

New Tax Law Affects Charitable Giving

The recently enacted Pension Protection Act of 2006 contains a package of provisions to help prevent abuse in the charitable sector and provide additional tax incentives for Americans to give more resources to the charitable community. The following provides a brief overview of those provisions.

Tax-free distributions from IRAs for charitable purposes. The Act permits taxpayers who have reached age 70-1/2, to exclude from gross income certain distributions of up to \$100,000 from a traditional individual retirement account (IRA) or Roth IRA which would otherwise be included in income. The charitable distribution must be made to a tax-exempt organization to which deductible contributions can be made. The change is effective for two years through 2007.

Charitable deduction for contributions of food inventory. Under the Act, an enhanced deduction for donations of food inventory which was formerly available only to C corporations is extended to all trades and businesses, effective for two years through 2007.

Basis adjustment to stock of S corporation contributing property. The Act provides that if an S corporation contributes property to a charity, an S corporation shareholder only has to reduce his basis in stock of the S corporation by his pro rata share of the adjusted basis of the contributed property, rather than by the amount of the charitable contribution that flows through to him. For example, if an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of \$200 and a fair market value of \$500, the shareholder will be treated as having made a \$500 charitable contribution and will reduce the basis of the S corporation stock by \$200. The provision is effective for two years through 2007.

Charitable deduction for contributions of book inventory. The provision extends the current-law provision that adds public schools to the list of eligible donees for the enhanced deduction for contributions of qualified book inventory by C corporations. The provision is effective for two years through 2007.

The tax treatment of certain payments to controlling exempt organizations. Under prior law, rent, royalty, annuity, and interest income paid to a tax-exempt organization by a controlled taxable subsidiary was generally treated as unrelated business income, which was taxable to the tax-exempt parent organization. The new law modifies that rule such that only the portion of such payments which is not regarded as fair market value will be treated as unrelated business taxable income. Exempt organizations are required to report certain amounts received from controlled organizations. The provision is effective for two years through 2007.

Qualified conservation contributions. The new law raises the limit on deducting contributions of capital gain property by individuals—from 30% of adjusted gross income to 50%—for qualified conservation contributions. The charitable deduction limit is raised to 100% for qualified conservation contributions by individual and corporate farmers and ranchers, as long as the contribution includes a restriction that the land

remain available for farming or ranching. Unused contributions can be carried forward for up to 15 years. The provision is effective for two years through 2007.

Charitable reform

The Act also imposes new requirements and restrictions on donors and exempt organizations.

The new rules:

- require reports to the Treasury Department on certain life insurance contracts.
- double the fines and penalties applicable to certain activities by charities, social welfare organizations, private foundations and exempt organization managers.
- clarify the terms of facade easements in historic districts, and also clarify that the charitable deduction is reduced if a rehabilitation tax credit has been claimed with respect to the donated property.
- limit the basis for donated taxidermy property to the cost of preparing, stuffing and mounting an animal and provide that the value of the deduction is equal to the lesser of basis or fair market value.
- require the recapture of any tax benefit derived from the contribution of property with respect to which a fair market value deduction was claimed if the property is not used for an exempt purpose of the donee organization. The change is effective for contributions made after September 1, 2006.
- prohibit deductions for contributions of clothing and household items unless they are in good used condition or better. In addition, IRS may deny a deduction for any item with minimal monetary value. These rules, which are effective for contributions made after August 17, 2006, don't apply to any contribution of a single item of clothing or a household item for which a deduction of more than \$500 is claimed if the taxpayer includes with his return a qualified appraisal for the donated property.
- require that in the case of a charitable contribution of money, regardless of the amount, the donor must maintain a cancelled check, bank record or receipt from the donee organization showing the name of the donee organization, the date of the contribution, and the amount of the contribution. This is effective for contributions made in tax years beginning after August 17, 2006.
- require that donors contributing a **fractional** interest in an item of tangible personal property to a charity contribute their remaining interest in the item to the same charity. The donee charity must take complete ownership of the item within 10 years or at the death of the donor, whichever occurs first. In addition, the donee must have (i) taken possession of the item at least once during the 10-year period as long as the donor remains alive, and (ii) used the item for its exempt purpose. Failure to comply with these requirements results in the donor's recapture of all charitable deductions claimed for **fractional** interest gifts of the item plus interest and the imposition of a 10% penalty. The change is effective for contributions, bequests, and gifts made after August 17, 2006.
- lower the threshold for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property for which a qualified appraisal is required.

- impose certain requirements on tax-exempt organizations that offer credit counseling services, subject to a four-year transition rule to limit the allowable amount of debt management plan income to 50% of revenues.
- apply an excess benefits transaction tax on any grant, loan, compensation or other similar payments from a donor-advised fund to a person that with respect to such fund is a donor, donor adviser, or a related person, and from a supporting organization to a substantial contributor or a related person.
- require that unrelated business income tax returns of section 501(c)(3) organizations be made publicly available.

If you would like more details about these or any other aspect of the new law, please do not hesitate to contact Vincent Ruocco, LLC, CPA by phone 203.932.2931 or by email vruocco@artcpas.com.

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