

# Client Alert

A report  
for clients  
and friends  
of the firm      November 2004

## Recent Legislation Limits Charitable Deductions

In response to perceived abuses in connection with donations of patents or other intellectual property, as well as gifts of cars, trucks and other vehicles, legislation was recently enacted to limit the tax deduction for these donations. The provisions were included in the American Jobs Creation Act of 2004 (the "Jobs Act"), which was signed by President Bush on October 22, 2004. The Jobs Act also provides for increased reporting requirements for non-cash charitable contributions. The following is a summary of the key provisions of the Jobs Act that are applicable to nonprofit organizations.

### Contributions of Patents or Other Intellectual Property

For contributions made after June 3, 2004, under the Jobs Act, if a donor contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the donor's initial deduction is limited to the lesser of the donor's basis in the contributed property or the fair market value of the property. The donor is also allowed an additional charitable deduction for certain amounts in the year of the contribution and in subsequent years based on a specified percentage of the "qualified donee income" received or accrued by the charitable organization from the contributed property. Qualified donee income includes net income received or accrued by the donee that is properly allocable to the contributed property (as opposed to the activity in which the property is used).

The amount of the additional charitable deduction allowed per year is determined in accordance with the following table:

Tax Year of Donor	Deduction Permitted for that Tax Year
1st year ending on or after contribution date	100% of qualified donee income
2nd year ending on or after contribution date	100% of qualified donee income
3rd year ending on or after contribution date	90% of qualified donee income
4th year ending on or after contribution date	80% of qualified donee income
5th year ending on or after contribution date	70% of qualified donee income
6th year ending on or after contribution date	60% of qualified donee income
7th year ending on or after contribution date	50% of qualified donee income
8th year ending on or after contribution date	40% of qualified donee income
9th year ending on or after contribution date	30% of qualified donee income
10th year ending on or after contribution date	20% of qualified donee income
11th year ending on or after contribution date	10% of qualified donee income
12th year ending on or after contribution date	10% of qualified donee income
All subsequent years	No deduction permitted

The additional deduction is allowed only to the extent that the sum of the amounts of qualified donee income, calculated using the above table, exceeds the amount of the deduction claimed for the contribution of the intellectual property (*i.e.*, the lower of basis or fair market value on the date of contribution). No charitable deduction is permitted with respect to any income received or accrued by the donee after the expiration of the legal life of the patent or other intellectual property, or, if earlier, after the tenth anniversary of the date of the contribution. Although this ten-year limitation

conflicts with the twelve-year limitation noted in the table above, the legislation does not reconcile these two provisions.

The donor is required to inform the donee at the time of the contribution that it intends to treat the contribution as a contribution subject to the additional charitable deduction provisions. The donor must obtain written substantiation from the donee of the amount of any qualified donee income properly allocable to the contributed property during the donee's tax year. The donee is required to file an annual information return that reports the qualified donee income and other specified information relating to the contribution. If the donor and donee have different taxable years, the additional charitable deduction is based on qualified donee income for the donee's taxable year that ends within the donor's taxable year.

The additional charitable deduction is not available for patents or other intellectual property contributed to a private foundation (other than a private operating foundation, common fund foundation or conduit foundation).

The amount to be treated as qualified donee income when the donee uses the donated property to further its exempt purpose will be determined by regulations.

### **Deductions for Charitable Contributions of Vehicles**

The Jobs Act provides that for contributions of vehicles (including cars, boats and airplanes) after December 31, 2004, the amount of the deduction will depend upon the use of the vehicle by the charitable organization.

If the vehicle is sold by the donee (without intervening use or material improvement), the amount of the donor's deduction may not exceed the gross proceeds of such sale. However, if the vehicle is used for significant tax-approved charitable work, the donor can claim the fair market value of the donated vehicle as a tax deduction.

The provision also imposes new substantiation requirements for contributions of vehicles for which the claimed value exceeds \$500 (excluding inventory). A deduction is not allowed unless the donor substantiates the contribution with a contemporaneous written acknowledgement by the donee. The acknowledgement must contain the name and taxpayer identification number of the donor and the vehicle identification number (or similar number) of the vehicle. In addition, if the vehicle is sold by the donee (without intervening use or material improvement), the donee must (i) certify that the sale was at arm's length between unrelated parties and (ii) state the

gross proceeds of the sale and that the deductible amount may not exceed those gross proceeds. In all other cases, the acknowledgment must contain a certification as to the intended use (or improvement) of the vehicle, the intended duration of such use and a certification that the vehicle will not be transferred before the completion of such use or improvement.

The donee is required to notify the Internal Revenue Service of the information contained in an acknowledgement. The acknowledgement is considered contemporaneous if it is provided within thirty days of sale of a vehicle that is not significantly improved or materially used by the donee, or, in all other cases, within thirty days of the contribution.

A penalty will apply if a donee organization knowingly furnishes a false or fraudulent acknowledgement, or knowingly fails to furnish an acknowledgement in the manner, at the time, and showing the required information. With respect to a qualified vehicle sold without a significant intervening use or material improvement, the penalty is the greater of (i) the product of the highest rate of tax specified in section 1 of the Internal Revenue Code (currently 35%) and the sales price stated on the acknowledgement, or (ii) the gross proceeds from the sale of the vehicle. For all other acknowledgements, the penalty is the greater of (i) the product of the highest rate of tax specified in section 1 of the Internal Revenue Code and the claimed value of the vehicle, or (ii) \$5,000.

The committee reports provide that Treasury may prescribe regulations or other guidance that would exempt sales of vehicles that are in direct furtherance of the donee's charitable purposes from the requirement that the donor may not deduct an amount in excess of the gross proceeds from the sale (for example, if an organization directly furthers its charitable purposes by selling automobiles to needy persons at a price significantly below fair market value).

### **Increased Reporting for Non-Cash Charitable Contributions**

The Jobs Act requires increased donor reporting for certain charitable contributions of property made after June 3, 2004.

The legislation extends to C corporations the requirement (which is now applicable to individuals, partnerships, S corporations, closely-held corporations and personal service corporations) that the donor must obtain a qualified appraisal of the property if the amount of the deduction claimed exceeds \$5,000. The legislation also provides that if the amount of the contribution of property exceeds \$500,000, then the donor (whether an individual,

partnership, or corporation) must attach the qualified appraisal to the donor's tax return. Property and all similar items of property donated to one or more donees are treated as one property for purposes of these dollar thresholds.

These substantiation requirements do not apply to donations of: (i) cash; (ii) publicly-traded securities; (iii) inventory; and (iv) any qualified vehicles sold by a donee organization without any significant intervening use or material improvement and for which an acknowledgment is provided.

The legislation provides that a donor that fails to substantiate a charitable contribution of property by the due date (including extensions) of the donor's tax return is denied a charitable contribution deduction. If the donor is a partnership or S corporation, the deduction is denied at the partner or shareholder level. However, the denial of the deduction will not apply if it is shown that such failure was due to reasonable cause and not to willful neglect.

### Exclusions from the Unrelated Business Income Tax

For purposes of unrelated business income from debt-financed property transactions, the Jobs Act excludes from the definition of "acquisition indebtedness" certain indebtedness incurred by a small business investment company. To be excluded from the acquisition indebtedness rules: (i) the small business investment company must be licensed after October 22, 2004 under the Small Business Investment Act of 1958 ("SBIA"); and (ii) the indebtedness must be evidenced by a debenture: (a) issued by the company under Section 303(a) of the SBIA; and (b) held or guaranteed by the Small Business Administration. The exclusion, however, does not apply during any period that any exempt organization (other than a governmental unit) owns more than twenty-five percent of the capital or profits interest in the small business investment company, or exempt organizations (including governmental units other than any agency or instrumentality of the United States) own, in the aggregate, fifty percent or more of the capital or profits interest in such company.

The Jobs Act also provides that any gain or loss from the qualified sale, exchange, or other disposition of any qualifying brownfield property acquired by an eligible taxpayer after December 31, 2004, and before January 1, 2010, is excluded from unrelated business taxable income. A "qualifying brownfield property" is any real property that has been certified as a brownfield site within the meaning of Section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980. The exclusion from unrelated business taxable income

generally is available to an exempt organization that acquires, remediates, and disposes of the qualifying brownfield property. In order to qualify for the exclusion, the eligible taxpayer is required to: (i) acquire from an unrelated person real property that constitutes a qualifying brownfield property; (ii) pay or incur a minimum level of eligible remediation expenditures with respect to the property; and (iii) transfer the remediated site to an unrelated person in a transaction that constitutes a sale, exchange, or other disposition for federal income tax purposes.

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