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TAX, BENEFITS AND NONPROFIT ORGANIZATIONS CLIENT ALERT

AMERICAN TAXPAYER RELIEF ACT OF 2012 IMPACT ON CHARITABLE GIVING AND EXEMPT ORGANIZATIONS

The American Taxpayer Relief Act of 2012 (the "Act") was passed by the United States Congress on January 1, 2013 and signed into law by President Obama on January 2, 2013. The following provisions of the Act should be of interest to exempt organizations and donors seeking deductions for charitable contributions.

Individual Income Tax Rates

The Act permanently extends the lower individual income tax bracket for taxable years beginning after December 31, 2012. Lower tax rates apply for income at or below \$400,000 for individual filers, \$425,000 for heads of households, and \$450,000 for taxpayers that are married and filing jointly. Income exceeding these thresholds is subject to a rate of 39.6 percent.

Reduction of Certain Itemized Deductions including Charitable Deductions

While the Act does not impose a specific limitation on charitable deductions, it does revive the "Pease" provision, which limits the amount of certain itemized deductions a taxpayer may claim, including charitable deductions. These limits are imposed on individuals with income in excess of \$250,000, heads of households with income in excess of \$275,000, and couples filing joint returns with income in excess of \$300,000. A taxpayer subject to this limitation will have the amount of his or her itemized deductions reduced by 3 percent of the amount by which his or her adjusted gross income exceeds these thresholds. However, the reduction may not exceed 80 percent of otherwise allowable itemized deductions. These dollar amounts will be adjusted for inflation for tax years after 2013.

In order to consider how the Pease limitation limits your itemized deductions if you are above a certain income threshold, please consider the following example:

Joe, who files jointly with Mary, has gross income of \$500,000 and adjusted gross income of \$450,000. They have itemized deductions of \$50,000, which include interest on their home mortgage, state and local tax liability and charitable contributions.

Without the Pease limitation, they would be able to deduct the full \$50,000 from their tax liability. If we apply the Pease limitation to their itemized deductions, their deductions are reduced by 3 percent of the amount by which their adjusted gross income of \$450,000 exceeds their Pease threshold amount of \$300,000. Joe and Mary's adjusted gross income is \$150,000 over their Pease threshold amount; their deductions are scaled back by \$4,500 ($\$150,000 \times .03$). Therefore, although they have itemized deductions of \$50,000, they can only deduct \$45,500 ($\$50,000 - \$4,500$).

In this example, the Pease limitation, which is calculated at 3 percent of the adjusted gross income of Joe and Mary minus a threshold amount, is set at \$4,500. If Joe and Mary had decided to give an additional \$1,000 that year to charity, they would have been able to deduct \$46,500 because they have already absorbed the full \$4,500 reduction in itemized deductions.

Qualified Conservation Contributions

The Act reinstates the increased contribution limits and carry-forward period for contributions of appreciated real property for conservation purposes (including partial interests in real property) retroactive to January 1, 2012, and extends it through December 31, 2013.

IRA Rollovers to Charitable Organizations

The Act reinstates retroactive to January 1, 2012, and extends through December 31, 2013, a provision that permits tax-free distributions, up to \$100,000 per year, from individual retirement accounts (IRAs) to certain public charities by individuals who are 70 ½ years or older. The Act includes a transition rule that permits a taxpayer to make a qualified charitable distribution during January 2013 and have it treated as made in 2012. Additionally, if a taxpayer made a distribution to himself or herself in December of 2012 and transfers this distribution to a qualified charity before February 1, 2013, the taxpayer may treat the distribution as a charitable distribution to the extent that it otherwise meets the requirements for qualified charitable distributions.

Contributions of Food Inventory

The enhanced deduction for contributions of apparently wholesome food from a taxpayer's trade or business is reinstated retroactive to January 1, 2012, and extended through December 31, 2013. Under this provision, a C corporation can claim a charitable contribution deduction equal to the lesser of (a) basis plus half of the property's appreciation, or (b) twice the property's basis. Taxpayers other than C corporations can claim an enhanced deduction but the aggregate amount of these contributions for the tax year cannot exceed 10 percent of the taxpayer's aggregate net income for that tax year from all trades or businesses from which those contributions were made for that tax year.

Basis Adjustment to Stock of S Corporations

The special rule for S corporations making charitable contributions of property is reinstated retroactive to tax years beginning after December 31, 2011, and extended through tax years beginning before January 1, 2014. Under this rule, a shareholder of an S corporation may take into account his or her pro rata share of charitable deductions, even if such deductions would exceed the shareholder's adjusted basis in the S corporation.

Extension of Grandfather Provision relating to Payments from Controlled Organizations

Under the Pension Protection Act, payments of interest, rent, royalties, and annuities paid to a tax-exempt organization by a controlled entity are generally treated as unrelated business taxable income. However, this treatment does not apply to such payments made pursuant to a binding written contract that was in effect on August 17, 2006, or an extension of such contract and that are no more than fair market value. The Act reinstates this rule for 2012 and extends the provision to the end of 2013.

Above-the-Line Deduction for Qualified Tuition Related Expenses

The Act reinstates the above the line deduction for qualified higher education expenses for taxpayers with adjusted gross income below certain limits retroactive to January 1, 2012 and extends the deduction through December 31, 2013. The maximum deduction is \$4,000 for taxpayers with adjusted gross income of \$65,000 or less (\$130,000 for joint returns) or \$2,000 for taxpayers with adjusted gross income of \$80,000 or less (\$160,000 for joint returns).

Elimination of Enhanced Charitable Deduction for Contributions of Book Inventory and Qualified Computer Contributions

The Act did not extend the enhanced charitable deduction for contributions of book inventory and qualified computer contributions. This deduction does not apply to any contributions made after December 31, 2011.

Possibility for Future Legislation to Impose Additional Limitations on Deductions

The Obama Administration has sought and may still seek legislation that further restricts the ability of taxpayers to reduce their tax liability by imposing a limitation (in addition to the Pease limitation and the Personal Exemption Phaseout). At this time it is unclear what form this limitation might take, such as a hard dollar or percentage cap on all itemized deductions or only on certain itemized deductions. Furthermore, it is unclear which income tax brackets might be affected by such a proposal. Nevertheless, if the administration is successful in enacting a further limitation, the value of a charitable deduction could decrease even further for some taxpayers.

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