightens the rules relating to charitable contributions of historic easements on buildings, allowing the deduction only if (i) the easement relates to the exterior of the building; (ii) the easement preserves the entire exterior, including the space above and to all of the sides of the building, from changes that are inconsistent with the historical character of the building; (iii) a qualified appraisal (including certain specified data) is attached to the tax return claiming the deduction, and reducing the deduction to take into account any federal rehabilitation credit. This change applies only to contributions made after July 25, 2006;

- (d) The act limits the charitable contribution deduction for appreciated taxidermy items contributed by the person who did the taxidermy or incurred the cost of the taxidermy, to the lesser of the taxpayer's basis in the property or its fair market value. This change is effective for contributions made after July 25, 2006;
- (e) The act recaptures the tax benefit from certain charitable contributions of tangible personal property that were deducted at fair market value based on the use of the property by the charity in conjunction with its exempt function, if the charity did not so use the property. This change applies to contributions made and returns filed after September 1, 2006;
- (f) The act denies the deduction for contributions of clothing or household items that were not in good or better condition or that had minimal monetary value (such as socks and underwear), with exceptions for items valued at more than \$500 where the taxpayer provides a qualified appraisal. This change is effective for contributions made after July 25, 2006;
- (g) The act lowers the threshold for imposing accuracy-related penalties on a taxpayer relating to valuation misstatements, imposing civil penalties on appraisers who prepare an appraisal that is deemed to have resulted in a substantial or gross valuation misstatement. These changes generally apply to returns filed after the date of enactment;
- (h) The act expands the base of the tax on private foundation net investment income, so that it includes income of a time similar to the items enumerated in

the Code, such as income from notional principal contracts (derivatives), annuities, and other substantially similar income, but not capital gains from property held for more than one year for the charity's exempt function. This change applies to taxable years beginning after the date of enactment;

- (i) The act provides new detailed rules on donor advised funds, including the first definition of a "donor advised fund," imposes new substantiation requirements for gifts to donor advised funds applying the excess business holdings rules of Section 4943 to donor advised funds, and imposes the excess benefit excise tax under Section 4958 on certain distributions from donor advised funds to disqualified persons and on distributions with more than an incidental benefit to disqualified persons. The bill also requires the Secretary to study the organization and operation of donor advised funds and supporting organizations, and applies an excess benefits transaction tax on any grant, loan, compensation or similar payment from a donor-advised fund to a donor, donor adviser, or a related person, and from a supporting organization to a substantial contributor or a related person. These changes apply to taxable years beginning after the date of enactment.

CONCLUSION

The notion that the "Devil is in the details" extends to estate planning, at least as much as it does to other endeavors. The Pension Protection Act creates new opportunities for certain types of charitable dispositions and retirement plan distributions, but it creates as

many traps for those seeking to take advantage of these and other traditional estate planning transactions. Practitioners should carefully scrutinize these provisions, to give their clients the highest possible level of service.