

PENSION PROTECTION ACT INCLUDES SAFEGUARD MEASURES AND TAX INCENTIVES FOR CHARITABLE GIVING

Over the last few years, Congress has passed legislation that impacts charitable organizations and donors. A significant amount of the legislative changes resulted from the Pension Protection Act of 2006 (Pension Act), which contains provisions designed to encourage charitable contributions by individuals. Some of the provisions represent Congress' intent to curb abuses of the charitable contribution deduction. As a result, the Pension Act restricts a donor's ability to obtain a deduction for certain kinds of property donations. However, with proper planning, donors may take advantage of new deduction opportunities while maximizing the tax benefits of gifts subject to new restrictions.

NONQUALIFIED DEFERRED COMPENSATION PLAN

Nonqualified deferred compensation plans are used to compensate executives in addition to qualified plans. Added to the Internal Revenue Code as part of the American Jobs Creation Act of 2004, Section 409A requires amounts deferred under a nonqualified deferred compensation plan, and not subject to a substantial risk of forfeiture, to be included in the employee's gross income. The plan does not qualify, however, if it contains any of the following characteristics:

1. It allows distributions no earlier than when the participant separates from service, becomes disabled or dies at a time specified under the plan, or when there is a change-in-control event.
2. It does not allow acceleration of benefits.
3. It complies with certain rules limiting the elections available under the plan.

On April 10, 2007, the Internal Revenue Service (IRS) released final regulations regarding the application of Section 409A to nonqualified deferred compensation plans. These final regulations are effective for tax years beginning on or after January 1, 2008. Prior to this date, plans must operate according to a good faith interpretation of Section 409A, however, the final regulations may be applied retroactively. These proposed regulations are effective for tax years beginning on or after January 1, 2008. Prior to this date, plans must operate according to a good faith interpretation of Section 409A and guidance provided in Notice 2005-1.

The rules of Section 409A apply when a compensation payment earned and vested in one tax year is paid in a later year. Not conforming to the restrictive rules of Section 409A immediately subjects all deferred compensation to federal income tax and imposes a 20 percent penalty on the includible compensation amount.

Typically, Section 457(f) governs nonqualified plans maintained by tax-exempt employers. In these plans, amounts owed to an employee are taxed when there is no longer a substantial risk of forfeiture.

REPORTABLE TRANSACTIONS

Treasury regulations require taxpayers and tax exempt organizations to file disclosure statements relating to tax strategies/transactions that the IRS has identified as "listed transactions," transactions substantially similar to listed transactions, and other reportable transactions. These disclosure statements must be filed with the proper tax return and sent separately to the IRS. Failure to disclose such transactions may result in significant penalties. In addition, some states have enacted tax shelter legislation requiring taxpayers to file reportable transaction disclosure statements with the appropriate state income and franchise tax returns.

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Tax exempt organizations should familiarize themselves with the six categories of reportable transactions and the rules in order to avoid penalties. The IRS provides more information on reportable transactions at www.irs.gov/business/corporations.

TAX-FREE DISTRIBUTIONS FROM IRAs

Effective for a two-year period ending December 31, 2007, distributions made from an IRA to a qualifying charity are excluded from income if the IRA owner, is at least 70½ years old and the amount is no more than \$100,000 per year. This provision removes a number of impediments that hindered owners from giving all or a portion of their IRA to charity.

Under the usual rules, a gift from an IRA to charity is a taxable distribution for the owner, who then claims an itemized deduction for the gift. This has adverse tax consequences for the owner including the possibility of the alternative minimum tax and the loss of itemized deductions and personal exemptions. Additionally, the deduction is limited to 50 percent of the IRA owner's adjusted gross income. Often, the owner does not get a full deduction in the year of the gift.

Treating the distribution as an exclusion from income, rather than as a deduction, removes these impediments for qualifying owners. Donors will need a written acknowledgement that the taxpayer received no benefit from the charity for the contribution in order to leverage the exclusion from income strategy.

CUT-BACK ON DEDUCTIONS FOR GIFTS OF TANGIBLE PERSONAL PROPERTY

Under prior law, a donor of tangible personal property (i.e., other than cash, securities or intellectual property) could deduct only the tax basis of the property rather than its higher fair market value if the charitable organization did not use the property in its exempt function. The Pension Act also applies this restriction to property that the charity disposes of within the same year that it was received. In addition, if the charity disposes of the gifted property within three years of obtaining it, the IRS will recapture the tax benefits that the donor received. A charity can avoid these adverse consequences by providing a certification that its original intended use of the property became impossible or infeasible.

LIMITATION ON CONTRIBUTIONS OF HOUSEHOLD GOODS AND CLOTHING

Many donors take advantage of the charitable contribution deduction by making gifts of used clothing and household goods. The Pension Act now only allows the deduction if the donated clothing or household goods are "in good used condition or better." This provision is effective as of August 17, 2006. It is not clear what Congress meant by "good used condition or better," and it is expected that the IRS will issue guidance in this area.

Fortunately, the limitation on "good used condition" does not apply to gifts of food, art objects, jewelry, gems or collections; nor does it apply to individual items of clothing or household goods with an appraised value exceeding \$500.

LIMITS ON DEDUCTION OF CASH GIFTS

New recordkeeping requirements in the Pension Act probably will not allow a deduction for small gifts of cash. Under the Pension Act, any gift of money by cash or check may be deducted only if it is supported by a bank record or a written acknowledgement from the donee. This provision is effective for taxable years beginning after August 17, 2006, and may discourage small cash gifts.

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RESTRICTIONS ON GIFTS OF FRACTIONAL INTERESTS

The Pension Act imposes significant limitations on gifts of fractional interests, an accepted planning technique for donors of tangible personal property such as artwork or collections. In a typical transaction, the owner of a painting gives a museum a gift of a 50 percent interest in the painting, which allows the donor to retain possession of the painting for six months each year while getting a deduction for 50 percent of the value. Although donors may still make additional fractional gifts, they are restricted by the following:

1. The donor must own 100 percent of the property before making the first gift.
2. Subsequent gifts of fractional interests must be valued as if made at the time of the initial gift (thereby eliminating the benefit of any appreciation in the property).
3. The IRS will recapture any tax deduction with interest if the charity does not receive 100 percent of the property by the donor's death or 10 years after the initial gift, whichever comes first.

CONTRIBUTIONS TO DONOR-ADVISED FUNDS

The Pension Act contains restrictions on "donor-advised funds," which are separately identified accounts funded by a donor and held by a charity for future distribution at the donor's recommendation. The Pension Act declares that such a contribution is deductible if each of the following applies:

1. The sponsoring organization for the fund is a charity.
2. The sponsoring organization is not a particular variety of Type III supporting organization.
3. The donor receives a written acknowledgement of the sponsoring organization's exclusive control over the use of the gift.

These restrictions serve to discourage gifts to organizations that allow the donor excessive control over distributions from the fund. The Pension Act, however, should not impact gifts to mainstream donor-advised funds.

INCREASED PENALTIES FOR VALUATION MISSTATEMENTS

Congress used the Pension Act to reexamine the penalties imposed on donor misstatements of the value of gifted property. The Pension Act reduces the threshold for imposition of the 20 and 40 percent tax penalties on significant valuation overstatements for charitable contributions. Formerly, the 20 and 40 percent penalties were imposed when the overstatement of value was greater than or equal to 200 and 400 percent, respectively. Those thresholds now are reduced to 150 and 200 percent. In addition, a new penalty is imposed on any appraiser responsible for the overstatement.

A number of important tax law changes were made over the last couple of years, several of which may impact your charitable organization receipts of donations and giving practices. Please do not hesitate contacting one of our tax professionals for further clarification.

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