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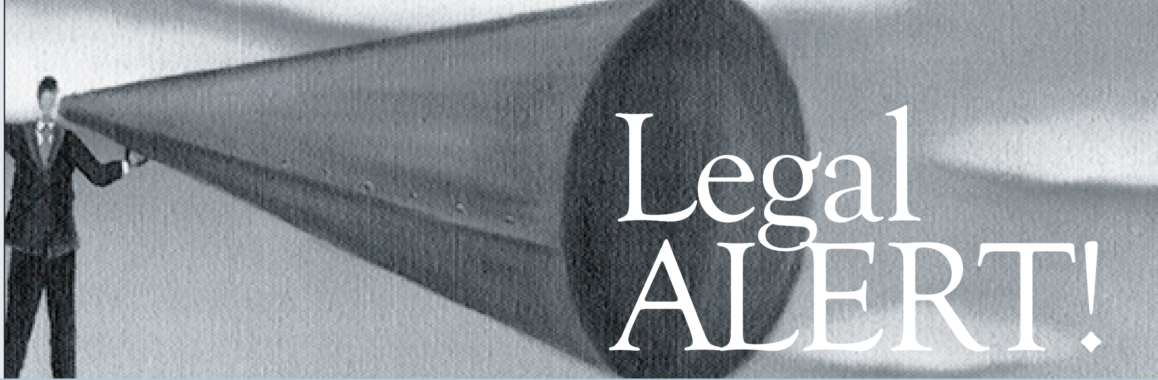

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Administration Budget Proposal would Significantly Impact Tax Benefits of Charitable Giving

On February 26, 2009, the Obama administration released its budget blueprint for the Fiscal Year beginning October 1, 2010 ("A New Era of Responsibility: Renewing America's Promise"). The next day, the Majority Staff of the Senate Budget Committee released an analysis of the 2010 budget proposal. Although the Administration will not release its full budget proposal until later in the spring, the budget blueprint has already engendered considerable discussion over the impact the budget will have on charitable giving by the wealthy. This Alert explains the impact the budget proposal would have on deductions for charitable giving if enacted as proposed.

<u>Summary of Proposal</u>

The Administration proposal would impact the tax benefits of charitable contributions in three ways:

First, the proposal would increase in the top marginal tax rate from 35% to 39.6%. According to the Senate Budget Committee Staff, this change would be effective in 2011. At first blush, this would appear to increase the tax-value of charitable contributions. However, this tax benefit would be offset by the second and third of the Administration's proposals.

Second, the tax rate at which high income taxpayers (i.e. those filing joint tax returns earning over $250,000 and singles earning over $200,000), could deduct itemized deductions would be capped at 28%. Neither the Administration's budget blueprint nor the Senate Majority Staff analysis states when this proposal would take effect. The illustration which follows treats this change as effective in 2011.

Third, the overall limitation on itemized deductions (the "3%/80% limitation"), which is phasing out in 2009 and will expire completely 2010, would be reinstated in 2011. This limitation applies to taxpayers whose adjusted gross income exceed a certain threshold (called the "applicable amount"). For 2009, the applicable amount is $166,800 for joint filers and $83,400 for singles. The "3%/80% limitation" requires taxpayers whose income exceeds the applicable amount to reduce their itemized deductions by 3% of the amount by which their adjusted gross income exceeds the applicable amount (but in no event by more than 80% of their total itemized deductions).

<u>Illustration of Proposal</u>

The impact of the Administration's proposal can best be illustrated by an example. Assume that John and Mary file a joint tax return and report an adjusted gross income of $375,000 in each of 2009, 2010 and 2011. John and Mary give $50,000 to charity in each of these years.

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The tax savings that John and Mary could expect from the charitable contributions in each of these years is reflected below.

Tax Benefits in 2009. Under current law, the maximum effective tax rate is 35%. Thus, every $100 in itemized deductions results in a tax savings of $35. John and Mary have a gross charitable contribution deduction of $50,000. However, under the "3%/80% limitation", John and Mary must reduce their itemized deductions by 3% of the amount by which their adjusted gross income exceeds the applicable amount (but not more than 80% of total itemized deductions). This reduction would ordinarily be $6,246. However, because this limitation is phasing out in 2009, John and Mary need reduce their itemized deductions by only one-third of this amount ($2,082). As a result, John and Mary may deduct $47,918 of the $50,000 contribution. At the 35% tax rate, the donation results in a tax savings of $16,771 (35% of $47,918), or 33.54% of the donated amount.

Tax Benefits in 2010. The Administration's proposals would not take affect until 2011. Therefore, the top marginal tax rate would remain at 35% in 2010. In addition, the "3%/80 limitation" will not apply in 2010. As a result, John and Mary will be entitled to deduct the entire $50,000 donation. At the 35% tax rate, the donation results in a tax savings of $17,500, or 35% of the donated amount.

Tax Benefits in 2011. If each of the Administration's proposals is enacted, the top marginal tax rate in 2011 will be 39.6%. However, the deduction for itemized deductions for wealthy taxpayers will be capped at 28%. In addition, the "3%/80% limitation" will be reinstated. Assuming that the "applicable amount" for purposes of the "3%/80% limitation" remains at the 2009 level, John and Mary would have to reduce their $50,000 charitable deduction by $6,246, resulting in a net itemized deduction of $43,754. Because the tax rate for deduction purposes would be capped at 28%, the donation would result in tax savings of $12,251 (28% of $43,754), or 24.5% of the donated amount.

<u>Conclusions and Hiscock & Barclay, LLP Recommendations</u>

If enacted as proposed, the proposals would result in a nearly one-third reduction of the tax benefits of charitable giving enjoyed by wealthy taxpayers.

It is impossible to predict whether and in what form the Administration's tax proposals will be enacted. We recommend that persons in the top marginal tax bracket who have charitable inclinations watch the news out of Washington over the next several months. The proposals relating to charitable giving have already generated attention in the mainstream media. This attention is likely to continue until the 2010 budget bill is enacted. If the Administration proposals appear likely to be enacted as proposed, taxpayers may find it advantageous to move up charitable giving from 2011 to 2009 or 2010, before the reduction in tax benefits takes affect. However, because the Internal Revenue Code limits the amount of charitable contributions which may be deducted in any year, we recommend that you consult your tax advisor about how to best structure charitable gifts over the next three years.

We will also monitor developments in Washington and provide periodic updates.

The principal author of this Alert is Raymond N. McCabe. Please contact Mr. McCabe or any member of our Tax Practice Area or Trusts and Estates Practice Area if you have any questions.

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