

[Bill Laskin](#) - Sun, 1/20/2013 - 00:00

The American Taxpayer Relief Act (ATRA) passed by Congress on January 1, along with the Affordable Care Act, have inaugurated a host of changes to federal tax rules that will alter donors' tax incentives for making charitable gifts, including planned gifts.

For the most part, there is good news to share:

- Despite consideration of a 28% limit on charitable deductions or a total dollar limit on all itemized deductions, in the end no significant new limits on the charitable deduction were introduced;
- There are opportunities for some taxpayers to save more in taxes by taking charitable deductions;
- There's less uncertainty about the future of transfer tax rates and exemptions, making some donors more comfortable with making estate plans that include charity; and
- The charitable IRA rollover is back, at least for 2013.
- **Increase in highest income tax bracket**
The top federal income tax rate has increased from 35% to 39.6%. All other federal income tax rates are the same as they were in 2012.

The new top bracket applies to married filing jointly and surviving spouses with taxable income over \$450,000, single taxpayers with taxable income over \$400,000, and heads of households with taxable income of \$425,000. These thresholds will be indexed for inflation after 2013.

Importance to donors: Donors in the new 39.6% bracket will benefit from greater tax savings by taking a charitable deduction against a higher rate.

- **Increase in highest capital gain and qualified dividend tax rate**
The top federal tax rate on most long term capital gain income and qualified dividends has increased from 15% to 20% for the same taxable income thresholds as for the new 39.6% income tax rate discussed above.

Importance to donors: The higher tax rate on long term capital gains will make gifts of appreciated property significantly more attractive to high income donors. For

example, an appreciated property gift that avoided \$12,000 in capital gain tax at a 15% rate will now avoid \$16,000 at a 20% rate.

- **3.8% net investment income tax (Medicare surtax)**

This new tax went into effect on January 1, 2013 as part of the Affordable Care Act of 2010, not ATRA. It is imposed on top of other income taxes and kicks in when modified adjusted gross income (MAGI) is above \$250,000 for joint returns and surviving spouses, \$200,000 for heads of households and single taxpayers, and \$125,000 for married filing separately. The surtax applies to the lesser of (1) net investment income or (2) the amount by which a taxpayer's MAGI exceeds the applicable threshold. There is no charitable deduction against the surtax.

Example: *George and Ann McNeil are married filing jointly with \$100,000 in wage income and \$200,000 of long-term gain on the sale of appreciated stock. They will be in the 25% income tax bracket, with capital gains taxed at a lower rate of 15%. However, since their MAGI is \$300,000, they are subject to the 3.8% surtax on \$50,000, the lesser of their \$200,000 in net investment income and their \$50,000 excess MAGI over the threshold (\$300,000 - \$250,000). The surtax effectively raises their marginal capital gains tax rate from 15% to 18.8%.*

If the McNeils had taxable income exclusive of their capital gain in excess of \$450,000, then the tax rate on their capital gain would increase from 20% to 23.8%. In each case, the surtax makes giving appreciated property to charity more attractive.

Payments from planned gifts: Planned gift beneficiaries who have a MAGI above their applicable threshold will owe the 3.8% surtax on their payments from gift annuities, charitable remainder trusts, or pooled income funds. In the case of CRTs, only income earned on or after January 1, 2013 is subject to the surtax when distributed. The surtax also applies to non-grantor charitable lead trusts with excess income above \$11,950.

Importance to donors: The Medicare surtax introduces additional complexity that gift planners will have to learn and adapt to in working with donors who may be subject to it. However, it strengthens incentives for charitable giving, particularly of appreciated property.

- **AMT thresholds increased**

The alternative minimum tax (AMT) is a parallel income tax system that is designed to assure that taxpayers who have taken certain types of deductions against the regular income tax pay at least a minimum amount of tax. The AMT has only two rates, 26% and 28%. For a taxpayer who would otherwise be in the 33% income tax bracket, for example paying the AMT reduces the value of her itemized charitable deductions from 33 cents on the dollar to 28 cents on the dollar.

The good news is that ATRA has permanently patched the AMT exemption amount and has incorporated an annual inflation adjustment so that the AMT will not apply to middle income taxpayers, as it would have without the patch. This change may encourage some middle income donors to make more charitable contributions, including planned gifts.

- **Charitable IRA Rollover Extended Through 12/31/2013**

ATRA has extended the popular charitable IRA rollover through 12/31/2013 and retroactive to 1/1/2012. The charitable IRA rollover enables a donor to make a gift to charity from his IRA and not include the amount distributed in his taxable income.

As in the past, the donor must be at least 70½, only rollovers from a traditional IRA or Roth IRA qualify, the total of all rollover gifts in a year must be \$100,000 or less, the gift must be made to a public charity (not a private foundation, supporting organization, or donor advised fund maintained by a charity), and the donor cannot receive a benefit in exchange for the gift (this requirement rules out gifts for life income arrangements).

In addition to making a charitable gift from an IRA an easy one-step process, the charitable IRA rollover offers tax advantages to donors who wouldn't be able to use their entire deduction if they were to withdraw IRA funds themselves and then donate them.

Example: Mary Chen does not itemize her deductions and is in the 28% income tax bracket. If she makes a \$5,000 rollover gift to your charity from her IRA, her income tax will be unaffected. If she were to withdraw the \$5,000 herself, she would have to include the \$5,000 withdrawal in her income. Since she does not itemize, Mary wouldn't get an offsetting deduction for giving it to charity. As a result, she would

pay an additional \$1,400 of income tax (28% x \$5,000).

Because the charitable IRA rollover is retroactive to the beginning of 2012, donors who made IRA rollover transfers to charity any time during 2012 can now treat them as qualified charitable IRA rollover gifts. Be sure your charity has provided these donors with proper documentation of their gift.

Donors who took an IRA distribution in December 2012 and made a cash gift to your organization later that same month can tie the two events together as an IRA rollover gift by making an election on their tax return. The Secretary of the Treasury will specify how to make the election later this year.

Opportunities available in January only: Two special provisions are available in January 2013 only, so donors will need to act quickly to take advantage of them. If a donor did not make a qualifying gift in 2012 but wants to, she can do so in one of two ways:

- Your donor can do a rollover gift in January and elect to have this gift be considered made in 2012.
- Donors who took an IRA distribution in December that meets all of the IRA rollover requirements other than a direct distribution to charity can claim it as a charitable IRA rollover gift in 2012 to the extent that they now transfer the distribution in cash to your organization. This transfer must occur by January 31, 2013.

The IRS provides [instructions](#) on how to report such gifts.

Importance to donors: The revival of the charitable IRA rollover is great news for gift planners, at least through the end of 2013. According to the Investment Company Institute, IRA assets totaled \$5.13 trillion as of June 30, 2012. The combination of an appealing giving opportunity and the huge reservoir of funds eligible to take advantage of it represents an excellent fundraising opportunity for gift planners. Make sure you use all of your marketing channels to let your charity's supporters know about the benefits of the charitable IRA rollover in 2013. Take advantage of the 11 months you know it has left.

- **Pease limitation - the 3% deduction reduction rule**

ATRA resurrects the "Pease" limitation on itemized deductions that was in effect from the late 1990s until it was completely phased out in 2010.

This limitation requires taxpayers with adjusted gross income (AGI) above a specified threshold to reduce their itemized deductions by 3% of the amount by which their AGI exceeds the threshold. The reduction also has its own limit: it cannot reduce total itemized deductions by more than 80%.

The thresholds for 2013 are \$300,000 for married filing jointly and surviving spouses, \$275,000 for heads of households, \$250,000 for single filers, and \$150,000 for married filing separately filers.

In the past, the Pease limitation had no more than a mild effect on charitable contributions. Now, that effect should be even milder because the new thresholds are substantially higher than the previous ones were so fewer donors will be affected by it.

Example: Mr. and Mrs. Smith file a joint tax return. Between them, they have a total AGI of \$500,000. They have taken itemized deductions for \$20,000 real estate taxes and \$10,000 in mortgage interest, as well as \$50,000 in charitable deductions, for a total of \$80,000 in itemized deductions. Because of the Pease limitation, their itemized deductions will be reduced to \$74,000 as follows:

$$\begin{aligned} \$500,000 - \$300,000 &= && \text{Amount subject to 3\% deduction reduction} \\ & \$200,000 \\ \$200,000 \times 3\% &= \$6,000 && \text{Amount of deduction reduction} \\ \$80,000 - \$6,000 &= \$74,000 && \text{Amount of itemized deductions after} \\ & && \text{reduction} \end{aligned}$$

Notice that the Smiths' real estate taxes and mortgage interest deductions far exceed their \$6,000 Pease limitation. The \$6,000 reduction can be thought of as affecting the value of only these deductions. Consequently, the Smiths' charitable deductions will reduce their total income tax due by the same amount, with or without the \$6,000 reduction. The Smiths would need a combined AGI of over \$1.2 million before the reduction in their total itemized deductions started eating into their itemized charitable deductions. If they lived in a state with a state income tax, and most people do, they would itemize a state income tax deduction and need an even greater combined AGI before their charitable deductions were reduced!

Importance to donors: The Pease limitation adds a layer of complexity for high

income donors, which could discourage some donors from making as many charitable gifts. From the viewpoint of tax incentives, however, the limitation should affect the charitable giving of only a tiny fraction of all donors.

- **Gift, estate, and GST tax exemption amounts are the same as in 2012 (with indexing for inflation), but permanent**

Under ATRA, the gift tax, estate tax, and generation skipping tax (GST) exemptions stay substantially the same as they were in 2012. With indexing for inflation, in 2013 they are \$5.25 million per individual, \$10.5 million for married couples.

ATRA makes permanent the portability of unused spousal gift tax and estate tax exemptions. This portability allows a surviving spouse to elect to use any unused exclusion remaining from his or her last deceased spouse. Portability is not available for the GST tax exemption.

Example: Karen McNeil dies in 2013, having made \$1 million in lifetime taxable gifts. She leaves her entire \$10 million estate to her husband, so no estate tax is due at her death. If an election is made on her estate tax return to allow her husband to use her \$4.25 million unused estate tax exclusion, his available exclusion amount will increase to \$9.5 million — his own \$5.25 million plus his wife Karen's unused \$4.25 million. He can use his \$9.5 million exclusion for lifetime gifts and any unused amount for estate taxes.

Importance to donors: Under ATRA, very few donors will have estates large enough to owe estate tax. For these donors, saving estate tax will not be a motivation for making bequests or other planned gifts. Gift planners will do well to focus on promoting to this group their organization's mission and the importance of leaving a legacy.

A big plus of the new law is that it lays to rest, at least for now, donor and advisor uncertainty over the future of transfer tax exemptions. Donors who were delaying their estate planning until this uncertainty was resolved can now proceed with their planning, including their charitable planning. This benefit applies to all donors no matter the size of their estate.

- **Increase in top gift and estate tax bracket and in GST bracket from 35% to 40%**

ATRA has increased the top federal gift tax and estate tax brackets from 35% to 40%. Consequently, the generation skipping tax (GST) rate has also increased from 35% to 40%.

The 40% rate kicks in at a taxable gift/estate of \$1 million, far below the \$5.25 million exemption available against these taxes. What this means is that a donor will pay a 40% tax on every dollar transferred above and beyond the \$5.25 million threshold (\$10.5 million for married couples).

Importance to donors: For most planned gift donors, the increase in gift/estate tax rate will make no difference, as the generous gift/estate tax exemptions will be sufficient to eliminate all gift/estate tax. However, for donors whose estates are large enough to owe estate tax, the higher top rate for taxable transfers will increase moderately the incentive to make outright bequests or fund a planned gift during life or at death. For some in this group, the estate planning benefits of the charitable lead trust will be especially attractive.

The combination of a higher top income tax bracket and higher top estate tax bracket also means there's a greater incentive for wealthy donors to designate qualified retirement plan assets for charity. Since retirement plan assets and other income in respect of a decedent (IRD) are subject to both income and estate taxes, the potential combined federal tax rate on these assets has risen from about 58% to over 63%. State taxes could drive that rate even higher.

- **Conservation contribution provisions extended**

ATRA extends through 12/31/2013 provisions that encourage qualified conservation contributions by increasing the donor's deduction limit, even if the property has appreciated, to 50 percent of AGI, and the carryover period for the unusable portion of the deduction to 15 years. The deduction limit increases to 100 percent of AGI when the donor is a qualified farmer or rancher and the property will be used in agriculture or livestock production. This extension represents an important fundraising and marketing opportunity for charities whose mission includes protection of the environment.

- **Sub S corp gift provisions extended**

When a Subchapter S corporation makes a gift of appreciated stock or real estate, the shareholders then claim their pro rata share of the contribution on their personal tax return. Under prior law, the shareholder had to reduce the

basis of his or her stock by the amount of the contribution claimed, which effectively negated the benefit of such gifts. ATRA extends through 12/31/2013 a provision that eases this problem by making the basis reduction equal to the shareholder's pro rata share of the basis of the contributed property, rather than the shareholder's pro rata share of the market value of the contributed property. Keep this extension in mind whenever working with a supporter who owns Subchapter S stock. Consider including an article about this opportunity in a newsletter early in the year.

Conclusion

On balance, we expect the tax changes reviewed above to be favorable to charitable giving, including planned giving. The resurrection of the charitable IRA rollover, in particular, gives gift planners a great opportunity to tap into a huge potential source of outright gifts for the remainder of 2013. Gift planners should continue to work toward convincing Congress to make the charitable IRA rollover permanent.

Higher top income tax and estate tax brackets will affect relatively few donors, but for these donors the higher brackets will provide additional incentive for them to make charitable gifts of all kinds. Donors who are in the highest income tax bracket and subject to the 3.8% net investment income tax will be able to avoid substantially more capital gains tax by funding charitable gifts such as charitable remainder trusts with long term appreciated property. Also significant, many donors and their advisors will be more comfortable doing charitable planning now that a possible dramatic increase in transfer taxes is no longer a concern.

Congress is not done grappling with the U.S.'s long term budget challenges. Broad tax reform may very well be part of the solution, parts of which would likely affect the incentives for making planned gifts. We won't know the specifics for many months. In the meantime, gift planners have a lot to work with in the new year to encourage planned gifts from their donors.

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