CLIENT ALERT

ROPES & GRAY

Charitable Giving

October 13, 2005

Katrina Emergency Tax Relief Act of 2005

On September 23, 2005, President Bush signed into law the Katrina Emergency Tax Relief Act of 2005 ("the Act"). The Act contains two key charitable giving incentives for donations through the end of 2005:

- Temporary suspension of percentage limitations on the deductibility of cash gifts to public charities, referred to in the Act as "qualified contributions;" and
- Temporary suspension of the 3% reduction in itemized deductions with respect to "qualified contributions."

"Qualified Contribution" Defined

To be a qualified contribution, a gift must be:

- made between August 28, 2005 and December 31, 2005
- exclusively in the form of cash
- to a public charity.

Cash gifts to private non-operating foundations do not meet the definition of a qualified contribution, nor do cash gifts to supporting organizations and donor advised funds which are subject to specific exclusion from the temporary relief. In fact, the provision covering donor advised funds is drawn broadly and would exclude a cash gift made to any type of separate fund over which the donor retained investment control or continuing oversight of its eventual distribution. Finally, cash gifts to certain planned giving vehicles - charitable remainder trusts and pooled income funds - do not qualify since these are not gifts "to" a public charity, but the gift component of a cash transfer in return for a charitable gift annuity would appear to meet the Act's requirements.

Department of Clear Thinking: A gift from an individual need *not* be directed toward Hurricane Katrina relief to be a qualified contribution. However, a corporate gift must be for relief efforts related to Hurricane Katrina.

Charitable Deduction of up to 100% of Adjusted Gross Income Permitted

Under existing law, individual donors of cash gifts to public charities may generally take a current year charitable contribution deduction of up to 50% of their contribution base (adjusted gross income subject to minor modifications). The Act temporarily increases the maximum deduction for qualified contributions to 100% of the donor's contribution base. The maximum deduction for qualified contributions by corporations is also increased temporarily from 10% of taxable income to 100%. To the extent a taxpayer's qualified contributions exceed the 100% percentage limitation, the carryover provisions of section 170(d) of the Internal Revenue Code (the "Code") continue to apply, allowing the taxpayer to carry that deduction forward for up to five years.

Suspension of 3% Reduction in Itemized Deductions

For higher income taxpayers, the Code imposes a reduction in otherwise allowable itemized deductions. For 2005, this reduction is 3% of the excess of a taxpayer's adjusted gross income over $145,950 ($72,975 for married individuals filing separately), with a maximum reduction of 80% of allowable deductions. Itemized deductions subject to this rule include state and local taxes, mortgage interest, most miscellaneous itemized deductions, and charitable deductions. Medical expenses, investment interest, and casualty, theft or wagering losses are not affected. Under the Act, qualified contributions are added to the latter list and accordingly will *not* be subject to the 3% reduction.

Contributions of IRAs

The Act does not address an individual's ability to contribute an Individual Retirement Account ("IRA") to a charitable organization without incurring tax. However, the increased maximum deduction allowable under the Act for cash gifts may provide an incentive (or at least remove a disincentive) to donate excess IRA assets to a public charity. Although a withdrawal from an IRA will still be treated as an addition to taxable income, the taxpayer will be able to deduct, as a qualified contribution, the full amount of the withdrawn contribution that is then donated to a public charity.

Some commentators have suggested that the Act creates the functional equivalent at the federal level of a tax-free rollover of an IRA to a charity. However, closer examination suggests that this is not quite the case. For example:

- Because the IRA withdrawal is added to the taxpayer's adjusted gross income, the donor may lose a greater part of the donor's itemized deductions subject to the 3% phase out, and may also lose part or all of the donor's personal exemption, which is also phased out at higher income levels.
- If the donor has other income tax deductions that phase out as income increases, such as medical expenses (7.5%), miscellaneous itemized deductions (2%), and casualty losses (10%), the donor will lose more of those deductions due to the addition to income of the IRA withdrawal.

In addition, a donor must also be mindful of state and local income tax consequences of an IRA withdrawal. Some states base tax liability on federal gross income, not taxable income. This means for state tax purposes, there may be no offset to the additional income from an IRA withdrawal, even if an individual makes a qualified contribution. Other states have their own freestanding systems, some of which do not provide for any form of charitable contribution deduction.

Other Tax Incentives

Some of the additional tax incentives provided by the Act include the following:

- For 2005 and 2006, a taxpayer who provides shelter to individuals who were displaced by Hurricane Katrina may take an additional personal exemption of $500 per displaced individual, up to a maximum additional deduction of $2,000.
- A taxpayer who uses a vehicle to provide relief related to Hurricane Katrina between August 25, 2005 and December 31, 2006 may take an itemized deduction using 70% of the IRS business mileage rate in effect on the date of use, rather than the IRS charitable mileage rate set at 14 cents per mile by Code section 170(i).
- A volunteer who is reimbursed by a public charity for the costs of using a vehicle to provide relief related to Hurricane Katrina between August 25, 2005 and December 31, 2006 may exclude from taxable income any amount by which the reimbursement exceeds deductible travel expenses, up to an amount that does not exceed the IRS business mileage rate.
- Any taxpayer engaged in a trade or business may take an enhanced deduction (i.e., in excess of basis), currently available only to C corporations, for donations of food inventory made between August 25, 2005 and December 31, 2005; however, taxpayers other than C corporations may only deduct up to 10% of their net income from the business entity or entities from which the inventory donation is made.

- Any taxpayer may take an enhanced deduction (i.e., in excess of basis), currently available only to C corporations, for donations of book inventory to primary or secondary public schools made between August 25, 2005 and December 31, 2005, so long as the books are suitable to and used for the donee's educational programs.

Stay Tuned for Additional Legislation

Although the changes described above are temporary, Congress is considering longer-term reform in this area of tax law. On September 28, 2005, Senators Rick Santorum and Joseph Lieberman introduced the Charity, Aid, Recovery and Empowerment (CARE) Act of 2005 and Representatives Roy Blunt and Harold Ford, Jr. introduced the Charitable Giving Act of 2005. We will keep you updated on the progress of these bills, both of which contain a variety of charitable giving reforms as well as other provisions applicable to tax-exempt organizations more broadly.