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A Polsinelli Shughart Update

American Taxpayer Relief Act of 2012 — The Effects on Charitable Giving



Major Tax Provisions Relating to Charitable Organizations 2

Other Law Changes Affecting Charitable Contributions 3

For More Information 4

The Nonprofit Organizations Team at Polsinelli Shughart has analyzed the charitable deductions provisions within the American Taxpayer Relief Act of 2012 (the “Act”) that President Obama recently signed into law. This analysis will provide a clear description of how these provisions may affect the ability of certain taxpayers to take charitable deductions and the affect this may have on charitable giving.

After much contention, on January 1, 2013, the U.S. Senate overwhelmingly passed legislation to avert the tax side of the “fiscal cliff,” sending the American Taxpayer Relief

Act of 2012 (the “Act”) to the House, where it was similarly approved and subsequently signed into law by President Obama. The Act avoids automatic sunset provisions that were scheduled to take effect after 2012 under the Bush-era tax cuts. Although the Act is not comprehensive tax reform, it is a positive for many taxpayers. This e-Alert focuses specifically on the charitable tax provisions of the Act. For a summary of the Act in its entirety, see the Polsinelli Shughart e-Alert titled “Congress Approves the American Taxpayer Relief Act of 2012, Preventing *Fiscal Cliff*” issued January 22, 2013.

Major Tax Provisions Relating to Charitable Organizations

Reinstated "Pease Limitation"

The personal exemption phase-out and the limitation on itemized deductions (including charitable deductions) have been reinstated for individual taxpayers with adjusted gross income ("AGI") of greater than \$250,000 and married filing jointly taxpayers with an AGI greater than \$300,000. This so-called "Pease limitation" on itemized deductions reduces the total amount of a high-income taxpayer's otherwise allowable itemized deductions by three percent of the amount by which the taxpayer's AGI exceeds an applicable threshold. These total itemized deductions cannot be reduced by more than 80 percent. The Pease limitation is applied in addition to the charitable contribution percentage limitation, which generally limits the deductibility of cash contributions to 50 percent of AGI. Effectively, anyone above the Pease limitation threshold has an actual marginal tax rate that is three percent higher than the "official" marginal tax rate (until the full 80 percent of their itemized deductions has been disallowed).

While commentators have suggested that the Pease limitation would have a negative impact on charitable giving, in practice, this is not necessarily the case.

- *Circumstances in which the Pease limitation may not impact taxpayers:*

Taxpayers below the threshold amounts set forth above are not affected by the Pease limitation. A Pease limitation taxpayer with other sufficient itemized deductions will still be able to take charitable deductions in full, with or without the Pease limitation.

Example: Assume married filing jointly taxpayers have an adjusted gross income of \$1,200,000 (thus are subject to the Pease limitation) and have the following itemized deductions: State and local taxes: \$30,000; Real estate taxes: \$10,000; Mortgage

interest: \$10,000; Charitable contributions: \$50,000, totalling \$100,000 in itemized deductions before the Pease limitation. The Pease limitation reduces the taxpayers' itemized deductions to \$73,000, as follows:

$\$1,200,000 - \$300,000 \text{ threshold} = \$900,000$
(amount subject to three percent Pease limitation)

$\$900,000 \times \text{three percent} = \$27,000$ (amount of Pease limitation)

$\$100,000 - \$27,000 = \$73,000$ (amount of itemized deductions after reduction)

In the example, the taxpayer's state and local taxes, real estate taxes, and mortgage interest deductions exceed the \$27,000 Pease limitation, without taking into consideration the charitable contributions. Practically, the \$27,000 Pease limitation will not affect charitable contributions if other itemized deductions are significant. In the example, the taxpayer's state and local tax amount of \$30,000 is enough to absorb the \$27,000 Pease limitation. As a general rule, as long as taxpayer's effective state income tax rate is higher than 3.75 percent (three percent Pease limitation / 80 percent limitation ceiling), a taxpayer's charitable deductions will reduce taxable income by the same amount, with or without the Pease limitation.

Taxpayers that pay AMT are not impacted by the Pease limitation. They receive the full benefit of their charitable contribution deductions at AMT rates of 28 percent or 26 percent.



- *Circumstances in which the Pease limitation may impact taxpayers:*

Example: Assume identical facts as the above example but presume the taxpayer lives in a state with no income tax. Accordingly, the taxpayer's itemized deductions total \$70,000 (Real estate taxes: \$10,000; Mortgage interest: \$10,000; Charitable contributions: \$50,000) before the Pease limitation. In this case, the Pease limitation reduces the taxpayer's itemized deductions to \$43,000, as follows:

$\$1,200,000 - \$300,000 \text{ threshold} = \$900,000$
(amount subject to three percent Pease limitation)

$\$900,000 \times \text{three percent} = \$27,000$ (amount of Pease limitation)

$\$70,000 - \$27,000 = \$43,000$ (amount of itemized deductions after reduction)

In the example, the Pease limitation is in excess of the other itemized deductions and directly reduces the taxpayer's \$50,000 charitable contribution to \$27,000 (the taxpayer's real estate taxes and mortgage interest deductions, totalling \$20,000, are fully absorbed by the \$43,000 Pease limitation, leaving \$23,000 to reduce the taxpayer's \$50,000 charitable contribution deduction).

Accordingly, the Pease limitation rules have a more potentially significant effect on the charitable contributions of taxpayers living in low or no-income tax states (i.e., Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming – all states with no income tax) and could discourage such taxpayers from making charitable gifts.

Other Law Changes Affecting Charitable Contributions

- The Act extends through December 31, 2013, the allowance of tax-free transfers to eligible charitable

organizations, or qualified charitable distributions ("QCDs"), which are otherwise taxable distributions from IRAs owned by individuals aged 70 1/2 or older. Every year, the IRA owner can exclude from gross income up to a maximum of \$100,000 of these QCDs.

- The Act extends through December 31, 2013, the modification of the tax treatment of certain payments to controlling tax-exempt organizations.
- The Act extends through December 31, 2013, the basis adjustment to stock of S corporations making charitable contributions of property.
- The Act extends through December 31, 2013, the special rule for contributions of capital gain real property for conservation purposes. The special rule allows the contribution to be taken against 50 percent of the contribution base. The Act also extends for two years the special rules for contributions by certain corporate farmers and ranchers. The special rule therefore allows for a larger charitable contribution.
- The Act extends through December 31, 2013, the enhanced charitable deduction for contributions of food inventory, regardless of whether the contribution is made by a C corporation. ■

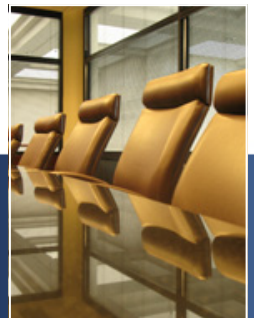




For More Information

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About our

Nonprofit Organizations Group

Polsinelli Shughart is one of the nation's leading providers of legal services to nonprofit organizations. Our attorneys have made significant contributions to nonprofit organizations through innovative approaches to legal and organizational issues.

Staffed by nationally recognized experts with business acumen and in-depth industry knowledge, our nonprofit attorneys are well versed on the issues facing tax-exempt organizations. The Polsinelli Shughart Nonprofit Organizations team literally wrote the book on tax-exempt and nonprofit law. Between them, our attorneys have published more than 25 books in this area reflecting their extensive practical experience in strategically and proactively serving the needs of nonprofit clients. Four of our nonprofit attorneys recently collaborated on a book about IRS Form 990. The redesigned form is one of the most significant developments facing nonprofit organizations in many years. In addition, two of our members authored a Tax Management Portfolio, published by the Bureau of National Affairs, a well-known tax treatise.

To learn more about our services, visit us online at www.polsinelli.com.

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About

Polsinelli Shughart

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About

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