IRS GETS LESS CHARITABLE

New tax rules for charitable deductions create hurdles to taxpayer philanthropy

BY SAMUEL L. BRAUNSTEIN AND CAROL F. BURGER

Generosity is a noble trait shared by many Americans. Just ask the Internal Revenue Service. Traditionally, this generosity has been rewarded with favorable tax treatment by the Internal Revenue Code and IRS regulations, primarily in the form of deductions pegged to qualifying charitable contributions of cash or property.

In 2004, the most recent tax year for which IRS statistics are complete, some $122.9 billion in cash gifts to charitable organizations were claimed on 38.5 million individual returns that itemized deductions (out of more than 132 million total returns). Some $43.4 billion in deductions for non-cash charitable contributions were reported on some 25.3 million individual returns.

But the federal tax laws are getting stingy in their treatment of charitable donations—one of the few remaining deductions available to a broad range of taxpayers—as part of a larger effort to clamp down on the tendency of taxpayers to "exaggerate" deductions. Business expenses claimed by self-employed taxpayers are also getting more attention from the IRS.

A number of restrictions on deductions for charitable donations are contained in the Pension Protection Act of 2006. The act requires, for instance, that all cash donations claimed as deductions be supported by bank records or written confirmation from the charity. The act also mandates that donated clothing and household items be in good used condition or better—a standard the act doesn't specifically define—to qualify for deduction. (Household items include furniture, furnishings, electronics, appliances, linens and similar items. The act did not change separate rules covering food, objects of art, jewelry and collections.) The act even sets new restrictions on donations of taxidermy property.

In addition, the act calls for the Treasury Department to take a closer look at donor advised funds, a vehicle for charitable giving that is growing in popularity. Under this approach, a donor deposits a gift with the fund. The fund gains full control over the donation, which allows the donor to claim any deduction at the time the gift is made, but the donor also retains the right to recommend the charities to which the fund should distribute the gift. Those recommendations usually are followed.

The act requires that contributions to a donor-advised fund made after Feb. 14, 2007, be accompanied by a contemporaneous written acknowledgment from the fund sponsor that it retains exclusive legal control over the assets contributed.

A number of donor advised funds are under examination by the IRS for possible violations of a requirement that donors may not receive personal benefits-payment of tuition or personal expenses, for example-from a fund. If that happens, the donor's tax deduction may be disallowed, and the investment income earned or benefits received may be taxed to the donor. Meanwhile, the organization sponsoring the fund may lose (or fail to qualify for) its tax-exempt status under IRC § 501(c)(3).

New rules also apply to contributions of used vehicles, boats and airplanes. Under the American Jobs Creation Act of 2004, the donor's deduction for any such items valued at more than $500 is limited to the gross proceeds received by the charity when it sells the vehicle in an arm's-length transaction. Exemptions to that rule apply when the charity makes significant intervening use of the vehicle or improves it, or the sale is to a needy individual in direct furtherance of the organization's charitable purpose. (When vehicles are donated, the charity must provide the donor with a 1098-C form or some substitute showing the gross proceeds of sale or setting forth evidence for an exception.)

But the tax laws relating to charitable gifts cover much more than simple donations of cash, clothes and cars.

Charitable donations often are big-ticket items involving sophisticated financial mechanisms. While clothing and household items are the most common types of donations, corporate stock accounted for the largest amount of donations reported by taxpayers using Form 8283 (Noncash Charitable Contributions) in 2004, according to the IRS' Statistics of Income Bulletin for spring 2007. The Bulletin also reports that nearly a quarter of the non-cash charitable donations reported on Form 8283 for 2004 were made by taxpayers with adjusted gross incomes of $10 million or more.

DIFFERENT GIFTS, DIFFERENT RULES

As stated in IRS Publication 526 (Charitable Contributions), "Generally, you can deduct your contributions of money or property that you make to, or for the use of, a qualified organization."

The simplicity pretty much ends there.

Cash donations to qualified organizations (listed in IRS Publication 78, available at www.irs.gov/charities) are deductible in full, up to certain maximums. For cash donations to a public charity or a private operating foundation, the maximum deduction is 50 percent of a donor's adjusted gross income for the year. If the gift recipient is a non-operating private foundation, the maximum deduction is 30 percent of the donor's AGI.

For tax purposes, it may be more advantageous to contribute appreciated property rather than cash. In general, if a taxpayer donates stock to a public charity that would have resulted in a long-term capital gain if it had been sold instead, the taxpayer may claim a charitable deduction for the fair-market value of the property-and is not required to pay tax on the appreciation.

For example: Years ago, Mr. Taxpayer bought stock for nearly nothing that now is worth $100,000. Assuming he is in a 45 percent combined federal, state and local ordinary income tax bracket, and a 25 percent combined bracket on capital gains, Mr. Taxpayer would only be able to keep $75,000 if he sold the stock for its current market value of $100,000. But if he instead contributes the stock to charity, he would be entitled to a $100,000 deduction, which would save him $45,000 in taxes. So the actual difference between selling the stock and donating the stock is only $30,000. Meanwhile, his charity of choice has stock worth $100,000, which it may immediately sell without incurring any tax liability.

But limitations also apply to donations of appreciated property. The adjusted gross income limitation is 30 percent when appreciated property is contributed to a public charity or private operating foundation, and 20 percent when the contribution is to a non-operating private foundation. Donors may, however, increase the percentage they can claim from 30 percent to 50 percent if they forego the built-in gain in value of the property.

The charitable deduction may be further limited if a gift of appreciated property is made to a private non-operating foundation. In general, for contributions of property other than "qualified appreciated stock"-publicly traded stock not subject to securities law restrictions on sale—a donor's deduction is limited to his tax basis unless the foundation makes a qualifying distribution out of corpus within 2½ months after the end of its tax year in which the contribution was received. The donor should be careful about having the foundation continue to hold the contributed property, particularly if its value is subject to fluctuations, since the amount the foundation must distribute remains fixed regardless of whether the property depreciates in value.

Charitable gifts of tangible personal property—i.e. cars, furniture, jewelry, art, rugs—may be particularly advantageous to the taxpayer since the maximum federal tax rate on long-term gains from the sale of such property is 28 percent, rather than the capital gains rate, which is 15 percent or lower, depending on income bracket.

The donor must be careful, however, before making gifts of artwork and certain other types of tangible personal property that the charitable entity would not reasonably be expected to use to carry out its tax-exempt mission. In that case, the donor's deduction is limited to his tax basis in the property rather than the fair market value.

For contributions of tangible personal property made after Sept. 1, 2006, the Pension Protection Act requires that a donor recapture as ordinary income the portion of a

deduction in excess of his tax basis if the claimed value of all similar items of contributed property exceeds $5,000 and the donee disposes of the property within three years.

Recapture would not be required, however, under one of two circumstances: (1) If the donee certifies and explains to the donor that the use of the property is in a manner consistent with the donee's tax-exempt purpose; or (2) the donee certifies that it has become impossible to use the property in an intended manner consistent with the donee's tax-exempt purpose.

Under existing rules, a donor will receive a reduced deduction for a contribution of property held as inventory, property that has been depreciated or any property not held for at least a year, since a full fair-market value deduction is generally available only for property which would generate long-term capital gain if it were sold. (Separate rules apply to certain items, including food and book inventories, contributed prior to Dec. 31, 2007.) Contributions by C corporations of certain computer or scientific technology or equipment, which would otherwise be ordinary income property, are subject to more lenient rules.

Here are other areas where special rules apply:

— In the case of mortgaged property or partnership interests when there are partnership liabilities, the donor may have to recognize gain when making the contribution and the charity may wind up with unrelated business taxable income.

— For donated securities of a corporation that is the target of a tender offer or that is in the process of liquidating, and securities that the donor was negotiating to sell, if the transaction has progressed too far, the donor will be deemed to have sold the property and will have to recognize a capital gain.

— A gift of a partial interest in property is made by donating a fractional interest or temporal interest in the property. Charitable gifts of lead or remainder interests made in trust are only deductible if the trust qualifies under the Internal Revenue Code. Other charitable gifts of partial interests generally are not deductible, with exceptions for contributions of remainder interests in personal residences or farms, contributions of undivided interests and qualified conservation contributions.

For instance, if Taxpayer X donates 100 shares to Charity Y, but retains the right to the dividend income, no portion of the gift is deductible because the gift is limited to a partial interest.

Likewise, no deduction is permitted for a gift of a future interest in tangible personal property until all intervening interests have expired or are held by persons other than the donor or persons related to the donor.

For gifts of undivided interests in tangible personal property to be deductible, the gift must consist of a percentage of every substantial right owned by the donor and must extend over the entire term of the donor's interest.

Under the Pension Protection Act, for contributions after Aug. 17, 2006, no deduction is permitted for a gift of an undivided interest in tangible personal property unless all interests in the property immediately before the contribution are held by the donor, or the donor and donee (an exception being proportional donations by multiple owners). If an additional interest in the same property is contributed at a later date, the value of the property for purposes of the later contribution deduction is the lesser of the value of the property at the date of the initial contribution or the value of the property at the date of the later contribution.

A charitable deduction that is initially allowed for a gift of undivided interests may be recaptured if the donor does not contribute full ownership before the earlier of 10 years after the initial contribution and the donor's death, or if the donee does not, within this period, have substantial physical possession of the property and use it for purposes consistent with its exempt function.

SUBSTANTIATE IT IN WRITING

The Pension Protection Act has reinforced the requirements for substantiating donations that escalate along with the value of the gift.

In addition to the act's requirement that all cash gifts be substantiated by the donor's bank records or written confirmation from the donee, any contributions of more than $250—in the form of cash or property—must be substantiated by a contemporaneous written acknowledgment from the donee that (in the case of property) describes the item contributed and states whether the donee provided any goods or services in return for the contribution, and if so, describes them.

"Contemporaneous," in this case, means prior to the date on which the taxpayer files a return for the contribution or to the due date, including extensions, for the return.
If a donor contributes property worth more than $500, the donor must also complete Section A of Form 8283 and include the form with his return.

If the donor contributes property (other than marketable securities) worth more than $5,000, or more than $10,000 in the case of closely-held stock, the property must be appraised, and the appraiser must sign Section B of Form 8283, which is filed by the donor. The donee must also sign file Form 8283, acknowledging receipt of the gift. If the charity disposes of the property within three years after receiving the gift, it must notify both the IRS and the donee of the disposition and any sales price, unless the charity consumed or distributed the property without receiving consideration and in fulfillment of the donee's charitable purposes.

If a taxpayer attends a $300-a-plate fundraising dinner, or purchases other goods or services from a charity, he can only deduct the value of his contribution in excess of what he receives. If this type of “quid pro quo” contribution exceeds $75, the charity must provide the donor with a written statement that includes a good-faith estimate of the value of the benefits given to the donor. An exception to the quid pro quo rules applies for items deemed to have insubstantial value (under $8.90 for 2007), non-commercial quality publications, and benefits worth less than 2 percent of the contribution up to a maximum of $89 (for 2007). Also exempted are certain membership benefits for an annual payment of $75 or less, including privileges that can be exercised frequently, like free admission to a museum or free parking.

A TOOL TO FIGHT TERRORISM

Taxpayers who seek deductions for their contributions to charities aren’t the only ones dealing with tougher tax guidelines. Charities themselves also must navigate through that more complex tax environment.

Some of the new rules put charities on the front lines in the fight against terrorism. Following the terrorist attacks on Sept. 11, 2001, President Bush’s Executive Order 13224 and the USA PATRIOT Act have put many aspects of charitable giving come under special scrutiny in government efforts to block the use of nonprofit organizations as a way of funding terrorist groups. As a result, charities now are required to maintain and submit much more information regarding their operations, composition and activities than at any time in the past.

Bush signed Executive Order 13224 on Sept. 23, 2001, declaring a national emergency to deal with threats from foreign terrorists to the national security, foreign policy and economy of the United States. Generally, the order prohibits transactions with “persons” (encompassing both individuals and organizations) deemed by the executive branch to be associated with terrorism. It blocks any assets controlled by or in the possession of such individuals and organizations and those who support them, including their subsidiaries, front organizations, agents and associates. The USA PATRIOT Act, passed by Congress later in 2001, expanded the Treasury Department’s powers to regulate financial transactions with suspected links to terrorist groups.

Executive Order 13224 has far-reaching significance for charities that make grants to support activities outside the United States.

The executive order authorizes the federal government to freeze all assets of individuals and organizations-including charities—identified as terrorists, controlled by terrorists or otherwise associated with terrorists. And the order specifically prohibits donations to such individuals and organizations, and all transactions involving frozen property. Knowledge or intent to assist a terrorist group is not necessary for the order to be invoked against a charity or other entity. The order also covers grants made by a charitable organization to other charitable groups.

Although Executive Order 13224 does not directly address whether it applies to an organization's donors, a donor advised fund, for instance, might find all its assets frozen if it received funds from any individual or organization linked by the government to terrorists and followed that party's recommendation to provide funding to individuals or organizations linked to terrorism.

For charities, a major burden is keeping track of who the government has identified as terrorists or linked to terrorists. Several government lists provide that information, primarily the Specially Designated Nationals list maintained by the Treasury Department's Office of Foreign Assets Control and the Justice Department's U.S. Government Terrorist Exclusion List. Fortunately, it's possible to subscribe to commercial services that monitor the government lists.

So far, only a few U.S. charities have been subjected to asset freezes or other sanctions for supporting, directly or indirectly, terrorist organizations abroad. Further, it appears unlikely that such sanctions will be imposed against the assets of U.S. nonprofits that follow appropriate procedures for tracking the use of funds to charitable projects abroad.

Nevertheless, many larger charities have modified their operational due diligence, accounting and reporting requirements in response to the mandates of Executive Order 13224. Many others, however, are finding procedural compliance to be a more complicated and difficult matter. Moreover, indications are that most nonprofits are totally unaware of how the executive order and the USA PATRIOT Act affect them.

The Treasury Department provided some guidance in 2002 when it issued Anti-Terrorist Financing Guidelines: Best Practices for U.S.-based Charities. Treasury issued the latest revised version of the guidelines in September 2006. The revised guidelines purportedly take into account various comments and suggestions from the charitable community, including the Council on Foundations, which submitted its own Principles of International Charity in 2005.

The Treasury Department's guidelines are labeled "voluntary best practices"-they provide no safe harbors from the mandates of Executive Order 13224 or the USA PATRIOT Act. The revised guidelines describe four general principles for charitable organizations: They should follow the law, exercise due care in performing their duties, maintain fiscal responsibility and consider precautions that are above and beyond legal requirements.

In Part VI (Anti-Terrorist Financing Best Practices), the guidelines encourage charities to apply a "risk-based approach," particularly with respect to foreign recipients of grants, and develop methods to guard against diversion of funds for use by terrorists. The guidelines also recommend a long list of basic information that should be collected about potential grantees before distributing any charitable funds or in-kind contributions.

MORE TO COME

The Pension Protection Act also is adding another layer of requirements on charitable organizations, especially smaller ones.

To qualify as a charitable nonprofit organization under IRC § 501(c)(3), an entity must file Form 1023 (Application for Recognition of Exemption). The IRS issued the most recent revised version of Form 1023 in June 2006, and the service says the new form requires additional effort by applicants but will speed up the determination process. In addition to calling for more financial information from applicants, the form focuses heavily on current hot-button issues for charities, including donor advised funds, potentially abusive transactions, conflict of interest and operations abroad.

And there's more. Except for private foundations, small tax-exempt charitable organizations—those whose gross receipts are normally $25,000 or less—are not required to file Form 990 (Return of Organization Exempt From Income Tax) or Form 990-EZ (Short Form Return of Organization Exempt from Income Tax). But the Pension Protection Act requires that, starting in 2008, those entities must file Form 990-N, an electronic form known as the e-Postcard, with the IRS annually. Some exceptions are made for small organizations that already file other informational forms with the IRS. Churches and affiliated auxiliaries and associations also will be exempt from filing Form 990-N. But organizations that are required to file Form 990-N will face the loss of their tax-exempt status if they fail to do so.

Few if any charitable organizations are likely to abandon their missions under the growing burden of government regulations, nor should they expect to lose the support of donors. At the same time, their task sure isn't getting any easier.

Samuel L. Braunstein, a member of Braunstein & Todisco in Fairfield, Conn., is vice-chair/professional services in the ABA Section of Taxation. Carol F. Burger is a member of Troutman Sanders in New York City.

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