

# Pension Protection Act of 2006

## Items of Particular Interest to Appraisers

The Act made a number of charitable donation reforms. Only a few of these reforms measures are summarized.

a. **Contributions of Fractional Interests in Tangible Personal Property.** A charitable deduction is allowed under current law for gifts of an undivided fractional portion of a donor's entire interest in tangible personal property (such as an undivided interest in a piece of art). If the gift is used in a manner related to the exempt purposes of the donee, the deduction is based on the relevant fraction of the entire fair market value of the property at the time of the contribution. If the donee's use is unrelated, the deductible amount is limited to the donor's basis in the property.

Several very important changes are made under the new law, effective for gifts made after the date of enactment.

(i) All interests owned by donor or donee. All interests in the item must have been owned by the donor and the donee immediately before the contribution. §170(o)(1)(A). An exception exists if all persons who hold an interest in the property make proportional contributions of an undivided portion of the entire interest they hold. §170(o)(1)(B). This rule also applies for gift tax as well as for income tax purposes.

(ii) Deduction for future gifts of undivided interests in the same property. If the use of the property is related to the donee's exempt purpose, and the deduction is based on the fair market value of the property, there is a special limit on future gifts of additional undivided interests in the same property (and the gift must be made to the same donee or else no deduction is allowed under the first new rule described above). In that situation the fair market value of any additional contribution is determined by using the lesser of (1) the property's fair market value at the time of the initial fractional contribution, or (2) the property's fair market value at the time of the additional contribution. §170(o)(2). *Therefore, there will be no increased deduction allowed attributable to increases in the fair market value of the entire property after the time of the initial fractional gift.* (However, consistency is not required where the property goes down in value after the initial gift.) Accordingly, making charitable gifts of undivided interests in tangible personal property will be much more problematic in the future, and will entail significant potential downside risks.

This rule also applies for estate and gift tax as well as for income tax purposes. §§2055(g) & 2522(e). This is critically important. For example, if an individual makes a gift of a fractional interest in property, and leaves the balance of the property to the charity at the individual's death, there can be a mismatch of estate inclusion and allowable deduction. The individual's remaining undivided interest would be included in the estate at its full value, but the estate tax charitable deduction would be allowed based on the value of the property at the time of the initial contribution.

(iii) Recapture of deduction and recapture penalty. A recapture of the income or gift tax (but not estate tax) charitable deduction will occur where the following events have not occurred with a within 10 years of the initial fractional gift or the donor's earlier death:

(I) if the donor does not contribute all of the remaining interest in the property to the donee (or if the donee is no longer in existence, to another §170(c) organization); AND

(II) if the donee has not (a) had substantial physical possession of the property, and (b) used the property in a use related to the organization's exempt function. §§170(o)(3)(B) & 2522(e)(3)(B).

*Accordingly, a gift of a fractional interest in property that is unrelated to the charity's exempt function can still be deducted initially based on the donor's basis (but not the full fair market value). However, if the property is not given a related use within the 10 year or earlier death period, the charitable deduction (plus interest) is recaptured. There is also a recapture penalty of 10% of the amount recaptured.*

(iv) Contributions before date of enactment. The legislative history states that a contribution of an undivided interest in tangible personal property before the date of enactment is not treated as the initial fractional contribution for purposes of these rules. The first additional undivided interest contribution after the date of enactment would be treated as the initial contribution for purposes of these new rules. (Therefore, for example, the 10 year period would run from the date of the first contribution after the date of enactment, not the date of prior contribution(s) of undivided interests in the same asset.)

**b. Miscellaneous Other Charitable Provisions.** There are numerous other provisions, including:

- Some additional limits on deductions of clothing and household items (the items must be in good used condition and must have more than minimal monetary value). §170(f)(16)(A-B).
- A charitable deduction for contributions of tangible personal property exceeding \$5,000 must be reduced or recaptured if the donee sells the property within three years of the contribution. §170(e)(7)(A).
- A charitable contribution by an S-corporation will reduce the shareholders' basis only by the contributed property's basis (rather than by his or her share of the full charitable contribution) for contributions made in tax years beginning in 2006 or 2007. §1367(a)(2).
- There are additional restrictions for façade easements or certain conservation gifts in historic districts. (A deduction is allowed for conservation easements for buildings located in historic districts only if the easement preserves the entire exterior of the building, prohibits any change inconsistent with the historical character of the exterior, and if the donee is a qualified organization that has the resources to manage and enforce the restriction. §170(h)(4)(B). Taxpayers claiming a deduction for building easements greater than \$10,000 must pay a filing fee of \$500, beginning six months from the date of enactment. §170(f)(13). The deduction is eliminated for conservation easements on vacant land in historic districts. §170(h)(4)(C).)
- Conservation contributions by individuals are deductible up to 50%, rather than the prior 30% limit for contributions of long term capital gain property unless the taxpayer elected to limit the deduction to basis of the contributed property, (and 100% for farmers and ranchers provided that the property is "generally available" for agriculture or ranching) with a 15 year carryover (rather than the usual 10 year carryover). §170(b)(1)(E). However, these relaxed percentage limitation and carryover rules are only available for conservation easements made in tax years beginning in 2006 and 2007; this is critical because locating organizations willing to accept the easement and negotiating the easement can be a quite lengthy process.

#### **4. Valuation Penalties.**

a. Substantial and gross valuation penalty tests toughened.

**Income tax:** Substantial valuation misstatement--If there is an underpayment of income tax by more than \$5,000 and if the value claimed on the return is from 150% to 200% (down from 200% to 400%) of the "correct" value, there is a penalty of 20% of the underpayment of income tax attributable to the overvaluation. Gross valuation misstatement--The penalty is 40% if the valuation claimed is 200% (down from 400%) of the "correct" value. § 6662(a,e & h).

**Estate and gift tax:** Substantial valuation misstatement--If there is an underpayment of estate or gift tax by more than \$5,000 and if the value claimed on the return is from 65% to 40% (up from

50% to 25%), there is a penalty of 20% of the underpayment of estate or gift tax attributable to the undervaluation. Gross valuation misstatement--The penalty is 40% if the valuation claimed is 40% (up from 25%) or less of the "correct" value. I.R.C. §6662 (g-h). For example, the 20% substantial valuation misstatement penalty could apply if an estate or gift tax return claims a 35% discount that is disallowed totally. It is much more likely to see penalty situations than in the past. For example, assume that the appraiser applies a 45% discount for a going business with an underlying value of 100,000, for a value of \$55,000. If the IRS and court determine that the discount should have only been 15%, the "correct" value would be \$85,000. The appraised value is only 64.7% [i.e., less than 65%] of the "correct" value, so 20% substantial understatement penalty would apply. § 6662(g-h).

*Reasonable cause is no longer a defense to a gross valuation misstatement penalty for income, estate, or gift tax purposes. These tougher rules apply to any returns filed after the date of enactment.*

#### **b. Penalty imposed on appraisers.**

Rather than the aiding and abetting penalty under §6701 (generally limited to \$1,000), appraisers are now subject to a penalty equal to the greater of \$1,000 or 10% of the underpayment attributable to the valuation misstatement, up to a maximum of 125% of the gross income received for preparing the appraisal, in certain circumstances. §6695A(b). The appraiser penalty applies (i) if the appraiser knew or should have known that the appraisal would be used in connection with a return or refund, and (ii) if the appraised value results in a substantial valuation misstatement or a gross valuation misstatement. §6695A(a). No penalty is imposed on the appraiser if the appraiser establishes that the appraised value was "more likely than not" the correct value. §6695A(c). (That may be difficult to prove after the court has determined that the correct value was actually substantially or grossly different than the appraised value.) *The appraiser penalty applies for appraisals prepared for returns or submissions filed after the date of enactment. We will have to see if this provision has a "chilling" effect on appraisers and significantly affects appraisals for tax purposes. Appraisers may be much more conservative in giving tax appraisals than when giving appraisals for "real life" transaction purposes.*

**5. Regulations to Avoid Transfer Tax Abuses of Section 529 Plans.** The Act gives the IRS broad authority to write regulations to avoid transfer tax abuses of Section 529 Plans. For example, the Committee Report gives the example of an individual who may create multiple Section 529 Plans for various beneficiaries (using the provision allowing contributions of five times the annual exclusion per donee), with the intention of subsequently changing the designated beneficiaries to a single common beneficiary, and distributing the entire amount to that beneficiary without further transfer tax consequences. Another abuse possibility is if the donor creates large Section 529 Plans, exempt from current income taxation, with the intent to change the beneficiary back to the donor at some point, thus effectively turning the Plan into a tax deferred retirement account without the restrictions and requirements of qualified retirement plans. The Act provides in new §529(f) that the IRS has the authority to prescribe regulations to carry out the purposes of Section 529 Plans and to prevent abuses, including regulations under chapters 11, 12, and 13 (i.e., estate, gift and GST tax).