

Charitable Contributions: Deductibility and Other Federal Income Tax Issues

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Organizations asking for your financial support often mention that contributions "may be tax deductible." The deductibility of charitable contributions for federal income tax purposes is subject to a variety of limits and restrictions. Outlined below is information to help you understand the applicable rules relating to charitable contributions made by individuals.

Contributions must be to a "qualified organization."

Charitable contributions are deductible only if made to a qualified organization. You cannot deduct contributions to an individual or to a non-qualified organization, even if the funds are used for a purpose that otherwise would be thought of as charitable. Generally, qualified organizations are U.S. based organizations that have been formally recognized as tax-exempt by the federal government and are one of the following types of organizations:

- Corporations, trusts, funds or foundations that are organized and operated for religious, charitable, educational, scientific or literary purposes, or to prevent cruelty to children or animals. Included in this category are churches, synagogues and mosques; public service charities, such as the Red Cross and the United Way and its member agencies; non-profit colleges, universities and other schools; non-profit hospitals and medical research organizations; and public libraries and museums.
- War Veterans' organizations.
- Domestic fraternal societies operating

under the lodge system. A contribution to this type of organization is deductible only if it is to be used solely for religious, charitable, educational, scientific or literary purposes, or for the prevention of cruelty to children or animals.

- Certain nonprofit cemetery companies or corporations. A contribution to this type of organization is not deductible if it is to be used for the care of a specific lot or crypt.
- The United States or any state, the District of Columbia, a political subdivision of a state or possession, or an Indian tribal government. A contribution to this type of organization is deductible only if it is voluntary and to be used solely for public purposes, *e.g.*, for public parks and recreation facilities or to support a volunteer fire department.

Types of contributions.

Charitable contributions generally may be made in cash, property or goods. In some situations, you may also deduct expenses incurred in providing charitable services.

Cash includes money, checks and credit card contributions. A cash contribution is made at the time of its unconditional delivery to the organization. Contributions by check are deductible in the year the check is mailed; credit card contributions are deductible in the year you authorize the charge.

Donated **property** is classified as either ordinary income property or capital gain property. Ordinary income property is

property that a sale on the date contributed would have resulted in ordinary income or short-term capital gain. For example, inventory or works of art by a donor may produce ordinary income, while stocks or bonds held for less than one year may produce short-term capital gain. Capital gain property is property that a sale at fair market value on the date of contribution would have resulted in long-term capital gain. For example, a sale of stocks or bonds held for more than one year would typically produce a long-term capital gain.

Commonly donated **goods** include used clothing, household items, computers, cars and boats.

Generally, you may not take a deduction for the value of your time spent engaged in charitable activities, but you may be able to deduct out-of-pocket **expenses** incurred while donating services to a qualified organization. The expenses must be un-reimbursed and directly connected with the services provided, and incurred solely because of the services provided and not personal, living or family expenses. These may include purchasing a uniform required by the organization which is not suitable for other use, and automobile expenses that are directly related to the use of your car in providing services.

Determining the value of your contribution.

Generally, charitable contributions are valued at their **fair market value** at the time of the contribution. However, special rules apply to property that has increased in value or which is subject to a debt (e.g., mortgaged property). **Fair market value** is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all relevant facts.

Appreciated property. The value of your contribution of donated property

that has increased in value since you acquired it depends on the classification of the property as either ordinary income property or capital gain property.

- *For ordinary income property*, the value of your contribution is limited to the amount you paid for the property.
- *For capital gain property*, the general rule is that the value of the contribution is the fair market value of the property. However, you must reduce the fair market value by the amount of the long-term capital gain (1) when donating property, other than qualified appreciated stock, to certain private foundations, (2) when donated tangible personal property is put to an unrelated use by the charity (e.g., if donated artwork is immediately sold to generate cash, instead of being added to a museum's permanent collection), or (3) if you elect to apply the 50% limit instead of the 30% limit, discussed below.

Depreciated Property. Generally, most goods you contribute will have decreased in value since you acquired them. The fair market value of used clothing is the price that buyers of used items pay in used clothing stores. Household goods often have little or no market value because of their age, condition or style. You must support any valuation of household goods with photographs, cancelled checks, receipts from the purchase or other evidence. Valuation of a car may be assisted by car buying guides (e.g., "blue books"), but the car's actual condition must be taken into consideration. (For example, if the blue book value is \$3,000, but the car needs \$1,000 in repairs, the value of your contribution is \$2,000.) You should also look at current sales and offerings in your area. When donating a boat, the boat must be appraised to determine the value of your contribution.

Note: The cost of obtaining an appraisal of any donated property is not itself deductible as a charitable contribution, but may be deductible as a miscellaneous itemized deduction, subject to the 2% of

adjusted gross income limit.

Benefits received may affect deductibility.

In addition to sending acknowledgements, organizations often thank donors for their contributions with tangible items, such as pins or tickets to a performance. Sometimes a donor will contribute and attend a fundraising event. The value of the benefit received reduces the amount of your contribution and, therefore, the deduction. For example, assume you pay \$100 to a charity to attend a dinner-dance. All of the money may go to the charity, but if the per-person cost of the event is \$25, you received a benefit (e.g., dinner, DJ) valued at \$25 and therefore can only deduct \$75 (the price paid, minus the fair market value of the event). Notably, if you make a donation and receive a ticket for an event but do not use the ticket, your deduction will still be reduced by the value of the ticket, unless you return the ticket for resale.

Colleges and universities often give donors preferential access to tickets to athletic events. Only 80% of the amount you donate is deductible as a charitable contribution if you make a payment to a college or university and, as a result, receive the right to buy tickets to an athletic event at the school's athletic stadium. Additionally, if part of the payment was for a ticket, the ticket price is subtracted from the payment and then the charitable contribution is limited by the 80% rule.

A complete summary of all of the rules affecting the deductibility of charitable contributions is beyond the scope of this Advisory, but interested readers may obtain more information from IRS Publication 526, Charitable Contributions, and IRS Publication 1771, Charitable Contributions - Substantiation and Disclosure Requirements. These publications are available on-line at www.irs.gov.

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Most qualified organizations that provide benefits to donors must document the benefits. For every donation over \$75 that was partly a contribution and partly a benefit, you should receive a written statement from the qualified organization. This statement should detail the amount of the benefit and the amount that is deductible.

Small items of appreciation from an organization, such as refrigerator magnets, are usually not classified as benefits. You can deduct your entire contribution to a qualified organization if you receive a small item or other benefit of token value and the organization has determined that the value of the item or benefit is not substantial and so advises you.

Limits on deductibility.

Current tax policy favors donations to qualified organizations. If the total of your annual charitable contributions is less than 20% of your adjusted gross income for the year, all of your contributions will be deductible, provided you itemize your deductions on your income tax return, and provided your adjusted gross income does not exceed an inflation-adjusted threshold amount (*i.e.*, for 2005, \$145,950, or \$72,975 if you are married filing separately). If your adjusted gross income exceeds the threshold, certain of your itemized deductions (including charitable contributions) will be reduced by 3% of the excess, subject to a floor of 80% of the amount of the deduction. If your charitable contributions exceed 20% of your adjusted gross income, in addition to the so-called "phase-out of itemized deductions" noted above, other limits may cap the total amount you may claim as a deduction in any given year. The applicable limits depend on the type of organization that receives the property and the type of property contributed.

Type of Organization. Generally, your maximum allowable charitable deduction cannot be more than 50% of your adjusted gross income for the year. (*But see information, on back page, about the Katrina Emergency Tax Relief Act of 2005.*) Contributions to veterans' organizations, fraternal societies, non-profit cemeteries and certain non-operating foundations, however, are limited to 30% of your adjusted gross income. For this reason, these organizations are sometimes referred to as "30% organizations" (as opposed to public charities, which may be referred to as "50% organizations").

Type of Contribution. Deductions for contributions of capital gain property are limited to 30% of your adjusted gross income. This limit is reduced to 20% of adjusted gross income if capital gain property is given to a 30% organization (such as a veterans' organization).

If your charitable contributions exceed the deduction limits, the excess may be carried-over and applied to future income tax returns for up to 5 years.

Recordkeeping.

You should maintain records detailing your charitable contributions. Although not submitted with your income tax return, these records substantiate the amount of any deductible contributions. The type of recordkeeping required depends on the amount and type of the contribution.

Cash contributions. Cash contributions under \$250 require: (1) a cancelled check or account statement, (2) a receipt from the charitable organization showing the name of the organization, the date of the contribution and the amount of the contribution, or (3) other reliable written records that include the name of the organization, the date of the

contribution and the amount of the contribution. Cash contributions over \$250 require an acknowledgement from the qualified organization or payroll deduction records. Generally, multiple contributions to the same organization are treated as separate contributions.

Noncash contributions. The records required for noncash contributions depend on the amount of the contribution. Contributions less than \$250 require a receipt from the charitable organization with the name of the organization, the date and location of the contribution, and a reasonably detailed description of the property. However, you are not required to get a receipt where it is impractical to get one (for example, from an unattended drop box). You should also retain information on the fair market value of the property at the time of the contribution, including any appraisal.

All other noncash contributions require an acknowledgement from the organization, including the name of the organization, the date and location of the contribution and a reasonably detailed description of the property. Additionally, the acknowledgement must include a description of the property you contributed, whether you received any goods or services in return for the contribution and a description and good faith estimate of any goods or services received. For all contributions over \$500 your records should include information about how and when you acquired the property and your cost or other basis in the property. Unless the gift consists of publicly traded securities, generally, contributions that are valued at over \$5,000 must be supported by a qualified written appraisal of the donated property.

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The Wiggin and Dana Estate Planning Advisory is a periodic newsletter designed to inform clients and other interested persons about issues and developments in the law affecting trust and estate administration and estate and tax planning for individuals and their families, fiduciaries, investment advisors and business owners.

This Advisory describes some of the basic rules applicable to charitable gifts. There are opportunities to do more sophisticated charitable gift planning involving deferred gifts, trusts and other procedures. Attorneys in Wiggin and Dana's Trusts & Estates Department would be pleased to advise clients on such matters. Our names and telephone numbers are listed on the first page.

Katrina Emergency Tax Relief Act of 2005

On September 23, 2005, President Bush signed the Katrina Emergency Tax Relief Act of 2005 into law. Aspects of this new law encourage increased charitable donations during the remainder of 2005. Significantly, individuals can take advantage of the tax breaks in this legislation even if their charitable contributions are to organizations whose activities are unrelated to the hurricane relief efforts.

There are still a number of open questions as to how the details of the new legislation will work, but outlined below are some of the highlights of the charitable giving provisions of the Act.

Suspension of the percentage limitations.

Generally, an individual's maximum annual charitable deduction is capped at 50% of adjusted gross income. Under the Katrina Relief Act, "qualified contributions" may be deductible in excess of the taxpayer's 50% limit for 2005. *Qualified contributions are cash contributions made during the period beginning August 28, 2005 and ending December 31, 2005 to a qualified charitable organization.* Notably, contributions of noncash property are not qualified contributions under the Act.

Assume your adjusted gross income for 2005 is \$100,000. Normally, your maximum charitable deduction for the year would be \$50,000. Assume you

donated \$45,000 to qualified organizations before August 28. Without the new law, the most you might be able to deduct for charitable contributions made during the remainder of the year would be an additional \$5,000. However, with the new law, any qualified cash contributions made between August 28, 2005 and December 31, 2005 can also be deducted, up to 100% of your adjusted gross income for the year, and any amount over that may be carried-over to future years.

Qualified contributions do not include a contribution to a segregated fund or account with respect to which the donor has advisory privileges with respect to distributions. Thus, contributions to donor advised funds will not qualify for this special tax relief.

The Katrina Relief Act also provides that:

- Qualified charitable contributions under this Act are not treated as itemized deductions for the purpose of the overall limitation on itemized deductions.
- A donor may claim an exemption of \$500 for providing at least 60 days of rent-free housing to a person dislocated from Hurricane Katrina. The exemption may be claimed for no more than four individuals (thus the maximum additional exemption is \$2,000).
- The mileage rate for charitable use of a vehicle is increased for the period after August 28, 2005 and before January 1, 2006.

Nothing in the Estate Planning Advisory constitutes legal advice, which can only be obtained as a result of personal consultation with an attorney. The information published here is believed to be accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues. If you would like to be added to the distribution list for the Wiggin and Dana Estate Planning Advisory, please contact Karen Osborn at 203.498.4449. **U.S. Treasury Circular 230 Notice:** Any U.S. federal tax advice included in this communication was not intended or written to be used, and cannot be used, for the purposes of avoiding U.S. federal tax penalties.

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