

PROFESSIONAL TAX & ESTATE PLANNING NOTES

March 2007

1 The Pension Protection Act of 2006: Implications for Charitable Giving

The name of the Pension Protection Act of 2006 (the “Act”) tells only part of the tale. The Act is, as well, a charitable giving reform act and a reform act for tax-exempt organizations. Indeed, it is almost certainly the most comprehensive legislation affecting donors and charities since the Tax Reform Act of 1969 – the law that gave us the qualifying charitable remainder trust (Code Section 664)¹ and the private foundation excise taxes (Code Section 4940 *et seq.*).

President Bush signed the Act into law on August 17, 2006, and almost immediately tax practitioners were pointing out unanswered questions, seemingly unintended

consequences and other interpretive issues raised by the Act. The I.R.S. has issued some guidance, and there will likely be both proposed and final regulations over the next several months and years that will guide tax practitioners – and their clients – in the ongoing effort to understand and apply the Act.

This article, highlighting some of the changes to the charitable deduction rules under Code Section 170, is the first in a series dedicated to the charitable aspects of the Act. Subsequent articles will consider the new rules affecting supporting organizations and donor-advised funds.

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The Act's charitable giving provisions will affect both the decisions made by donors and the fundraising strategies of charities. There are several positive changes for various forms of charitable giving – in particular, gifts of individual retirement account (“IRA”) assets and gifts by S corporations – but those changes are not available for tax years beginning after 2007. Most of the permanent changes under the Act could make some charitable gifts – particularly gifts of tangible personal property – less appealing to donors and charities alike.

This summary focuses on four areas of particular interest to donors and charities: IRA rollovers to charity, qualified appraisals, charitable gifts of artworks and other tangible personal property, and charitable gifts of appreciated property by S corporations. There also are provisions (not discussed here) concerning donations of food and book inventory, clothing, taxidermy, property, and conservation easements, as well as the substantiation of cash donations under §250.

IRA Rollovers

Subject to a number of limitations, the Act permits individuals to make tax-free distributions to charities from traditional or Roth IRAs.² These distributions are commonly referred to as “rollovers,” even though pension-law purists point out that the term “rollover” is most appropriately used when assets are “rolled over” from one qualified plan to another. The term in the Act is “qualified charitable distribution” or “QCD.”

Under prior law, an individual could make charitable gifts of IRA assets during his or her lifetime only by first taking a distribution from the IRA, which would be wholly or partially subject to income tax, and then

donating all or part of the distribution to charity and taking a deduction based on the usual charitable deduction limitations. Now, however, an individual who has reached the age of 70½ years may direct that up to \$100,000 per year be distributed from his or her IRA to charity without the adverse income tax consequences that could occur in the two-step process described above.³ The distribution to charity may be counted toward the minimum distribution requirements that apply to traditional IRAs once the beneficiary attains age 70½.⁴

Those who could benefit most from the new IRA rules are those taxpayers whose charitable deductions would be reduced by the annual percentage limitation on charitable gifts⁵ or the floor on itemized deductions,⁶ non-itemizers (e.g., high-income earners who do not itemize deductions because they live in a state such as Florida or Texas with no income tax), and those who live in a state such as New Jersey or Massachusetts that does not recognize a *state* income tax charitable deduction.

The donee organization must be a public charity (i.e., an organization described in Code Section 170(b)(1)(A)) *other than* a supporting organization or a donor-advised fund.⁷ The limitation to Code Section 170(b)(1)(A) organizations precludes distributions to private *non-operating* foundations, but does not preclude distributions to private *operating* foundations and so-called conduit foundations (see Code Section 170(b)(1)(E)). A contribution to a field-of-interest or unrestricted fund at The New York Community Trust will qualify, although a contribution to a donor-advised fund will not.

The IRA distribution must be made in 2006 or 2007, and it must be made directly by the IRA trustee to the charity.⁸ The individual cannot receive any *quid pro quo* or consideration for the distribution, and he or she must obtain written substantiation from the donee organization that it received the distribution and provided no goods or services in consideration for it.⁹ Because the distribution to charity is not a deductible charitable contribution, the distributable amount is not limited by the annual percentage limitation¹⁰ on charitable gifts or the floor on itemized deductions.¹¹

Early in 2007, the I.R.S. issued a notice¹² that clarified several points about QCDs, including the following:

- (1) IRA custodians need not deliver checks to qualified charities. Rather, a check may be delivered first to the IRA beneficiary and then delivered by him or her to the charity, provided the check as issued by the IRA custodian is payable to a qualified charity.
- (2) QCDs may be made from an inherited IRA, provided the beneficiary (i.e., the individual who inherited the IRA) has attained age 70½. It evidently is not material whether the creator of the IRA had attained that age at the time of his or her death.
- (3) If a distribution to charity is not a QCD, the amount is treated as a distribution from the IRA to the IRA beneficiary and a contribution by him or her to the charity (subject to the usual Code Section 170 rules including the percent limitations).

To analyze fully the benefits of an IRA charitable rollover, both state and federal tax consequences and opportunities should be taken into account.

To analyze fully the benefits of an IRA charitable rollover, both state and federal tax consequences and opportunities should be taken into account. A New York taxpayer, for example, may exclude from New York taxable income the first \$20,000 (or \$40,000 for a married couple) withdrawn from an IRA in a given tax year. As a result, in some cases, a New York taxpayer may be better off withdrawing \$20,000 from the IRA and taking a charitable deduction for it, thereby possibly generating a charitable deduction that exceeds the income that is (for New York tax purposes) attributable to the \$20,000 distribution. In addition, the taxpayer could direct a QCD from the IRA of up to \$100,000.

[Effective: January 1, 2006 through December 31, 2007]

Qualified Appraisals for Appreciated Property

New rules govern qualified appraisals of charitable gifts of appreciated property other than publicly traded securities. Those advising donors of art, collectibles, real estate, and interests in a closely held business may wish to take special care to familiarize appraisers with the new rules and, indeed, may wish to review appraisals to ensure that they are fully in compliance with the new rules. Charities, too, should be mindful of the increased burden on donors and appraisers.

For contributions of property (other than cash or publicly traded securities) for which a deduction greater than \$5,000 is claimed, donors have long been required to provide a “qualified appraisal” and have been liable for penalty taxes if they underpaid their taxes as a result of a “substantial valuation mis-

statement.” Under the Act, the threshold for what constitutes a substantial valuation misstatement is lowered, and a penalty is imposed on appraisers as well as donors.¹³ Furthermore, appraisers face more stringent rules in order to be classified as qualified appraisers.¹⁴

The penalty tax on donors for underpayment of taxes due to a substantial valuation misstatement remains at 20% of the amount of the underpayment – or 40% if the valuation that led to the underpayment of tax represents a “gross” misstatement.¹⁵ However, for income tax purposes, the threshold for a substantial valuation misstatement has been reduced from 200% to 150% of the correct value.¹⁶ For example, if a painting deductible at fair market value (“FMV”) is finally determined to be worth \$100,000 but a deduction of \$150,000 is claimed, there is a substantial valuation misstatement. (Under prior law, the threshold for the claimed deduction in this hypothetical situation would have been \$200,000.) In addition, a valuation is now a “gross” misstatement for income tax purposes if it is 200% or more of the correct value; the prior threshold was 400% of the correct value.¹⁷

For the appraiser whose appraisal supports a deduction involving either a substantial or gross valuation misstatement, the penalty is generally the greater of \$1,000 or 10% of the amount of the donor’s underpayment of tax.¹⁸ However, in no event can the penalty exceed 125% of the gross income received by the appraiser from preparing the appraisal.¹⁹ No

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penalty is imposed if the appraiser establishes to the satisfaction of the I.R.S. that the value claimed in the appraisal was “more likely than not” the proper value.²⁰

Two statutory definitions are now relevant to the qualified appraisal process. There must be a “qualified appraisal,” which is an appraisal that is (a) treated as such under regulations or other guidance prescribed by the Secretary of Treasury and (b) conducted by a “qualified appraiser” in accordance with generally accepted appraisal standards and regulations or other guidance by the Secretary of Treasury.²¹ Late last year, the I.R.S. released “transitional guidance” concerning the definition of “qualified appraisal.”²² The new, statutory definition of “qualified appraiser”²³ is significantly more restrictive than the existing definition under the Treasury Regulations.

[Effective: August 17, 2006. However, the misstatement thresholds and appraiser penalties are applicable to any return filed after July 25, 2006 on which a deduction is claimed for a façade easement.]

Gifts of Tangible Personal Property

Donors of items of tangible personal property, such as artwork, a collection of books, or sports memorabilia, face significant new limitations under the Act. Even though Code Section 170(e) allows donors to continue to deduct the FMV of tangible personal property donated for a “related use” to a public charity or to a private operating foundation, there could be adverse tax consequences in future tax years unless donors and charities carefully follow the complex new rules.

“Related Use” Gifts. If the donee organization sells or otherwise disposes of donated property within three years following the gift, the donor’s deduction will be reduced to the donor’s basis *unless* the donee organization provides a certification, under penalties of perjury, that either (i) describes how it used the property in furtherance of the organization’s purposes or (ii) states how it intended to use the property at the time of the contribution and certifies that this intended use became “impossible or infeasible to implement.”²⁴ A \$10,000 fine and criminal sanctions could apply to the organization for making certifications that are knowingly inaccurate.²⁵

If the donee organization does not provide that certification and disposes of the property before the last day of the tax year in which the gift is made, the donor’s deduction is limited to the cost basis of the donated item.²⁶ If instead, the donee organization disposes of the property after the end of the first tax year but within three years of the gift, the deduction will be “recaptured” (*i.e.*, treated as ordinary income) in the year the property is disposed of to the extent the deduction exceeded the donor’s basis in the contributed property.²⁷
[Effective: Contributions made after September 1, 2006]

Form 8282. The donee organization must file an expanded version of I.R.S. Form 8282 (Donee Information Return) if, within three years of the donation, it disposes of donated property (other than publicly traded securities) valued by the donor at more than \$5,000.²⁸ Form 8282 was previously

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required only for property disposed of within two years of the donation. The additional information that the donee organization must provide includes a description of the donee’s use of the property, a statement of whether the use was a “related use,” and the certification described above, if applicable.²⁹ In January 2007, the I.R.S. released an updated Form 8282.

[Effective: Forms 8282 filed after

September 1, 2006]

Fractional Interests in Tangible Personal Property.

Donors commonly make charitable gifts of tangible personal property, such as artwork, antiques, and historical memorabilia, in fractional or percentage shares. Among other benefits, fractional interest gifts enable the donor to divide the deduction among multiple tax years, thereby increasing the likelihood (under the annual percentage limitations) that the donor will be able to absorb the deduction fully. Traditionally, if the property appreciated in value, the appreciation would be taken into account at the time each additional fractional interest was contributed.³⁰

The Act significantly reduces the appeal of fractional interest giving. First, the charitable deduction is lost at the outset or, if taken at the outset, is fully “recaptured” (with interest) if:

- the donor does not own “all interest” in the donated property immediately prior to the initial gift of a fractional interest, or together the donor and donee organization do not own “all interest” prior to the donor’s subsequent gift of a fractional interest;

- the donor fails to contribute all of his or her interest in the property to the charity by the time of the donor's death or the 10th anniversary of the initial fractional gift, whichever occurs first; or
- the donee organization does not have "substantial physical possession" of the property and has not used it for a "related use" (*e.g.*, exhibition or research) by the time of the donor's death or the 10th anniversary of the initial fractional gift, whichever occurs first.³¹

For a limited period of time, the Act improves the tax incentives for a subchapter S corporation to make charitable gifts of appreciated property.

Second, for gifts of fractional interests made after the initial contribution, the donor's deduction must ordinarily be calculated based on the FMV used at the time of the *initial* contribution.³²

Third, for estate tax purposes, the donor's *estate* may now take a charitable deduction for a fractional interest based only on the FMV of the property at the time of the donor's initial contribution, unless the property has declined in value (in which case the date-of-death FMV is used).³³ Because the date-of-death FMV of the asset presumably would be used for purposes of determining the amount to be included in the donor's estate, the estate could be whipsawed if the property has appreciated since the donor's initial contribution. In other words, the estate could be forced to pay estate tax on an asset that is in fact going to charity.

It is not clear that Congress intended that result. Indeed, an unnamed aide to Senator Charles Grassley (R-Iowa), chair of the U.S. Senate Finance Committee when the Act was passed, reportedly told

The New York Times in December 2006 that the U.S. Department of Treasury would "be directed to forbid the I.R.S. to collect taxes on any artwork that remains partly in an estate so long as the work is contractually intended for a museum."³⁴ Clarifying guidance is called for to harmonize the amount included in a decedent's gross estate with the amount for which an estate tax charitable deduction is allowed.

[Effective: August 17, 2006]

Gifts by an S Corporation

For a limited period of time, the Act improves the tax incentives for a subchapter S corporation to make charitable gifts of appreciated property. Traditionally, even though the S corporation's charitable deduction was passed through on a *pro rata* basis to its shareholders, each shareholder's basis in his or her S corporation stock was reduced by an amount equal to his or her pro rata share of the FMV of the donated property. The benefit the shareholder might have received from the charitable deduction could have been partly offset by the increased capital gains tax eventually payable upon disposition of his or her S corporation shares. For gifts made in S corporation taxable years beginning after December 31, 2005 but before December 31, 2007, however, each shareholder's basis in the S corporation shares will be reduced only by his or her *pro rata* share of the S corporation's *basis* in the donated property.³⁵ For S corporation gifts of cash, the change will make no difference for the shareholder. However, if an S corporation owns appreciated property (*e.g.*, real estate, works of art, or shares of stock), the Act could create a "window of opportunity" for a tax-advantaged charitable gift.

[Effective: Contributions made in tax years beginning after December 31, 2005 through tax years beginning not later than December 31, 2007]

Conclusion

Even though the Act imposes some significant new limitations that will affect some charitable gifts, particularly gifts of tangible personal property and gifts requiring an appraisal, the Act also offers several valuable opportunities. This is particularly true of the IRA “charitable rollover,” which will enable eligible individuals to make a significant gift to charity, including The New York Community Trust, using IRA assets that previously could not have been given to charity without adverse tax implications. But the window of opportunity—through December 2007 only—is brief. Charitable gifts by S corporations of appreciated assets also could offer a new planning opportunity for S corporation shareholders, although only during tax years that start in 2006 or 2007.

End Notes

- ¹ All Code Section references are to the Internal Revenue Code of 1986, as amended.
- ² Act Section 1201(a); Code Section 408(d)(8).
- ³ *Id.*
- ⁴ I.R.S. Notice 2007-7 (Jan. 29, 2007), Part IX, Answer 42.
The term “IRA beneficiary” is used in this article to refer either to the creator of the IRA or a subsequent beneficiary of the IRA.
- ⁵ Code Section 170(b). “I.R.C.” refers to the Internal Revenue Code of 1986, as amended.
- ⁶ Code Section 151(d)(3).
- ⁷ Code Section 408(d)(8)(B)(i).
- ⁸ Code Section 408(d)(8)(B)(i) and 408(d)(8)(F). *See* I.R.S. Notice 2007-7, Part IX.

- ⁹ Joint Comm. on Taxation, *Technical Explanation of H.R. 4, The “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006*, JCX-38-06 (August 3, 2006), pp. 263-64 and 267.
- ¹⁰ Code Section 170(b).
- ¹¹ Code Section 151(d)(3).
- ¹² I.R.S. Notice 2007-7, Part IX.
- ¹³ Act Section 1219; Code Section 6662(e)(1)(A) and 6695A.
- ¹⁴ Code Section 170(f)(11)(E)(ii)-(iii).
- ¹⁵ Code Section 6662(a) and 6662(h)(1).
- ¹⁶ Code Section 6662(e)(1)(A).
- ¹⁷ Code Section 6662(h)(2)(A)(i).
- ¹⁸ Code Section 6695A(b).
- ¹⁹ *Id.*
- ²⁰ Code Section 6695A(c).
- ²¹ Code Section 170(f)(11)(E)(i).
- ²² I.R.S. Notice 2006-96 (Nov. 13, 2006), Section 3.02(2).
- ²³ Code Section 170(f)(11)(E)(ii)-(iii).
- ²⁴ Act Section 1215; Code Section 170(e)(1)(B)(i) and 170(e)(7).
- ²⁵ Code Section 6720B.
- ²⁶ Code Section 170(e)(1)(B)(i).
- ²⁷ Code Section 170(e)(7).
- ²⁸ Code Section 6050L(a).
- ²⁹ Code Section 6050L(a)(1).
- ³⁰ *See* Act Section 1218.
- ³¹ Act Section 1218(a); Code Section 170(o)(1)(A) and 170(o)(3).
- ³² Code Section 170(o)(2).
- ³³ Act Section 1218(b); Code Section 2055(g).
- ³⁴ “The Man Museums Love to Hate,” *The New York Times* (Dec. 10, 2006).
- ³⁵ Act Section 1203; Code Section 1367(a)(2).

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About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust, with assets of almost \$2 billion, is an aggregate of funds set up by individuals, families, and businesses to support charitable organizations.

A fund in The Trust can help your clients carry out their charitable objectives while qualifying for the maximum tax deduction. Funds can be set up during lifetime or by will and often are an essential part of financial and estate planning. In addition to gifts of cash and publicly traded securities, funds can be established with a wide variety of assets including closely held stock, limited partnerships, mutual funds shares, retirement plan assets, and copyrights.

Because of our administrative efficiency, we are able to offer our services for a very low fee—three-tenths of 1%, i.e., 30 basis points; investment fees are also low. Expert financial management of funds is not tied to any one company or investment vehicle; investments are matched to each donor's grantmaking plans.

Trust staff are always available to advise donors about grantmaking opportunities and ensure that their charity will be carried on beyond their lifetimes. Donors can recommend grants to qualified charities anywhere in the U.S., with assurance that each nonprofit is carefully scrutinized for its fiscal and programmatic soundness.

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