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NEWSLETTER

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How Does the Pension Protection Act of 2006 Affects Your Estate Planning?

There has been a lot written and there will be a lot more written on the Pension Protection Act of 2006. Our copy of the Act is over two inches thick on onion-like paper. Below we have set forth highlights we think may be most relevant to your estate planning goals and concerns. Please call us if you have questions.

Charitable Contributions from IRAs – In 2006 and 2007, you can make contributions up to \$100,000 directly from your IRA to public charities. To take advantage of this provision, you must be at least 70 ½ and the gift must be to a public charity or a “conduit” private foundation. Why would you want to do this? Because by making a gift directly from your IRA to the charity, you don’t have to take the money out first and include it in your gross income. This means that you avoid the possibility that a portion of your charitable deduction will be lost because of the percentage (of your AGI) limits on gifts to charities for income tax purposes. Please call us or consult your income tax advisor for more information on whether such a direct charitable gift from your IRA is appropriate for you.

Rollover of Employer Plan Benefits to Non-Spouse Beneficiaries – As of 2007, your non-spouse beneficiary – e.g., your child or your domestic partner – of your employer-sponsored retirement plan, such as a 401(k) or profit sharing plan, can direct the trustee (administrator) of the plan to transfer your account into an IRA – like an “inherited” IRA. Why is this important? Because, at your death, your non-spouse beneficiary will not be required to take a lump sum distribution or a five-year payout. While the payments must start immediately, the non-spouse beneficiary can stretch them out over his or her expected lifetime. This means that your non-spouse beneficiary can keep taxable income from the inherited plan to a minimum. The tax treatment is similar to an “inherited IRA” and puts your non-spouse beneficiaries in the same position that they would have been had you rolled your company sponsored plan into an IRA during your lifetime. Three important notes: One, this new rule does not apply to your IRA – your spouse is still the only one who can truly rollover your qualified plans or your IRAs and defer distributions until he or she attains age 70 ½; Two, your estate may still need other cash to pay estate taxes and avoid your beneficiaries having to take large (taxable) distributions from the inherited plan to pay estate taxes; Three, there are no provisions for using a trust in conjunction with these new rollover provisions, and until

regulations are promulgated for the use of a trust in this context, caution suggest that a trust not be used. Stay tuned.

Basis Adjustment S-Corporation Stock –

If you are a shareholder of an S corporation, the Pension Protection Act eliminates the disparity between you and a partner in a partnership in the context of charitable contributions made by the business entity. The Act amends the tax code to provide that instead of your basis in your stock being reduced by the amount of the charitable deduction reflected in your K-1 (your allocable share of the FMV of the contributed property), your basis will be reduced by only that amount equal to your allocable share of the tax basis of the property contributed to the charity. For example, if you and shareholder “B” each own 50% of your S-corp and the S-corp makes a charitable contribution of \$200,000 of stock with a basis of \$50,000, you and your fellow shareholder will each have a charitable deduction of \$100,000 (assuming that the contributions otherwise qualifies under Section 170) and your basis will each be reduced by \$25,000. Under prior law, your basis in your stock would have been reduced by up to the entire pass-through contribution deduction of \$100,000 (up to the amount of the basis, because basis cannot ever be less than zero). The change in the law applies to contributions made by S-corporations in tax years beginning in 2006 (even if made before the Act’s effective date) or in 2007.

Charitable Easements – To encourage contributions of real property for conservation purposes, the Act makes several favorable changes to the percentage limitation rules under Section 170(b), applicable to “qualified conservation contributions” by individuals. Although, as a general rule, a taxpayer may not deduct in any one year more than 30% of his or her contribution base for donations to charity of

capital gain property, the Act allows a taxpayer to take a charitable deduction for a qualified conservation contribution, made before 2008, of up to 50% of the taxpayer's contribution base. Any excess deduction is carried over for the 15 succeeding tax years. The Act is even more generous with respect to "qualified" ranchers and farmers. Such taxpayers (including corporations that qualify) may deduct charitable contributions consisting of qualified conservation contributions of up to 100% of the taxpayer's contribution base if made before 2008 (and carry over any excess for the succeeding 15 years). In short, a farmer or rancher may be able to shelter all of his or her taxable income. There are several conditions that must be met for a contribution of real property to be a “qualified conservation contribution” and there are some disqualifying factors that must be taken into consideration. Notwithstanding the substantial tax benefits of making a “qualified conservation contribution” before the end of 2007, because of the technical qualifying conditions and the disqualifying factors, obtaining a private letter ruling from the IRS in advance of making such a contribution of real property is strongly recommended.

The Importance of a Properly Run

Private Foundation – The Act essentially doubles the excise tax penalties for private foundations, foundation managers, and disqualified persons (effective for tax years beginning after August 17, 2006) for acts of self-dealing, failure to make the 5% minimum annual distribution requirement, owning excess business holdings or investments that jeopardize charitable purposes, and certain taxable expenditures. If you have any questions or concerns about the management of your private foundation, we encourage you to contact us or an experienced foundation management company (For a link to such a company, go to the Philanthropy section of the Resources

Page on our website and click Foundation Source.)

Charitable Remainder and Charitable Lead Trusts – Take note that the excise tax on self dealing applies to split interest charitable trusts as well.

Charitable Contributions of Fractional Interests in Tangible Property (i.e., Art), Related Use, and Recapture Rules – Effective August 17, 2006, new rules dramatically change the income, estate and gift tax consequences of gifts of fractional interests. Here are the highlights: The property subject to the fractional interest gift must be owned entirely by the donor (read an individual) or entirely by the donor and the donee. The Act authorizes the Secretary of the Treasury to issue regulations making exceptions to this rule – i.e. if you and your spouse, domestic partner or sibling jointly own a piece of artwork. Stay tuned.

The remaining interest of the property must be transferred to the donee within the earlier of ten years or the donor's death (this raises questions as to what the Treasury regulations will be on jointly made donations). Failure to make the complete transfer within these time limits will result in the recapture, with interest, of income and gift tax charitable deductions and the imposition of a 10% recapture penalty. So, it is highly unlikely that a donor will be keeping that painting in the living room for more than ten years after an initial fractional gift.

Assuming that the property is related use property, the value for estate, gift, and income tax purposes of each subsequent donation of fractional interest is the lesser of the value used for determining the initial fractional contribution or the fair market value of the property transferred at the time of the subsequent contribution. This means that a donor will not realize any charitable

deduction on the appreciation in value of the property over time.

Moreover, if the charity disposes of the property in the year in which the contribution is made, the donor's deduction is based on his or her cost basis and not the fair market value. If the charity disposes of the property (or it otherwise ceases to be used for a purpose or function related to the charities tax exemption) after the year of the donation but before the end of the third year after the donation, the donor must recapture as ordinary income an amount equal to the excess of the amount of the deduction previously claimed over the donor's tax basis in the property at the time of the contribution.

There is a recapture safe harbor: Among other things, the charity must certify to the IRS under penalty of perjury that the intended use of the property has become impossible or infeasible to implement. We suggest careful consultation with your professional advisors and the charities that are your intended donees before you make any charitable gifts of fractional interests in your tangible property.

Valuation Penalties – Here is a summary of the new rules for overvaluing property for income tax deduction purposes and undervaluing property for estate and gift tax purposes:

For taxpayers, a substantial valuation misstatement will be deemed to occur for income tax purposes if the value of the property used is 150% (or more) of the amount determined to be the correct value. And it will be deemed to occur for estate or gift tax purposes if the value used to determine the amount of such tax is 65% (or less) of amount determined to be the correct value. A gross valuation misstatement will be deemed to occur for income tax purposes if the value used is 200% (or more) of the

amount determined to be the correct value. A gross valuation misstatement will be deemed to occur for gift or estate tax purposes if the value used is 40% (or less) of amount determined to be the correct value.

The Act also eliminates the “reasonable cause” exception in the case of underpayments relating to substantial or gross valuation misstatements. As a result, taxpayers can no longer assert a defense to the imposition of accuracy-related penalties on the ground that the claimed value of contributed property was based on a qualified appraisal and the taxpayer made a good faith investigation of the value of such property. In addition, an appraiser can now also be subject to penalties for underpayments of income tax if the appraiser knew or reasonably should have known that the appraisal would be used in connection with an income tax return or refund claim.

Donor Advised Funds, Supporting Organizations – The Act makes extremely complex, administratively burdensome, sweeping, and highly criticized changes to the rules governing donor advised funds and supporting organizations. Because there is already a plethora of information available (and there will undoubtedly be more written) on this part of the Act, and because the Act directs the Secretary of the Treasury to complete a study on donor advised funds and supporting organizations within one year of the enactment of the Act and to make additional recommendations (we read that as new or additional regulations and potential changes to the law), we are not reporting on this now. If you have personal questions or concerns, we will be happy to address them.

In conclusion, we hope that our discussion and outline above of several areas of the Act has been useful to you. Please note that the Act has many more provisions that affect

everything from façade easements, to more on charities, to taxidermy. Please contact us or your tax or estate planning counsel with any questions or concerns. You can reach us at info@maclean-law.com.

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