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# Newsletter

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## INDIVIDUAL TAX DEVELOPMENTS

Of all the recent tax law changes enacted by Congress, there is one that has the potential of reducing income taxes for nearly every retiree. Thanks to a major new change in the tax law, those over age 70½ are now permitted to make a direct transfer from their Individual Retirement Accounts (IRAs) to charity without reporting any taxable income on the IRA withdrawal. This change is effective now for the 2006 tax year and also applies for 2007.

At first glance, this may not seem like a major change. After all, if we take a taxable distribution out of our IRA and subsequently give those funds to charity, it would seem the reportable IRA income and the charitable deduction are simply a wash in our tax return. But in reality, this rarely has happened in the past. Here are a variety of illustrations to point out why the new opportunity of a direct IRA-to-charity approach is better.

### *Lower Income Filers*

A key point is that these tax-free transfers of an IRA to charity count toward the annual required withdrawal that every retiree over age 70½ must take from their retirement accounts. Many retirees, especially those with modest income, use the IRS standard deduction rather than claiming detailed itemized deductions that include their charitable contributions. For example, for 2006, joint filers are given a standard allowance of \$12,300, while a single filer retiree may claim \$6,400. As a result, these taxpayers can use an IRA transfer to fund their normal church contribution, for example, and avoid the income they otherwise would have been required to take from their IRA. Yet they retain the same deductions due to the standard allowance.

*Example.* Al, a retiree, is required to draw about \$5,000 per year from his IRA under the minimum distribution rules. Al also regularly contributes \$3,000 to his church, but does not receive any tax benefit because his standard deduction is greater than his total itemized deductions. If Al arranges for \$3,000 of his IRA withdrawal to go directly to his church annually, he will cut his taxable income by \$3,000.

### *Middle Income Filers*

The greatest savings of using the IRA-to-charity transfer accrue to that large group of taxpayers who face the phase-in of taxable social security benefits. Under a complex tax formula, middle income retirees have an increasing portion of their social security benefits brought into taxable income as their other reportable income increases. Adding \$10,000 of extra income can mean as much as \$8,500 of social security benefits becoming taxable! But the formula goes the other way also. Reducing IRA withdrawal income by a charitable transfer may also significantly reduce taxable social security benefits.

*Example.* Bill and Edna are retirees who collect \$30,000 in gross social security benefits, and have \$36,000 of other retirement income (IRA withdrawals, interest and dividends, etc.). At these income levels, they are in the 85% phase-in range on social security benefits. Bill and Edna give \$5,000 to their church annually

and claim this as an itemized deduction. If they direct an IRA transfer to their church for this \$5,000 contribution, they will have \$5,000 less of IRA income, but also \$5,000 less of charitable deductions. However, \$5,000 less of IRA income also means \$4,250 (85%) less in taxable social security, saving them about \$1,000 of Federal and state income taxes.

### ***Upper Income Filers***

Upper income filers are typically claiming itemized deductions, and may not appear to gain an advantage from accomplishing their larger charitable contributions through direct IRA transfers. However, greater income brings with it the many phase-outs of tax deductions and credits. For example, upper income filers lose a portion of their itemized deductions and personal exemptions merely by reason of the size of their income. Similarly, some tax credits become unavailable, and the likelihood of incurring the Alternative Minimum Tax (AMT) is much greater. For these reasons, most upper income filers will benefit from direct IRA-to-charity transfers by decreasing the income portion of their return, on which these various phase-outs are calculated.

### ***The Rules for IRA-to-Charity Transfers***

There are several rules that must be followed to bypass your 1040 with an IRA-to-charity transfer:

- The IRA owner must have attained age 70½ by the date of the transfer.
- The privilege only applies to IRA accounts. Retirement plan funds and other types of accounts, such as SEPs, would first need to be rolled to an IRA before the charitable transfer may occur.
- Any one individual is limited to \$100,000 per year of tax-free IRA-to-charity transfers.
- If an individual has some deductible and some nondeductible IRA accounts, any charitable transfer is first considered to come from the income portion, treating all IRAs as if pooled.
- The charity must be a publicly funded organization; it cannot be a private foundation or donor-advised fund.
- The charitable transfer is not subject to any percentage-of-income limitation, meaning that generous taxpayers who have previously encountered a limitation on their charitable gifts will not be limited on IRA transfers.
- The normal charitable receipt and documentation rules continue to apply. Assuming the IRA-to-charity transfer is \$250 or more, a receipt is required, and there cannot be any significant goods or services given back to the donor by the charity.

It seems clear that this new IRA-to-charity rule has opportunity for most over age 70½ retirees. If you have any questions about how it may apply to your situation, please let us know.

### **New Charitable Deduction Rules**

Within the depths of the massive pension legislation enacted this year, Congress also took the opportunity to adjust a number of rules affecting charitable contributions. Here is two of interest:

#### ***Cash Contributions***

In a surprising development, Congress now requires that all contributions of cash, regardless of amount, must be substantiated via bank record, such as a canceled check or credit card charge, or be supported by a receipt

from the charity that indicates the charity name, date of contribution, and the amount of the contribution. Fortunately, this rule is not effective until the 2007 tax year.

*Example.* Jed and Sue have a waterfront property that they enjoy as a second residence. While enjoying weekends at that location, they often attend weekly church services and normally contribute \$20 in cash. In the past, with careful notations of these cash contributions, they would have been allowed to include those in their charitable deductions. However, effective 2007, Jed and Sue will need to issue a check for these contributions, or obtain a receipt from the church to claim any deduction.

### ***Conservation Easements***

In general, a charitable contribution is not allowed for donating a partial interest in real estate. However, a special rule allows conservation easements, in which the donor retains underlying title, to qualify for charitable deductibility. A typical conservation easement is accomplished by placing a perpetual restriction on the property, in conjunction with a charity or public entity, which assures the property, will not be developed. The donor is allowed a charitable deduction equal to the diminished value.

To encourage a greater number of conservation contributions, Congress has enhanced these in two ways. Previously, a taxpayer's deduction for a qualified conservation contribution was limited to 30%-of-income annually, with any excess contribution limited to a five year carryforward. The new law allows up to 50% of income to be offset by these contributions, with any excess contribution eligible for a 15 year carryover.

In the case of farmers and ranchers, the 50% income limit is enhanced to 100%, with this privilege also applying to incorporated farms and ranches that place real estate in a qualified conservation easement. These changes are effective for tax years beginning in 2006.

### ***Appraisal Rules***

The IRS has had regulations in the past regarding requirements for appraisals of appreciated property that is the subject of a charitable contribution. Congress has significantly tightened those rules by making several changes. The tax law now contains a higher standard on the definition of an individual who serves as a qualified appraiser for charitable tax deduction purposes. In addition, Congress has added a new penalty that applies to those who prepare an appraisal for charitable purposes that involves a substantial or gross valuation error. And finally, the taxpayer penalties on claiming a charitable deduction with a significant valuation error have been broadened. These changes were all effective with enactment of the legislation, as of August 18, 2006.

### **Hybrid Vehicle Credits**

It previously was fairly simple. If you purchased a hybrid vehicle (one burning both gasoline and also propelled by electricity), you were entitled to claim a \$2,000 deduction in your tax return. But that system ended with the 2005 tax year, and, beginning in 2006, we now have a more complicated credit system that applies to hybrid vehicles and other energy efficient vehicles sold by manufacturers. Given the confusion in the marketplace about these credits, we believe that a few words of advice and explanation are important.

### ***The Credit Amount***

The tax credit amount varies for each make and model of vehicle. A manufacturer certifies the energy savings with the IRS, under a complicated formula that produces a specific credit amount that is assigned to the vehicle. This tax credit can vary significantly, from a low of \$250 (Chevrolet Silverado Hybrid 2 wheel drive) up to \$3,150 (Toyota Prius).

But there is further complexity. The tax rules limit the available credit to the first 60,000 qualifying vehicles sold in the U.S. by the manufacturer. Once that point is attained, the credit amount goes into a phase-down based on the date of acquisition.

For calendar year 2006, all of the hybrid vehicles qualify for 100% of their certified credit amount, with the exception of Toyota and Lexus models. Effective for vehicles purchased October 1, 2006, through March 31, 2007; those vehicles only receive 50% of their stated credit. And from April 1 through September 30, 2007, only 25% of the credit applies, with no credit after September 30, 2007. So, by way of illustration, if a taxpayer purchases a Toyota Prius in December of 2006, the credit is 50% of the \$3,150 certified amount, or \$1,575.

### ***Other Complexities***

Unfortunately, this hybrid tax credit only offsets regular income tax. It is not available to reduce AMT. The hybrid credit can only reduce regular tax to the point that it reaches AMT. Middle and upper income filers often have only a small gap between their regular tax and AMT, effectively limiting the benefit from this credit.

Businesses that purchase a hybrid vehicle will also receive the credit. But the credit amount must be treated as a reduction in the depreciable basis of the vehicle, and this has the effect of diminishing the value of the credit.

In terms of claiming the new hybrid credit in 2006 tax returns, we simply need to know the make and model of your purchased hybrid vehicle and the date it was acquired. No certification or other documentation is required.

And finally, there is no tax benefit for vehicles that burn both regular fuel and E-85 (ethanol fuel). Congress has chosen to incent ethanol with tax credits for the producers of the fuel rather than any credit for acquisition of the vehicle itself.

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## **BUSINESS DEVELOPMENTS**

### **Managing Tax Depreciation**

For small business owners, a key tax provision in recent tax years has become the Section 179 first year bonus depreciation deduction. The write-off can be significant: Up to \$108,000 of first year equipment purchases can be claimed as an immediate deduction. But the eligibility rules are confusing. Understanding these rules and budgeting your equipment replacements to fit within the Section 179 parameters is an important part of good tax planning.

Eligibility for the Section 179 first year deduction is limited to smaller businesses that do not exceed an annual asset addition limit. For tax years beginning in 2006, that threshold is \$430,000 of eligible purchases. Typically, eligible assets for Section 179 include equipment, fixtures, and vehicles, but not buildings. If the annual eligible purchases exceed the \$430,000 threshold, there is a dollar-for-dollar reduction in the eligible first year deduction.

*Example.* Jones Construction files on a calendar year and purchased equipment of \$450,000 during 2006. Jones must reduce its \$108,000 Section 179 limit by \$20,000, the amount by which its qualifying purchases exceed \$430,000. Accordingly, Jones may only claim a first year Section 179 deduction for 2006 of \$88,000 (\$108,000 - \$20,000). Had Jones been able to better budget its equipment purchases for the year to remain below the \$430,000 limit, it could have achieved a \$20,000 greater first year deduction.

### ***Other Eligibility Rules***

In view of the significance of this deduction, it is important to understand the other eligibility restrictions:

- Both new and used assets qualify, but only the boot paid counts if the asset is acquired through a trade.
- An entity's Section 179 deduction is limited to its business net income. Accordingly, if an S corporation is in a loss position, no Section 179 deduction is allowed.
- Property is ineligible if purchased from a related party.
- Property that is purchased and leased to others faces a complicated calculation to determine eligibility (but this rule does not apply to C corporations).

### ***Special Vehicle Rules***

Normally, automobiles are subject to a small annual depreciation limit that makes the Section 179 deduction impractical. For example, for an automobile placed in service in 2006, the first year depreciation limit is \$2,960, assuming 100% business use.

But a special privilege exists for vehicles with a gross vehicle weight rating over 6,000 pounds, such as full-size SUVs, pickups, and vans. These vehicles are allowed up to \$25,000 of first year depreciation.

But even this \$25,000 limit on larger trucks and vans has exceptions. Three categories of over-6,000 pound vehicles continue to qualify for a full write-off of their tax cost under Section 179, up to the \$108,000 limit:

- Vehicles with a seating capacity of more than nine persons behind the driver's seat (e.g., hotel shuttle van).
- A pickup truck with at least a six foot interior length cargo box.
- A van designed to carry cargo with no seating behind the driver's seat (e.g., an electrician's or plumber's van).

*Example.* Able Mfg. buys a full-size pickup truck with an 8 foot box to be used in the business at a cost of \$38,000. Assuming that this vehicle has a weight rating over 6,000 pounds, the entire cost of the pickup may be deducted under Section 179, because it is a truck with a six foot or greater interior length box. On the other hand, if Able purchased a four door pickup with a short 5.5 foot interior length box or an enclosed SUV without an open box, the Section 179 deduction would be limited to \$25,000.