

ADVISORY

SULLIVAN & WORCESTER TAX ADVISORY

Charitable Giving Incentives and Reforms

The Pension Protection Act of 2006 (the "Act"), signed by the President on August 17, 2006, introduced important incentives as well as reforms for charitable giving. These changes are in addition to many new rules regarding the operation of tax-exempt organizations¹ and, taken together, will have a significant impact on philanthropy in America. Many of the following charitable giving incentives are limited in their scope and provide brief windows for implementation. The reforms, while targeted toward specific types of giving, are not limited in their duration.

CHARITABLE GIVING INCENTIVES

I. Tax-Free Distributions from Individual Retirement Accounts

For years this much sought after incentive has been proposed for passage by Congress. What finally was passed as part of the Act is a limited and temporary provision providing incentives for direct distributions to certain charities from individual retirement accounts (IRAs).

For the remainder of 2006 and 2007, a direct distribution of up to \$100,000 each year from a taxpayer's individual retirement accounts to certain public charities will be excluded from income. Only donors who have reached 70½ may take advantage of this provision. To be excluded from income the distribution to charity must be made directly by the IRA trustee.

Distributions may not be made to private foundations, supporting organizations or to donor advised funds. Nor will distributions be "qualifying distributions" if the contribution is not wholly deductible under present law (determined without regard to percentage limitations that would be taken into account if the distribution were first taken into income and then contributed to the charity). Therefore, a direct transfer to a split-interest trust, such as a charitable remainder or lead trust, or in return for a charitable gift annuity, will not be a qualifying distribution. Further, if proper substantiation is not obtained for the direct distribution to charity, the transfer will not be a qualifying distribution because such substantiation is required for a gift to be deductible under present law.

IF YOU WOULD LIKE ADDITIONAL INFORMATION, PLEASE CONTACT:

John K. Graham
617 338 2941
jgraham@sandw.com

Judith G.H. Edington
617 338 2422
jedington@sandw.com

BOSTON

Sullivan & Worcester
One Post Office Square
Boston, MA 02109

NEW YORK

Sullivan & Worcester
1290 Avenue of the Americas
New York, NY 10104

WASHINGTON, DC

Sullivan & Worcester
1666 K Street, NW
Washington, DC 20006

SULLIVAN &
WORCESTER

A "qualified charitable distribution" as described above will not be taken into account in calculating a donor's deduction under Section 170 for other charitable gifts made. Qualified charitable distributions *are* taken into account for purposes of the minimum distribution rules applicable to the IRA. Special rules will apply for taxpayers that direct distributions from IRAs that include nondeductible contributions, generally treating distributions as first coming from deductible portions of the individual's IRA (e.g. consisting of income).

II. S Corporation Stock

Under prior law, when an S corporation made a charitable contribution of appreciated property, a shareholder's basis in the S corporation stock was reduced by his pro rata share of the fair market value of the charitable contribution. This basis reduction caused the taxpayer to recognize more gain when his S corporation stock was sold – a result that would not have taken place if the appreciated property had been donated directly by a shareholder. The Act addresses this result by providing that the decrease in the shareholder's basis in the S corporation stock by reason of a charitable contribution equals the pro rata share of the adjusted basis of the contributed property, not its fair market value. Unfortunately this "fix" only applies to gifts made in tax years beginning in 2006 and 2007.

III. Incentives for Qualified Conservation Contributions

Generally speaking, a taxpayer may not deduct in any one year a cash gift to a public charity (as opposed to a private grantmaking foundation) that exceeds 50% of his adjusted gross income ("contribution base"). A gift that exceeds this percentage limitation may be carried forward for the five years following the initial gift. Deductions for gifts to public charities of long-term capital gain property are limited to 30% of the taxpayer's contribution base. The taxpayer's gifts are aggregated for purposes of applying the percentage limitations and gifts of capital gain property are taken into account after other charitable contributions.

Gifts of land for conservation purposes, including gifts of conservation restrictions ("conservation gifts"), made after August 17, 2006 and prior to

December 31, 2007 will qualify for the 50% percentage limitation instead of the 30% that would normally apply to appreciated property. Further, any excess deduction resulting from such gifts can be carried forward for 15 instead of 5 years.

Gifts of land for conservation purposes are not taken into account when determining the amount of other allowable gifts made by the taxpayer. For example, assume a taxpayer has a contribution base of \$100 and makes a conservation gift of property with a fair market value \$80. The taxpayer makes other charitable gifts subject to the 50% limit of \$50 in the same year. A deduction is allowed for \$50 for the non-conservation gifts, with \$10 carried forward for up to 5 years. No deduction for the conservation gift may be taken in the year of the gift because other 50% gifts had been made that take up 50% of the taxpayer's contribution base. However, the conservation gift may be carried forward for up to 15 years. This ordering enables gifts limited to the five year carry forward to be utilized first, followed by the conservation gifts which will benefit from the extended carry forward period.

If the taxpayer receives over 50% of his income from farming or ranching, then a conservation gift may be deducted up to 100% of the excess of the taxpayer's contribution base over other allowable charitable contributions, so long as the land is restricted in a way that ensures that it remains available for agriculture or livestock production.

Gifts of land in fee or gifts of conservation restrictions on land tend to be gifts of high fair market value. Existing percentage limitations have generally meant that only persons with high incomes have been able fully to deduct these gifts. For a limited period, this provision will make conservation gifts advantageous for a broader range of taxpayers.

Incentive paired with reform. Conservation restrictions are difficult gifts to value. Despite the mandate for providing incentives for these and other conservation related gifts, the IRS is concerned that gifts of appreciated property, especially conservation restrictions, are being over-valued for deduction purposes. To address this concern the Act lowers the thresholds for applying penalties for overvaluing (for income tax

purposes) or undervaluing (for gift and estate tax purposes) the valuation of property. The Act also introduces penalties against appraisers if the appraisal results in a substantial or gross valuation misstatement and tightens the definition of who is a qualified appraiser.

CHARITABLE GIVING REFORMS

I. New Substantiation Requirements

Currently, to take a charitable income tax deduction of \$250 or more, a donor must receive a contemporaneous acknowledgment from the donee charity to substantiate the contribution. This is in addition to other substantiation requirements that may apply depending on the value and nature of the contribution (e.g. qualified appraisal requirements for noncash contributions over \$5,000).

Under the provisions of the Act, effective for tax years beginning after August 17, 2006

- No income tax charitable deduction will be allowed for any contribution of cash (check or other monetary gift) unless the taxpayer maintains as a record of the gift a bank record or a written communication from the donee charity that shows its name and the date and amount of the contribution. A cancelled check should satisfy the bank record requirement; presumably so would a credit card statement showing the payment to charity, but that is less clear from the plain text of the statute. As the current substantiation rules for gifts of \$250 or more will meet this requirement, this provision clarifies the record keeping requirement for cash gifts of less than the \$250 threshold. This rule will impact small cash contributions where there are practical difficulties in obtaining receipts (e.g., the offering plate at religious organizations).
- No income tax charitable deduction will be allowed for any contribution to a donor advised fund unless the taxpayer receives a contemporaneous written acknowledgment from the sponsoring organization of the fund stating that it has exclusive legal control over the assets contributed to the donor advised fund.

II. Requirements Tightened for Easements on Certain Historic Buildings

The Act strengthens the requirements for deductible donations of easements on historic buildings (so-called "façade easements") located

in a registered historic district and disallows a charitable deduction for land and certain structures located in such districts. Under the provisions, the easement must protect the entire exterior of the building (including height) and prohibit any change that is inconsistent with the building's historic character. The taxpayer and the donee organization must enter into a written agreement in which the donee certifies that it is an organization qualified to accept the easement under the Internal Revenue Code and that it has the resources to manage and enforce the restrictions under the easement and is committed to doing so. The Act also imposes a \$500 filing fee when claiming a deduction over \$10,000 for an easement on a building located in a registered historic district and bolsters the return requirements supporting claimed deductions. In particular, a qualified appraisal (no matter the value of the claimed deduction), along with pictures of all exteriors views of the building, and a description of all existing restrictions on alterations to the building's exterior, including zoning laws, local ordinances, neighborhood association rules and similar restrictions, must be included with the taxpayer's return claiming the deduction.

III. Tax Recapture if Exempt Use Property Sold

For charitable income tax purposes, the value of a gift of appreciated tangible personal property (e.g. artwork) is limited to the taxpayer's cost unless the charity uses the property for a purpose related to its charitable mission ("exempt use property"). Effective for contributions after September 1, 2006, the Act introduces recapture provisions to adjust the tax benefit of the donation if exempt use property (for which the donor claimed a deduction of more than \$5,000) is sold by the charity within 3 years of the donation. Specifically, if the exempt use property is sold in the year it is donated, the value of the taxpayer's donation is reduced to basis. If sold after the year of donation but within three years, the taxpayer will recognize ordinary income in an amount equal to the excess of the allowed deduction over the basis in the disposed property.

No recapture of tax benefits is required if the donee charity certifies either (i) the property was used in a manner related to the exempt purpose of the charity and describes the use and how it

furthered such purpose or (ii) the intended use was to further the charity's exempt purpose but such use has become impossible or infeasible to implement.

The provisions also impose a \$10,000 fine on any person who identifies a contribution as exempt use property knowing that it is not intended for such use.

IV. New Rules for Gifts of Fractional Interests

Gifts of fractional interests in tangible personal property, such as artwork, have become a useful tool for gift and estate planning. The Act introduces new rules for and restrictions on these types of gifts.

First, no charitable income or gift tax deduction is allowed for a gift of a fractional interest in tangible personal property unless just prior to the gift all interests in the property are owned by the taxpayer or the taxpayer and the donee charity.²

Secondly, the Act addresses the valuation of the second and subsequent gifts of the same property (whether or not fractional gifts). The value of this subsequent gift will be determined by using the lesser of the (i) fair market value of the property at the time of the initial fractional contribution or (ii) the fair market value of the property at the time of the subsequent contribution. This valuation rule applies to the charitable deduction for such gifts for income, gift and estate tax purposes. Prior to this rule, which is effective for gifts made after August 17, 2006, it was possible to make gifts of tangible personal property that appreciated over time such that the total value for income tax deduction purposes exceeded the fair market value of the property when the initial gift was made.

It is intended that fractional gifts made after August 17, 2006 will be treated as the "initial" fractional gift for purposes of the new rules, even if a fractional gift of the same property had been made prior to the date of enactment.

Lastly, the provisions require that

- the taxpayer's entire undivided interest in the tangible personal property be contributed to the same charitable donee (if still in existence) before the earlier of 10 years after the initial gift or the taxpayer's death; and
- during the period the charity holds only a

fractional interest in the property, the charity has substantial physical possession and uses the property in a way related to the charity's purpose.

These last two requirements are enforced by a recapture of the income and gift tax charitable deductions for all previous gifts of the property, plus interest, if the requirements are not met. An additional tax equal to 10% of the amount recaptured is also assessed on the taxpayer.

As written, these new rules lead to potentially draconian results if a donor does not make a gift of 100% of his interest in the tangible personal property **prior** to death. First, the "appreciated" value of the gift will remain in the taxable estate of the donor even though the property is fully bequeathed to the recipient charity. And if the donor dies **before** donating his entire interest, the recapture provisions will apply. Until further clarification of the application of these provisions, we advise against making gifts of fractional interests of tangible personal property.

¹ We have prepared a companion Client Advisory addressing changes in law that affect charitable organizations, such as supporting organizations and private foundations, as well as donor-advised funds. If you have not received this companion Advisory and would like to, please call John Graham (617/338-2941) or Judy Edington (617/338-2422) to request a copy or access a copy of the Advisory through our website at www.sandw.com.

² This is a harsh result for children who may have inherited in equal shares artwork from their parent as it would prevent a gift of part of or their entire undivided share to charity. Perhaps to address this result, the provision provides that the Secretary of the Treasury may, by regulation, allow an exception to the new rule in the case where all persons who hold an interest make proportional contributions of their interest in the property.

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This summary highlights those changes in the law regarding charitable giving we thought most relevant to our clients. To review your own charitable giving plans and interests in more detail, please call John Graham (617-338-2941), Judy Edington (617-338-2422) or any member of the Sullivan & Worcester LLP tax department.