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Memorandum Regarding Recent Developments in the Tax Law Affecting Individuals and Charitable Organizations

October 5, 2006

This memorandum briefly highlights recent tax law changes that may be of interest to our individual clients and to charitable organizations, including those effected by the Pension Protection Act of 2006 (the "PPA"), which was signed into law by President Bush on August 17, 2006.

New "Inherited" IRA Rollover Option for Non-Spouse Beneficiaries

Starting in 2007, the non-spouse beneficiary of a qualified retirement plan, such as a 401(k) plan, may roll the plan account into an inherited IRA. There are a number of reasons that a beneficiary may wish to roll over a qualified plan into an inherited IRA upon the plan owner's death. With an inherited IRA, the beneficiary may elect to take distributions from the account over his or her life expectancy, providing significant income tax deferral. By comparison, if the "life expectancy election" is unavailable under the terms of a qualified plan, the beneficiary would be forced to withdraw the account in a lump sum. Moreover, an inherited IRA account may provide the beneficiary with greater investment control and, in many cases, with more investment options.

Favorable New Rule Regarding IRA Distributions to Charities

For 2006 and 2007 only, if you have reached age 70½, you can contribute up to $100,000 each year to charity from your IRA income-tax-free. The amount contributed to charity counts toward your minimum distribution requirement but will not be included in your gross income. The exclusion does not apply to contributions to donor advised funds, supporting organizations or most private foundations.

This exclusion from gross income may be more valuable than a charitable deduction because of certain limitations on itemized and charitable deductions under the Internal Revenue Code (the "Code") and State income tax laws. However, if you hold long-term capital gain property with a low income tax basis, it may be more advantageous to take the required minimum distribution, which would be includable in your gross income, and to donate your appreciated property to charity. Your donation would offset (at least in part) the

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income attributable to your required minimum distribution, and you would avoid any capital gains with respect to the unrealized appreciation in the donated assets.

Changes Regarding Gifts of Fractional Interests in Tangibles to Charities

As a result of changes effected by the PPA, fractional gifts of tangible personal property are no longer an attractive technique for charitable giving. Under the new rules, if you make an initial gift of a partial interest in, for example, a painting to a museum, the value of the partial gift will be fully deductible for income and gift tax purposes, as under current law. However, when you make subsequent gifts of your remaining interest in the artwork, your charitable income and gift (or estate) tax deductions will be based on the value of the artwork at the time of the initial gift. As a result, you will not receive a deduction for any appreciation in the value of the artwork after the initial gift. For income tax purposes, the result will be a smaller income tax deduction. For gift or estate tax purposes, this limitation on the charitable deduction may actually result in the imposition of a gift or estate tax. In addition, if you fail to transfer your entire interest in the tangible property to the charity within ten years after the initial contribution (or prior to your death, if earlier), you will be required to recapture income and gift tax deductions already taken and will be liable for interest and penalties. These rules apply to all gifts made after August 17, 2006.

If you have already made a gift of a fractional interest in tangible property to charity and would like to donate the balance of your interest in the property, you should give away your entire remaining interest through a single lifetime or testamentary transfer.

Recapture of Deductions Where Charity Ceases Related Use of Donated Tangible Property

If you contribute appreciated tangible personal property to a charity, you may take a charitable income tax deduction for the fair market value of the property if the property is to be used in connection with the charity's tax-exempt purposes. The deduction for a donation of appreciated tangible personal property that is not to be used in furtherance of the charity's exempt purposes is limited to the taxpayer's basis in the property.

Prior to the PPA, you could take a full deduction for the value of the donated tangible property if it was reasonable to anticipate that the property would be put to a related use. Under the new rules, if the charity disposes of the property within three years after receiving it, your charitable deduction is reduced to your tax basis in the property (through recapture provisions if the sale occurs after you have already taken the deduction). The charity has the burden of notifying the IRS and the taxpayer of any such disposition. A disposition by the charity will not reduce the taxpayer's deduction if the charity provides a certification to both the IRS and the taxpayer that its original intent to use the property for

exempt purposes became impossible. This rule is effective for contributions made and returns filed after September 1, 2006.

**More Stringent Substantiation
Requirements for Charitable Contributions of Cash**

Starting in 2007, no charitable deduction will be allowed for your cash contributions of under $250 to charity unless you retain a cancelled check, bank statement showing the gift or receipt from the charitable organization that received the contribution. The pre-PPA rule requiring a written receipt from the charity for contributions in excess of $250 remains in effect.

New Restrictions on Used Items Donated to Charity

In order to obtain a charitable deduction for a donation of used clothing or household items, you must now retain a receipt indicating that the donated item was in at least "good" condition. These rules apply to all gifts made after August 17, 2006.

Changes Regarding Conservation Easements

The PPA provides an incentive for some taxpayers to grant a conservation easement with respect to their real property prior to 2008. In 2006 and 2007, if you grant a conservation easement to charity, your charitable deduction will be allowable up to 50% of your adjusted gross income (rather than only 30%), and you may carry forward any excess deductions for 15 years (rather than for five years).

However, there are new restrictions on obtaining an income tax deduction if you grant a façade easement with respect to your residence. The relevant property must itself be a registered historic site. Prior to the PPA, it was sufficient for the residence to be located in a historic district. In addition, in order to obtain the income tax deduction, new reporting requirements must be met, including disclosure of all existing restrictions on alteration or development of the property. Moreover, your deduction will be reduced to account for any rehabilitation credit that you have received.

Increased Excise Taxes for Charities

The PPA doubles private foundation excise taxes applicable to self-dealing transactions, excess business holdings, jeopardy investments or failure to make required minimum distributions. In the public charity context, the PPA also doubles the excise taxes applicable to "excess benefit" transactions. The provisions are effective starting in 2007.

New Thresholds for Valuation Misstatements

The Code requires you to submit property appraisals with income, estate or gift tax returns under certain circumstances and applies penalties if the property value has been "substantially" or "grossly" misstated for purposes of calculating taxes. The PPA sets new thresholds for determining what is a "substantial" or "gross" misstatement, so that the penalties will be triggered more easily.

For estate and gift tax purposes, an underestimate of value is deemed "substantial" if it is 65% or less of the correct value and "gross" if it is 40% or less of the correct value (before, the percentages were 50% and 25%, respectively). For income tax purposes, an overestimate of value is deemed "substantial" if it is 150% or more of the correct value and "gross" if it is 200% or more of the correct value (before, the percentages were 200% and 400%, respectively).

In addition, the PPA eliminates the "reasonable cause" defense for "gross" misstatements. Penalties will also be more readily applicable to appraisers who have provided the misstated property valuations. The new rules apply to appraisals submitted after August 17, 2006.

529 Plans to Remain Tax-Exempt

The PPA has made permanent the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") relating to Section 529 of the Code. As a result, distributions from 529 Plans for qualified higher education expenses will continue to be exempt from Federal income taxes. These Code provisions were scheduled to expire at the end of 2010 under EGTRRA.

"Kiddie Tax" Now Applicable Until Age 18

Another noteworthy recent change in the tax law was effected by the Tax Increase Prevention and Reconciliation Act of 2005, which became law on May 17, 2006. The "kiddie tax", which taxes the unearned income above a certain threshold (over $1,700 for 2006) of a child at the parents' top marginal income tax rate, now applies until a child attains age 18. Prior to this legislation, the "kiddie tax" applied only to children under age 14.

Current Annual Exclusion and Federal Estate, GST and Gift Tax Exemptions

As we approach the end of 2006, we wanted to remind you of the current annual exclusion amount and exemptions from Federal estate, gift and generation-skipping transfer ("GST") taxes, which follow.

The annual exclusion for gift-tax-free gifts in 2006 is $12,000 per donee (or $24,000 per donee for married persons electing to split gifts). It is expected that this inflation-adjusted number will be the same for 2007. The annual exclusion for tax-free gifts to non-citizen spouses in 2006 is $120,000. It is expected that this inflation-adjusted number will increase for 2007, likely to $125,000.

The Federal Estate Tax Exemption and the exemption from the GST tax are $2,000,000. Unless the Federal transfer tax laws are amended again, exemptions are scheduled to increase to $3,500,000 in 2009. The estate and GST taxes are scheduled to be repealed in 2010 but then re-imposed with $1,000,000 exemptions in 2011.

The Federal Gift Tax Exemption is $1,000,000. The Federal gift tax is not scheduled for repeal in 2010.

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If you would like to discuss how these changes affect you, please call one of the attorneys in our Private Clients and Charitable Organizations Practice Group.

This memorandum and our previous memoranda are available at www.clearygottlieb.com in the Private Clients practice area.

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