

# **Recent Federal and North Carolina Developments in Charitable Planned Giving and Selected Planned Gift Vehicles**

North Carolina Planned Giving Council

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## **I. Federal Tax Legislation Summary**

### **A. President Obama's "Green Book"**

The Department of the Treasury recently released in May 2009 the "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" publication which is commonly referred to as the "Green Book." Included below are the three proposals contained in the Green Book that are directly related to the gift and estates tax practice.

#### **1. Duty of Consistency – Require Consistency in Value for Transfer and Income Tax Purposes**

##### Current Law

Section 1014 provides that the basis of property acquired from a decedent generally is the fair market value of the property on decedent's date of death. Similarly, property included in the decedent's gross estate for estate tax purposes generally must be valued at its fair market value on date of death. Although the same valuation standard applies to both provisions, current law does not explicitly require that the recipient's basis in that property be the same value at which that property was reported for estate tax purposes.

Section 1015 provides that the donee's basis in property received by gift during the life of the donor generally is the donor's adjusted basis in the property, increased by gift tax paid on the transfer. If, however, the donor's basis exceeds the fair market value of the property on the date of the gift, the donee's basis is limited to that fair market value for purposes of determining any subsequent loss.

Section 6034A imposes a consistency requirement – specifically, that the recipient of a distribution of income from a trust or estate must report on the recipient's own income tax return the exact information included on the Schedule K-1 of the trust's or estate's income tax return – but this provision applies only for income tax purposes, and the Schedule K-1 does not include basis information.

##### Reasons for Change

Taxpayers should be required to take consistent positions in dealing with the Internal Revenue Service, whether or not principles of privity apply. If the logic underlying the new basis in property acquired on the death of the owner is that the new basis is the amount used to determine the decedent's estate tax liability, then the law should require that the same value be used by the recipient, unless that value is in excess of the accurate value. In the case of property transferred on death or by gift during life, often the executor of the estate or the donor, respectively, will be in the best position to ensure that the recipient receives the

necessary information that will determine that recipient's basis in the transferred property.

#### Proposal

This proposal would require both consistency and a reporting requirement. The basis of property received by reason of death under Section 1014 would have to equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor would have to equal the donor's basis determined under Section 1015. This proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments). A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary information to both the recipient and the IRS. A grant of regulatory authority would be included to provide details about the implementation and administration of these requirements, including rules for situations in which no estate tax return is required to be filed or in which gifts are excluded from gift tax under Section 2503, for situations in which the surviving joint tenant or other recipient may have better information than the executor, and for the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.

This proposal would be effective as of the date of enactment.

## **2. Valuation Discounts – Modify Rules on Valuation Discounts**

#### Current Law

The fair market value of property transferred, whether on the death or during the life of the transferor, generally is subject to estate or gift tax at the time of the transfer. Sections 2701 through 2704 of the Internal Revenue Code were enacted to prevent the reduction of taxes through the use of "estate freezes" and other techniques designed to reduce the value of the transferor's taxable estate and discount the value of the taxable transfer to the beneficiaries of the transferor when the economic benefit to the beneficiaries is not reduced by these techniques. Generally, Section 2704(b) provides that certain "applicable restrictions" (that would normally justify discounts in the value of the interests transferred) are to be ignored in valuing interests in family controlled entities if those interests are transferred (either by gift or on death) to or for the benefit of other family members. The application of these special rules results in an increase in the transfer tax value of those interests above the price that a hypothetical willing buyer would pay a willing seller, because Section 2704(b) generally directs an appraiser to ignore the rights and restrictions that would otherwise support significant discounts for lack of marketability and control.

#### Reasons for Change

Judicial decisions and the enactment of new statutes in most states have, in effect, made Section 2704(b) inapplicable in many situations, specifically, by

recharacterizing restrictions such that they no longer fall within the definition of an “applicable restriction.” In addition, the Internal Revenue Service has identified additional arrangements designed to circumvent the application of Section 2704.

#### Proposal

This proposal would create an additional category of restrictions (“disregarded restrictions”) that would be ignored in valuing an interest in a family controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor’s family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder’s right to liquidate that holder’s interest that are more restrictive than a standard identified in regulations. A disregarded restriction also would include any limitation on a transferee’s ability to be admitted as a full partner or holder of an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family controlled entity so as to avoid the application of Section 2704 if certain standards are met. This proposal would make conforming clarifications with regard to its interaction with the transfer tax marital and charitable deductions.

This proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of Section 2704).

### **3. Grantor Retained Annuity Trusts (GRATs) – Require Minimum Term for GRATs**

#### Current Law

Section 2702 provides that, if an interest in a trust is transferred to a family member, the value of any interest retained by the grantor is valued at zero for purposes of determining the transfer tax value of the gift to the family member(s). This rule does not apply if the retained interest is a “qualified interest.” A fixed annuity, such as the annuity interest retained by the grantor of a GRAT, is one form of qualified interest, so the gift of the remainder interest in the GRAT is determined by deducting the present value of the retained annuity during the GRAT term from the fair market value of the property contributed to the trust.

Generally, a GRAT is an irrevocable trust funded with assets expected to appreciate in value, in which the grantor retains an annuity interest for a term of years that the grantor expects to survive. At the end of that term, the assets then remaining in the trust are transferred to (or held in further trust for) the

beneficiaries, who generally are descendants of the grantor. If the grantor dies during the GRAT term, however, the trust assets (at least the portion needed to produce the retained annuity) are included in the grantor's gross estate for estate tax purposes. In this event, although the beneficiaries will own the remaining trust assets, the estate tax benefit of creating the GRAT (specifically, the tax free transfer of the appreciation during the GRAT term in excess of the annuity payments) is not realized.

#### Reasons for Change

GRATs have proven to be a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers, providing that the grantor survives the GRAT term and the trust assets do not depreciate in value. The greater the appreciation, the greater the transfer tax benefit achieved. Taxpayers have become more adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), in many cases to 2 years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability.

#### Proposal

This proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of 10 years. Although a minimum term would not prevent "zeroing out" the gift tax value of the remainder interest, it would increase the risk of the grantor's death during the GRAT term and the resulting loss of any anticipated transfer tax benefit.

This proposal would apply to trusts created after the date of enactment.

#### **4. Estate Tax Rate and Applicable Exclusion Amount**

To better measure the effects of the Administration's proposed policy changes, the Appendix to the Green Book states that the Administration's baseline projection of current policy continues all of the tax reductions enacted in 2001 and 2003 which are set to expire on December 31, 2010, except for the real of estate and generation-skipping transfer taxes. Estate and gift taxes were assumed to be extended at parameters in effect of calendar year 2009 (i.e., a top rate of 45% and an applicable exclusion amount of \$3.5 million).

#### **B. Legislative Proposals**

##### **1. H.R. 436, Certain Estate Tax Relief Act of 2009**

On January 9, 2009, H.R. 436, Certain Estate Tax Relief Act of 2009, was introduced by Representative Pomeroy (D-ND). The bill proposes to:

- Retain the current \$3.5 million applicable exclusion amount in effect for 2009
- Retain the present basis step-up rules
- Freeze the maximum rate at 45% for estates up to \$10 million
- Subject estates valued in excess of \$10 million to an additional 5% tax, not to exceed the amount of the applicable exclusion amount plus \$119,200
- Add two new subsections to IRC § 2031 related to valuation:
  - The first subsection would generally disallow the use of valuation discounts in transfers of interests in non-publicly traded entities holding “nonbusiness assets” (“passive assets”). In tiered ownership structures, except for de minimis interests (less than 10% interest in the lower-tier entity), the lower-tiered entities will also be disregarded and the interest will be valued by treating the owning entity as holding directly its share of the assets of the lower-tiered entity.
  - The second subsection proposes to eliminate minority interest valuation discounts with respect to any interest in family controlled, non-publicly traded entities, regardless of any active trade or business. (This provision would specifically prohibit taking minority discounts when transferring FLP interests to family members)

**2. H.R. 498, Capital Gains and Estate Tax Relief of 2009**

On January 14, 2009, H.R. 498, Capital Gains and Estate Tax Relief Act of 2009, was introduced by Representative Mitchell (D-AZ). The bill proposes to:

- Make the applicable exclusion amount permanent at \$5 million (phased in by 2015)
- Index the applicable exclusion amount for inflation after 2015
- Reunify the estate and gift tax
- Set the top estate and gift tax rate at the capital gains rate for estates of up to \$25 million and double that rate for estates over \$25 million
- Index the \$25 million figure for inflation after 2015
- Repeal the estate tax deduction for state death taxes
- Retain the present basis step-up rules
- Allow for “portability” — make the unused applicable exclusion amount of the first spouse to die available to the surviving spouse

**3. S. 722, The Taxpayer Certainty and Relief Act of 2009**

On March 26, 2009, S. 722, The Taxpayer Certainty and Relief Act of 2009, was introduced by Senate Finance Committee Chair Baucus (D-MT). The bill proposes to:

- Retain the current \$3.5 million applicable exclusion amount in effect for 2009
- Freeze the maximum rate at 45% for estates
- Reunify the estate and gift tax
- Index applicable exclusion amount for inflation starting after 2010
- Allow for “portability” – make the unused applicable exclusion amount of the first spouse to die available to the surviving spouse
- Increase special use valuation amount under § 2032A to \$3.5 million

#### **4. H.R. 2023, Sensible Estate Tax Act of 2009**

On April 22, 2009, H.R. 2023, Sensible Estate Tax Act of 2009, was introduced by Representative McDermott (D-WA). The bill proposes to:

- Make the applicable exclusion amount permanent at \$2 million (indexed for inflation after 2010)
- Revise the applicable estate tax rates such that the initial rate would be 45%, estates between \$5 million and \$10 million are subject to a rate of 50% and estates valued at greater than \$10 million are subject to a 55% rate (each rate being indexed for inflation after 2010)
- Restore the state death tax credit and repeal the state death tax deduction
- Reunify the estate and gift tax
- Allow for “portability” – make the unused applicable exclusion amount of the first spouse to die available to the surviving spouse

#### **5. H.R. 3905, Estate Tax Relief Act of 2009**

On October 22, 2009, H.R. 3905, Estate Tax Relief Act of 2009, was introduced by Representative Berkley (D-NV). The bill proposes to:

- Make the applicable exclusion amount permanent at \$5 million (phased in by 2019)
- Index the applicable exclusion amount for inflation after 2019
- Reduce the maximum estate tax rate by 1% each year from 2010 to 2019 such that the maximum rate in 2019 would be 35%
- Repeal the estate tax deduction for state death taxes (phased out by 2019)

#### **6. Senate Finance Committee Estate Tax Extender Bill**

As calendar year 2009 draws near to its end, the likelihood of passage of any of the four above noted estate tax reform bills becomes diminished. As recently as October 19, 2009, a senior Senate Finance Committee staffer, Russell Sullivan, stated that the more likely outcome is that the Senate Finance Committee will propose an “extender” bill which would serve to extend the current estate tax provisions through 2010, thereby avoiding the estate tax sunset and providing

