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Overview of the Philanthropic Impact of the "American Taxpayer Relief Act of 2012"

by Robert Sharpe

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On January 1, 2013, Congress enacted the American Taxpayer Relief Act of 2012 (ATRA). While this legislation will have broad impact on the nation as a whole, in this paper we take a first look at the aspects of the law that will impact philanthropic funding of America's nonprofit community.

Given all of the controversy surrounding proposals put forth in recent months that could have had a negative impact on charitable giving, let's look first at what Congress did NOT do in the legislation. This knowledge will be important when it comes to taking action steps in the early days of 2013.

Charitable Deduction Remains Intact

Throughout 2012, a number of proposals were made to limit the amount or value of charitable deductions. Some suggested a cap on the amount of deductions that could be claimed regardless of one's tax bracket. Many feared that mortgage interest and other relatively fixed deductions would crowd out charitable gifts and could result in an effective elimination of the charitable deduction.

The administration and others proposed limiting the value of deductions to the 28% tax bracket. This would result in those in higher tax brackets being subject to tax on amounts given to charity, the effect of which would be to increase the amount of pre-tax income required to make charitable gifts.

Fortunately, the legislation as passed does not address the tax deductibility of gifts. Speculation abounds, however, that this issue will resurface in the next round of fiscal negotiations most expect to begin in a matter of weeks.

Pease Amendment Returns

There was also speculation that the so-called Pease Amendment, which expired in 2010, would not be reinstated in the tax code. That did not happen. Those who work with higher income donors should be aware of this and be prepared to discuss it if the issue is raised.

What is the Pease Amendment? Introduced in 1991, the Pease Amendment was designed to partially limit deductions for higher income taxpayers. Under its terms, total itemized deductions were reduced by 3% of the amount that a taxpayer's adjusted gross income (AGI) exceeded a threshold amount. Beginning in 2013 the Pease Amendment again applies with a threshold amount of $300,000 for married taxpayers who file jointly ($250,000 for single persons).

Some have commented on the possible negative impact of the return of this provision. The Sharpe Group does not believe this will occur. In 1991 when the amendment was first enacted, we predicted there would be little or no effect on giving. Over the subsequent 18-year period the Pease Amendment was in effect, this proved to be the case for reasons outlined in the footnote below.[1]

The Charitable IRA Is Back!

In addition to the good news regarding the lack of significant new limitations on the amount or value of charitable deductions, Congress included a late holiday gift to America's nonprofit community through the restoration of the IRA Charitable Rollover provision.

In addition to the extension of IRA Rollover gifts made in 2013 subject to the same amount ($100,000) and other restrictions in place since 2006, Congress announced a "January Sale" on gifts made from traditional or Roth IRAs. For IRA gifts to charity completed by those over age 70½ before the end of January 2013, such gifts will be deemed to have been made in 2012. This means that it is possible for those who act in a timely manner to make IRA Rollover gifts of up to $200,000 in 2013.

Another unexpected but welcome provision is the "January Do-Over" provision. Taxpayers who took a withdrawal (mandatory or otherwise) from their IRA during December 2012 may make a cash contribution of all or part of the amount of the withdrawal up to $100,000 before the end of January 2013 and treat the gift as if it had been a direct distribution to charity that qualified as an IRA Rollover gift for 2012.

Higher Income and Capital Gains Tax Rates

One of the more divisive issues surrounding the fiscal cliff negotiations concerned maximum tax rates for higher income Americans. While the president campaigned on higher taxes for couples earning $250,000 or more ($225,000 for heads of household and $200,000 for individuals), the final bill raised those amounts to $450,000, $425,000 and $400,000 respectively. For persons earning more than these threshold amounts, additional income will be taxed at the pre-2001 tax cut maximum rate of 39.6%.

In the case of capital gains and qualified dividend income, income tax rates increase from 15% to 20% at the same income threshold amounts that trigger the new 39.6% tax bracket. A Medicare contribution tax of 3.8% on capital gains, dividends, interest and other unearned income passed in 2010 health care legislation will also come into play in 2013 for those with adjusted gross income over $250,000 ($200,000 for singles and heads of household).

1 Why the Pease Amendment has not historically proven to be an impediment to giving by most

Example: George and Martha have an adjusted gross income of $500,000. Their itemized deductions include $30,000 in mortgage interest, $10,000 in state taxes and $10,000 in charitable gifts. The Pease Amendment will require that their itemized deductions for 2013 be reduced by 3% of the amount their AGI exceeds $300,000. Thus, they must reduce their total itemized deductions by 3% of $200,000, or $6,000. If they are in the 39.6% tax bracket this means their taxes are increased by $2,376, an effective tax increase in their case of one half of one percent.

Note that even if they had made no charitable gifts, the $6,000 reduction would still apply, reducing their fixed deductions regardless of whether they made charitable gifts. Even if their AGI were $1 million, the Pease reduction of 3% of $700,000, or $21,000, would not even serve to absorb all of their mortgage interest, much less their other deductions. As a result, since their charitable gifts are well outside the "reduction zone," there is arguably no practical impact on the value of their charitable deduction. A small number of taxpayers with very high incomes and/or no deductions other than charitable gifts could, however, see a negative impact from the reintroduction of the Pease Amendment.

Those who are subject to higher tax rates will be pleased to learn that their charitable gifts will be deductible against the higher rates and not limited to 28% or 35% as had been proposed. The after-tax cost of a charitable gift is, in effect, the amount a person would have left if they did not make a gift. If your tax rate is 35%, absent a charitable gift, you would have 65 cents of each dollar remaining to spend, save or give to others.

If you are in the 39.6% bracket, you would keep just over 60 cents of each dollar if no gift were made. Thus the argument that higher tax rates mean a lower cost of giving. If state income taxes are also applicable, a charitable gift saves even more. But this illustration also makes it clear that gifts to charity are not simply a "write off" where there is no cost involved and no donative intent is required.

Note that it is not appropriate to add the Medicare contribution tax on top of income tax to determine the after-tax cost of a gift as the Medicare tax is an excise tax that is paid on affected income and no deductions can be taken against that income. Charitable gifts do not, therefore, serve to reduce the tax on that income.

Taking Stock and Giving It

The new higher capital gains tax rate combined with increased ordinary income tax rates means that gifts of appreciated stock and other qualified properties will be relatively more attractive than in the past. For securities and other appreciated property donated to charity in 2012, the combined tax savings of 35% for income tax and 15% for capital gains could result in a total savings of up to 50% compared to 35% for cash gifts.

In 2013, on the other hand, with ordinary tax rates as high as 39.6% and capital gains tax rates increased to a maximum of 20%, the total savings can be just under 60%, a reduction in cost of as much as 20% for gifts of appreciated property as compared to an 8% reduction in the cost of cash gifts.

In addition, for those subject to the 3.8% Medicare contribution tax, a gift of appreciated property will permanently bypass that tax as well as the capital gains tax, as no sale takes place that would cause gain to be reportable. For that reason, the effective tax on capital gain income at the federal level could be as high as 23.8% and the total tax savings from a gift could be more than 63%. As in the case of cash gifts, state capital gains tax could further increase the savings from appreciated property gifts rather than cash.

Life Income Gifts

For those who encourage gift annuities, charitable remainder trusts and other split-interest gifts, keep in mind that capital gains and qualified dividend rates remain significantly lower than taxes on other sources of income. For that reason, gift annuities funded with appreciated stock and other gifts that result in payments partially in the form of capital gains or qualified dividends will remain attractive to donors who are interested in a predictable source of tax-favored income.

To summarize, with investment market values at post-recession highs, it may be more important than ever to make sure that appropriate donors are made aware of the interplay of federal and state tax rates as they consider what to give.

AMT Permanently Patched

For years, Congress has periodically patched provisions of the Alternative Minimum Tax that would otherwise serve to ensnare millions of middle-income taxpayers for whom the AMT was never meant to apply. What the AMT effectively does is eliminate many itemized deductions as part of a recalculation of taxes at a lower minimum rate. Congress acted to permanently raise the income level at which the AMT begins to apply and indexed that level for future inflation.

Some higher income taxpayers will continue to be affected by the AMT. What gift planners need to know is that charitable gifts have, contrary to what some believe, always been deductible against both the regular and the Alternative Minimum Tax. The difference is that the AMT rate is lower and the tax savings are thus somewhat less. In no case, however, does a taxpayer subject to the AMT wind up paying tax on their gifts, as would be the case if the charitable deduction were eliminated as some have proposed.

Estate Tax Changes

Absent Congressional action, the level at which estate and gift taxes applied was set to fall from $5 million to $1 million on January 1, 2013, and maximum tax rates were to rise from 35% to 55%. Under the American Taxpayer Relief Act of 2012, Congress surprised observers by maintaining the exemption for both estate and gift tax purposes at $5 million indexed for inflation ($5.12 million for 2012) and raised the maximum rate to just 40%.

Those who are working with donors with substantial estates should continue to emphasize the use of charitable lead trusts and other planning vehicles that can help charitably minded individuals make gifts while minimizing estate and gift taxes. When working with those who are no longer subject to estate taxes, many will find they now will have more discretionary estate dollars that will be newly available as they no longer must pay tax on amounts left to non-charitable recipients.

In other cases, older donors who may have planned for charitable bequests as part of their estate distributions and can now expect no estate tax savings may wish to accelerate the bequest and make it in the form of a gift annuity or other life income gift that provides them with immediate income tax savings while also increasing their spendable income in times of lower interest and other investment returns.

Miscellaneous Provisions

In addition to the more broadly applicable aspects of the new law discussed above, other miscellaneous provisions are included in the legislation. Special rules for real property contributed for conservation easements are extended, as is the enhanced charitable deduction for contributions of food inventory and the basis adjustment to stock of S Corporations making charitable contributions of property. The law also reinstates phase-outs of personal exemptions for higher income taxpayers. This should have little impact on charitable giving except to the extent that the loss of personal exemptions results in somewhat less discretionary income from which to make gifts. The same can be said for the end of reduced payroll tax deductions that for the past two years have resulted in additional discretionary income for millions of donors. The loss of that benefit could also impact smaller charitable gifts by some donors.

A “Bird in the Hand?”

When announcing the terms of the new tax law, commentators on both sides of the aisle made it clear that changes to the tax rates were just the beginning of a broader approach to deficit reduction. Spending cuts will be considered in the next round of negotiations. The president and others have mentioned the need to broaden the tax base by limiting deductions that “are not available to all Americans.” Reducing deductions has been termed by others as a reduction in tax expenditures. Whatever the case may be, it is not unlikely that further changes in the amount of deductions available, or their value, could be in the offing.

When coupled with the January 31, 2013, deadline for IRA Rollover gifts and the prospect for future limitations of the amount deductible for charitable gifts, we believe that early 2013 will be an excellent time to encourage additional gifts that will almost certainly be fully deductible for 2013, if not in future years after the next round of changes.

While almost every donor will be affected by one or more of the provisions of the new legislation, those who enjoy supporting charitable interests will, as noted at the outset, be relieved to find that a variety of proposed changes that could have negatively affected charitable giving were not included in the 2012 tax act.

As a result, now is the time to share the good news with your donors and reap maximum results from this welcome period of certainty, however brief.

About the Author

Robert Sharpe, president of the Sharpe Group, is a leader in the field of nonprofit financial development and a noted author and speaker. With more than 30 years of nonprofit fund development and consulting experience, Mr. Sharpe has helped many of the nation's leading nonprofits plan, develop and implement successful major gift planning and endowment development programs.

He is the author of many articles on a variety of gift planning topics and has been published in *The Wall Street Journal*, *The New York Times*, *Newsweek*, *Forbes*, *Smart Money*, *Market Watch*, *The Chronicle of Philanthropy*, *Trusts & Estates*, *Kiplinger's* and others. He is a frequent speaker at gatherings across the country. He chairs the philanthropy committee of the editorial board of *Trusts & Estates* magazine and writes a column on related matters.

Mr. Sharpe is co-author of Model Standards for Gift Valuation adopted by the Partnership for Philanthropic Planning. He is a cum laude graduate of Vanderbilt University and Cornell Law School.

About Sharpe Group

For 50 years, the Sharpe Group has been a leader in helping to ensure the financial security of thousands of America's educational, healthcare, religious, social service and cultural institutions.

With offices in Washington, Memphis and San Francisco, the Sharpe Group includes consultants, marketing experts and creative resources.

Sharpe consultants frequently present at leading industry conferences and are quoted regularly in national publications, including *The New York Times*, *The Wall Street Journal*, *Trusts & Estates*, *Kiplinger's*, *The Chronicle of Philanthropy* and many other leading publications.