

Message From The Firm

This is our fourth and last newsletter regarding the estate planning and exempt organization aspects of the Pension Protection Act. The theme remains the same, which is to force people to use charitable entities correctly. The articles address the issues of excise taxes, appraisal penalties and the modified taxation of private foundations. All three articles show the punitive measures that are in the law, which the IRS will be using to enforce the law.

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Excise Taxes



By Jonathan Karp, Esq. (JonKarp@Reish.com)

The Pension Protection Act of 2006 significantly increases the excise taxes on certain violations by public charities, social welfare organization and private foundations, doubling these excise taxes in many circumstances and doubling the maximum amount of the penalties. As a result of the new complexities and penalties, increased costs are likely to be incurred in connection with establishing and operating these charitable entities.

For self dealing (improper transactions between a charitable organization and a disqualified person, such as the donor) and excess benefit transactions (a transaction in which economic benefits are provided by the charitable entity directly or indirectly to or for the benefit of a disqualified person in excess of the consideration paid by the disqualified person to the charitable entity for such benefit), the initial tax on such transaction is doubled from five percent to ten percent of the amount involved. Similarly, the initial tax on foundation managers is doubled from 2.5% to 5% of the amount involved, and the maximum dollar limitation of these excise taxes which can be imposed on the foundation manager for each act of self dealing is doubled to \$20,000.

Failure to distribute the annual minimum required amounts by foundations will result in an excise tax of 30% of the undistributed amount (doubled from 15%) being assessed against the foundation manager.

Excess business holdings (generally ownership of more than 20% of the voting interests in a business entity) will result in an excise tax of 10% (doubled from 5%) of the amount of such holdings.

Investments characterized as "jeopardizing investments" will lead to excise taxes of 10% (doubling the former 5% excise tax) of the amount of the investment and is imposed on both the foundation and the foundation managers. The dollar limitation on these excise taxes assessed against the foundation is similarly doubled to \$10,000 per investment while the maximum excise tax which can be imposed on foundation managers is doubled to \$20,000 per investment. Jeopardizing investments, while not specifically listed, are any investment which shows a lack of reasonable business care or prudence in covering both the short and long term financial needs of the foundation in the pursuit of its exempt function. Examples of transactions which will be subject to careful examination include securities transaction conducted on margin loans, commodity futures trading, working interests in oil and gas wells, investments such as puts, calls and straddles, trading in warrants and short selling.

Taxable expenditures, such as expenditures by the charitable entity for lobbying, influencing public elections or voter registration, grants to individuals for travel, study

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Tax Bill Summary



By Mike Foster, Esq. (MikeFoster@Reish.com)

As part of its long-standing effort to combat abuses in the appraisal and valuation process, Congress has tightened the rules for determining when a substantial or a gross misstatement of value has been reported on a tax return, and has enacted new penalties that will be imposed on the appraisers responsible for such misstatements.

Taxpayer Penalties

Under the new law, a taxpayer will be subject to a 20% penalty for a substantial valuation misstatement on an income tax return (typically a charitable contribution of property) in which the property value is misstated by 150% or more, rather than 200% under prior law. Thus, a claimed gift of \$15,000 will subject the taxpayer to this penalty if the donated property is ultimately determined to be worth \$10,000 or less.

A 40% penalty for a gross valuation misstatement will be imposed when the claimed value of donated property is 200% or more of the amount ultimately determined to be the correct value, rather than 400% under prior law.

In the case of gift and estate taxes, the taxpayer will be subject to the 20% substantial valuation misstatement penalty if the value of transferred property reported on a return is 65% or less than the value as ultimately determined, rather than 50% under prior law. Thus, a transfer of property valued at \$65,000 on the gift tax or estate tax return will be subject to this penalty if the property is ultimately determined to be worth \$100,000 or more. Note that the emphasis of these penalties for gift and estate taxes is on undervaluing property in order to reduce transfer taxes, whereas for income tax

purposes the emphasis is on overstating value in order to increase the charitable deduction.

The 40% gross valuation misstatement penalty will apply to a transfer reported on a gift tax or estate tax return if the reported value is 40% or less than the value of the property as ultimately determined, rather than 25% under prior law.

Under prior law, these penalties could be abated if the taxpayer could show reasonable cause for the misstatements. Under the new law, the penalty for gross valuation misstatements cannot be abated.

Planning Point

Since these new penalties apply directly to taxpayers, not to appraisers or other advisors, clients must take care to deal only with reputable advisors who have agreed in writing to defend their work against IRS challenges.

Appraiser Penalties

In the case of a valuation misstatement (whether substantial or gross), any person who prepared an appraisal that he or she knows or reasonably should have known would be used in connection with the filing of a tax return or a claim for refund is subject to a penalty.

The amount of the penalty is the greater of 10% of the tax underpayment, or \$1,000, but not to exceed 125% of the fee charged for the appraisal.

While seemingly clearcut on its face, this new penalty provision has generated discussion within both the tax and appraisal professions.

As an initial matter, as a result of ambiguity in the drafting of the new statute (Internal Revenue Code section 6695A), tax professionals are debating whether

this new penalty provision applies to appraisals provided for income tax purposes only or to estate and gift tax as well. While on a go forward basis advisors will most likely assume, in an abundance of caution, that the penalty will apply in income, gift and estate tax matters. The effective date of this new legislation (discussed below) may cause problems because some appraisals that were done before the legislation was signed will be governed by the legislation. In the event the appraiser penalty is raised in such a situation involving estate tax or gift tax, we should certainly expect a claim by the appraiser that the penalty does not apply to those taxes.

For purposes of the penalty, an “appraisal” does not have to be a formal written appraisal prepared by a certified appraiser. An accountant, lawyer, financial advisor, real estate broker or other professional, or an executor, trustee or charitable organization could provide information in connection with the preparation of a tax return that triggers the penalty. In those cases, however, the likely absence of a separate fee for preparing the “appraisal” would render the penalty moot. However, a person who is compensated for even an oral appraisal, would be subject to the penalty.

There currently does not appear to be a statute of limitations for the IRS to assess this appraisal penalty. Whether this was intentional or a legislative oversight remains to be seen.

The penalty will not apply if the appraiser can establish that the value presented in the appraisal was “more likely than not” the appropriate value. How this burden of proof can be sustained by an appraiser given the extent of the misstatement that triggers the penalty remains to be seen.

For professional appraisers, imposition of the penalty carries with it more than just the dollar amount of the penalty. The rules regarding a professional’s ability to

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Taxation of Private Foundations

Excise Taxes

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By Jeffrey Lewis, Esq. (JeffLewis@Reish.com)

Several types of entities are exempt from federal income tax. These are generally nonprofit organiza-

tions operated exclusively for religious, charitable, scientific, literary or educational purposes. These organizations obtain their exemption from federal income tax under the provisions of Section 501(c)(3) of the IRC.

Generically, there are two types of 501(c)(3) organizations. First, is a publicly supported charity; second, is a private foundation. A publicly supported charity is one that receives more than one-third (1/3) of its annual contributions from members of the organization and the public in general, and no more than one-third (1/3) of its support from its investments and business income. A private foundation generally is a 501(c)(3) organization that is not a publicly supported organization.

Notwithstanding the fact that a private foundation is exempt from federal income tax, it is still subject to an excise tax on its net investment income. The excise tax is two percent (2%) of such income.

The term "net investment income" was generally defined prior to the Pension Protection Act of 2006 (PPA) as the total of the private foundation's gross investment income and capital gain net income, less the costs incurred in generating such income. Gross investment income specifically included only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, payments with respect to securities loans, and royalties. This definition has been changed by the PPA.

Also, under law prior to the PPA, a private foundation could use loss carrybacks (but not loss carryovers) in calculating net capital gain income.

Under the PPA, three significant changes are made. First, gross investment income's definition is broadened. Not only will gains and losses from the sale or other disposition of property used for production of interest, dividends, rents, payments with regard to securities loans and royalties be subject to the excise tax, but also "income from sources similar" to above will be taxable. This will probably cause annuities, notional principal contracts (dealing with interest rate swaps) and income from substantially similar investments to be subject to the excise tax.

The second significant change that the PPA made is capital gains generated through appreciation will be subject to the excise tax. For example, under prior law, capital gain income from the sale of appreciated, non-dividend paying stock would not be subject to tax. Under the PPA's expanded definition of gross investment income, this appreciation will be subject to tax.

A third change made by the PPA is that net capital gain income can no longer be offset by loss carrybacks. The prohibition against reducing net capital gain income by loss carryovers is retained by the new law.

As a result of the changes made by the PPA, private foundations should make certain that they are in compliance with the new income taxation rules. In order to accurately calculate any excise taxes due under the new rules, private foundations should work closely with their certified public accountant. ❖

or similar purposes, which do not comply with procedures established by the IRS for such expenditures, and certain grants to non-charitable organizations, and expenditures for any non-charitable purposes, are also subject to increased excise taxes. The excise tax imposed on the foundation for such expenditures is doubled to 20% of the amount of the expenditure, while the excise tax imposed on the foundation manager is doubled to 5% of the amount of the expenditure. The maximum amount of these excise taxes are also doubled to \$10,000 on the initial expenditure and \$20,000 for foundation managers who refuse to correct expenditures.

The IRS has the authority to abate or not assess these excise taxes if the charitable entity or the foundation manager, as the case may be, can establish that the violation was due to reasonable cause and was not the result of willful neglect and that the violation was corrected within the permissible correction period.

The result of these changes will be that charitable organizations and their volunteer boards will be required to expend significantly more time monitoring the charitable entity's operations to ensure compliance with these rules, since the consequences of violations have been doubled. Further, the organizations will likely have to increase their reliance on specialized counsel with knowledge and experience in these areas, which will increase operating costs. In many cases, clients considering establishing private foundations might instead elect to utilize donor advised funds established at community foundations so that there are professional managers who will be responsible for compliance with, and therefore any violations of, these rules. However, the downside is that some people prefer private foundations, which provide increased flexibility and ability to train family members in charitable pursuits and decision making, which may be lost if community foundations are utilized. ❖

Bill Summary

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practice before the IRS is governed by an administrative document referred to as "Circular 230." Because of a recent change to Circular 230, it is possible that an appraiser who has been subjected to the new appraiser penalty will be barred from testifying, or presenting evidence, in IRS audits and appeals. Some tax and appraisal professionals are concerned that this is an unfair result in a number of circumstances, such as (1) the appraiser having relied upon an appraisal by another person, such as an appraiser of a family limited partnership interest relying on a separate appraisal of the partnership's underlying assets, or (2) the absence of specific knowledge that the subject appraisal would result in an underpayment of tax. At this time it is uncertain how or whether the IRS will

utilize its ability to "blacklist" appraisers under these and other circumstances.

Effective Date

The taxpayer penalties and the appraiser penalties set forth above apply for all tax returns filed after August 17, 2006. Therefore, an appraisal prepared months earlier will be subject to these new rules if the actual tax return or claim for refund for which the appraisal was prepared is filed after August 17, 2006.

Planning Point

Appraisers and tax professionals must continue to exercise extreme caution when preparing appraisals or advising clients on any matter which involves reporting a value for an asset that is deducted, transferred, depreciated or amortized on a tax return.

Qualified Appraisers and Appraisals

In order to obtain an income tax charitable deduction for certain contributions of property other than cash or market-

able securities (in excess of \$10,000 for closely held stock, and \$5,000 for other property) a "qualified appraisal" must be prepared by a "qualified appraiser" and a summary filed with the return. The new law expands upon the definitions of both "qualified appraiser" and "qualified appraisal."

Planning Point

While a discussion of these changes is too detailed for a summary such as this, any person filing an income tax return after August 17, 2006 that relies upon a "qualified appraisal" should confirm with his or her appraiser that the new standards set forth in the statute are satisfied. Otherwise, the taxpayer could lose his or her income tax charitable deduction. ❖

Around the Firm

Mark Terman will present "When The New Year Ball Drops: Will You Be Ready To Catch It?" to the Professionals in Human Resources Association on December 14th. Robin Gilden and Stephen Halper are panelists at a CEB Program on Forming and Operating Limited Liability Companies in Anaheim and Los Angeles on January 13th and 27th. Robin is a part of the planning committee for the USC 2007 Tax Institute conference being held on January 22nd through the 24th.

Best wishes for the Holidays and a Happy New Year.

Any tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

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