Pension Protection Act of 2006

by Austin Bramwell

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The Pension Protection Act of 2006 (the "Act"), signed into law on August 17, 2006, makes a number of changes to the tax laws governing charitable giving. For example, the Act creates new rules for distributions to charity from individual retirement accounts, gifts of fractional interests in tangible property, and charitable gifts of real property interests for conservation purposes. The Act also stiffens the tax penalties that apply to private foundations and split-interest charitable trusts. This article describes four changes that taxpayers may wish to take into account in their tax planning.

IRA Distributions

An individual retirement account ("IRA") is a custodial account which is exempt from federal income taxation and which is maintained exclusively for an individual (and, at his death, his beneficiaries). While contributions to a "traditional" IRA (as opposed to a Roth IRA) are tax-deductible, distributions from a traditional IRA are included in the owner's gross income and taxed at ordinary rates. Meanwhile, to avoid penalties, the owner must begin withdrawing IRA assets beginning in the taxable year in which he attains the age of 70½. Thus, in effect, the government offers taxpayers a current tax deduction in exchange for their agreement to pay taxes in the future at ordinary rates rather than at lower capital gains tax rates. Whether this deal makes sense depends on a variety of factors unique to each taxpayer, and one's own sense of where the tax laws are headed.

Under the Act, however, through the year 2007 an individual who has reached the age of 70½ can cause a qualified charitable distribution of up to $100,000 to be made from his IRA directly to charity. Such distributions are not included in gross income, but still count towards the owner's required distribution for the year in which the qualified distribution is made. Thus, a qualified charitable distribution makes it possible to reduce or eliminate income tax generated by required distributions. (Of course, the individual must also forego the benefit of distributing the assets to himself.)

On the other hand, an individual who makes a qualified charitable distribution cannot at the same time deduct from his gross income the amount of the distribution. Many taxpayers over the age of 70½, even those with charitable intentions, would thus be well advised not to make qualified charitable distributions from an IRA. Instead, they should make charitable contributions of non-IRA assets, thereby obtaining a tax deduction to offset the income tax liability generated by any required IRA distributions. Not only that, but by making charitable gifts of appreciated assets, they can also avoid paying taxes on gains when the assets are sold.

In short, it is unclear how many taxpayers will benefit from the opportunity to make qualified charitable distributions. One example might be a taxpayer who faces limits on the amount of deductible charitable contributions he can make for the year. For example, a taxpayer may have "maxed out" his ability to obtain charitable deductions in virtue of the general rule that a taxpayer cannot take a deduction for more than 50% of his "contribution base." In any case, taxpayers should consider carefully any invitation from a charity to take advantage of the new qualified charitable distribution provision.

Conservation Contributions

Historically, wealthy persons in America have sought to restrict future land development in order to preserve the perceived “historical” or “rural” features of their neighborhoods and weekend homes. Such restrictions reduce supply of real estate, thereby increasing the value of the surrounding land in dollar terms, as well as, perhaps, its value as a marker of wealth and status. In addition to these benefits, the Internal Revenue Code (the “Code”) gives taxpayers additional tax incentives to restrict land use.

Generally, an individual may not obtain a tax deduction for transferring to charity less than his full interest in property. Nevertheless, a taxpayer can make a tax deductible gift to charity of a either a restriction on the use of real property (an “easement”) or a remainder interest in real property, so long as the gift will be used exclusively for “conservation” purposes and other technical requirements are met. Moreover, in the estate tax context, a gift or bequest of a conservation easement confers an unusual “double” benefit: not only can an estate take an estate tax deduction, but it can also to some extent exclude the value of the gift from the gross estate. Thus, if a gift or bequest of a conservation easement is made, an estate can significantly reduce estate taxes, even as the decedent’s property is preserved for posterity without being defaced by new development.

The Act has made qualified conservation contributions even more attractive for some taxpayers. Generally, a taxpayer may not deduct more than 30% of his “contribution base” for charitable gifts of capital gain property. (Roughly speaking, a taxpayer’s “contribution base” is equivalent to his adjusted gross income for the year.) Under the Act, however, a taxpayer can, before 2008, give up to 50% of his contribution base for a qualified conservation contribution. Any excess can be carried over for the next 15 years (up from 5 years). For many wealthy taxpayers, it may be possible to obtain both this enhanced income tax deduction and the “double” benefit (in the form of a deduction and an exclusion) for estate tax purposes. Taxpayers interested in making a gift of real property for conservation purposes should consult with tax planners as to the most tax-efficient way to make the gift.

Private Foundations

In 1970, in response to perceived abuses, Congress began to use the tax code to regulate so-called “private foundations.” Private foundations have since faced more onerous reporting requirements than other charities and have been subject to excise taxes for conducting their activities in certain disfavored ways. In particular, to avoid excise taxes, private foundations must make minimum distributions each year and refrain from certain acts of self-dealing, expending funds in certain disfavored ways, having excess business holdings, and making investments that jeopardize the foundation’s tax-exempt status. Despite these obstacles, private foundations remain popular with wealthy families, who often view them as an efficient means of securing their upper-class bona fides.

The Act, however, has effectively doubled the excise taxes that apply to private foundations. Private foundations, therefore, should exercise additional caution in supervising their activities. The higher excise taxes also apply in some cases to certain so-called “split-interest” charitable trusts. These are trusts in which one or more charities have either a remainder interest in the trust property or current income interest, but in which non-charitable beneficiaries have the other interests. Properly structured split-interest charitable trusts have long been popular vehicles in variety of contexts for taxpayers to maximize the income, estate and gift tax advantages of making a charitable gift. Under the Act, however, trustees of these trusts will need to exercise extra caution in complying with certain of the rules that apply to private foundations.

Fractional Gifts of Tangible Property

As stated previously, unless an exception applies, a taxpayer may not obtain a tax deduction for transferring to charity less than his full interest in property. The Code does, however, allow a deduction for an undivided portion of a donor's entire interest in property. Under this exception, for example, taxpayers in the past were able to donate fractional interests in tangible property (for example, a collection of artwork) to charity. The charity could then have the right to take possession of the artwork for a certain number of days each year. Thus, a taxpayer could donate a percentage interest in artwork to charity, yet still retain possession of the artwork for part of the year—for example, the part of the year when she expected to be living in the residence where the artwork is kept.

The Act, however, has imposed new rules on gifts of tangible property to charity. For example, if a taxpayer makes a gift of a fractional interest in tangible property, he must eventually make a subsequent gift of the remaining interest in the same property, or else be forced to recapture his gift and income tax deductions. If the property in the meantime appreciates in value, these rules (unless revised) may subject many taxpayers to unexpected gift or estate taxes. Hence, it may no longer make sense for taxpayers to make gifts of fractional interests in tangible property.

<u>Conclusion</u>

The Pension Protection Act of 2006 creates both opportunities and pitfalls for taxpayers with charitable intentions. This article describes four important changes, but the Act contains many more. Taxpayers should consult with their tax planners to determine to what extent the Act may affect them.

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