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Charitable Gifts Bring Tax Benefits Under the Pension Reform Act of 2006

By Richard S. Scolaro

For the years 2006 and 2007, distributions from an IRA or Roth IRA directly to a qualified charity do not have to be included in the taxable income of the donor. Prior to the start of this provision, any distribution from an IRA to a charity was deemed to be first made to the donor and includable in the donor's income. The donor would then be entitled to a charitable deduction. While

VIEWPOINT

the charitable deduction is not available, the exclusion from income is far more advantageous. To qualify, the transfer must be a "qualified charitable distribution," which is a direct transfer from the IRA or Roth IRA to a public charity or a private conduit foundation. *Be careful:* Donor-advised funds and private foundations are not eligible beneficiaries.

The donation is limited to transfers made after an individual has reached 70½ years of age — not the year in which the individual reaches age 70½. Thus, if an individual reaches age 70½ on Dec. 22, 2006, the gift must be made on or after Dec. 23 and before Dec. 31, 2006 in order to qualify for the exclusion from income for 2006.

The distribution is limited to \$100,000 in 2006, and \$100,000 in 2007.

Significantly, the distribution also satisfies the minimum-distribution requirement for the year of the gift, either in whole or in part. For example, if the minimum-distribution requirement for the individual is \$25,000 in 2006, and a direct distribution of \$30,000 was made to a qualified charity after the individual had reached 70½, the minimum-distribution requirement for the year would have been met.

The benefits include:

A. Excluding the transfer from inclusion in the taxable income of the donor.

B. The distribution satisfies wholly or partially the minimum-distribution requirements for that year.

C. Distributions made directly to the qualifying charity are first made from the taxable portion of an IRA, and not the non-taxable portion.

D. Taxpayers who do not itemize greatly benefit.

E. Those who itemize and have reached the maximum contribution-benefit deduction for that year may now benefit a qualified charity with an IRA transfer.

F. Withholding is not required.

G. Anyone wishing to make additional contributions from other sources are not restricted or limited by the contribution.

Gifts of fractional interests

Donations of fractional interests and intangible personal property have also been affected by the Pension Reform Act (hereinafter, the "Act"). The new law requires that, in order to receive a charitable deduction, the recipient of the donation must receive full ownership of the property within

10 years after receipt of the initial gift, or by the date of the donor's death. If full title is not transferred within this specified time period, the donor will be required to recapture the full charitable deduction and will incur a 10-percent penalty, together with interest.

The Act further requires that the donation recipient of the tangible personal property receive "substantial physical possession" during the 10-year period.

Further, the property must be valued by an independent, fair-market value appraisal. The appraisal is of the fractional interest. Subsequent donations are valued at the lesser of fair market value as of the date of the initial donation, or as of the date of the subsequent gift. Thus, any appreciation in value is not beneficial for purposes of determining the charitable deduction.

New recordkeeping requirements

For all cash gifts made on or after Aug. 17, the charitable deduction will *not* be allowed unless the person making the donation retains bank records or maintains written communications from the charitable organization. The records must indicate the name of the charity, the date of the contribution, and the amount of the donation.

Tangible personal property

There are other rules pertaining to contributions of tangible personal property for which a deduction of more than \$5,000 is claimed. Principally, the new provision provides that if a charity disposes of tangible personal property within three years of the date of receipt, and the deduction claimed by the donor was \$5,000 or more, the donor must, in effect, recapture the difference between the fair market value of the property as of the date of donation and his/her original basis in the property.

Penalties

The Act also includes increases in the penalties for inaccurate appraisals pertaining to donated tangible property. It also disallows contributions of undivided interest and intangible personal property unless immediately before the contribution, all of the interests in the particular property are owned by the donor and/or by the charity.

Insurance proceeds

Of much interest to charities as well as the insurance industry, the Act mandates annual reporting by any exempt organization (i.e., charity) which acquires an interest in an insurance contract on the life/live(s) of any individual(s) if the policies are fully or partially funded by third parties. The proceeds, in the event of death, are still exempt from tax, but failure to report could result in significant penalties.

The new rules do not apply if all people interested in the policy have an insurable interest and the sole interest in the contract

SCOLARO: Must be from an IRA or Roth IRA to a public charity or a private conduit foundation

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is owned by and payable to a designated beneficiary.

"S" corporations

A new provision pertaining to contributions by S corporations is most important. Prior to the enactment, any contribution by an S corporation was deductible at an individual shareholder level, but the contribution also reduced the shareholder cost basis for his or her stock. Under the new rule, the reduction in the cost basis of the shareholder's stock is limited to the corporation's adjusted basis in the contributed property — *not* the fair market value

of the contributed property.

Other provisions

Though not pertaining to a charitable deduction, the Act provides that non-spouse beneficiaries of distributions from a qualified plan (i.e., pension, profit sharing, 401(k), 403(b), and 457(d) plans) can be rolled over by non-spouse beneficiaries into an individual-retirement account (IRA) or an individual-retirement annuity. The rollover must be a direct trustee-to-trustee transfer to a new IRA. This rule eliminates the adverse consequences experienced by non-spouse beneficiaries, which required the full proceeds to be included in the recipient's taxable income

soon after death.

Under the provision, the rolled-over amount is treated as an "inherited" rollover and, therefore, further rollovers are not permitted. However, the rollover is treated as an IRA of the decedent and, therefore, the minimum distribution rules applicable to the decedent apply.

Hence, distributions must begin by the end of the year following the year of death and will be based either on the beneficiary's life expectancy or, if the decedent had reached his "required beginning date" (April 1 of the year following the year he attained age 70½) and the beneficiary was older than the decedent, on the remaining life expectancy of the decedent. Under those rules, if the non-spouse beneficiary dies before fully depleting the account balance, payments over the remaining life-expectancy period for the deceased beneficiary may continue to that beneficiary's designated beneficiary.

is named as a beneficiary may qualify for this new rollover treatment, to the extent provided in regulations to be issued. Prior to issuance of those regulations, caution should be applied in anticipating the breadth of those regulations.

Direct rollovers to Roth IRAs

Commencing with distributions made after Dec. 31, 2007, direct rollovers can be made from tax-qualified retirement plans, tax sheltered annuities, and 457 plans to Roth IRAs. The rollover is not available to individuals that have adjusted gross income of \$100,000 or more until after Dec. 31, 2009. The rollover amount is subject to tax in the year of the rollover. The benefit of a direct rollover to a Roth IRA is that it will no longer be necessary to roll into a traditional IRA and then roll out of that IRA into the Roth IRA. □

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Trusts as designated beneficiaries

The Act also provides that a trust that

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RETALIATE: 'This is the wake-up call'

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The requirement states that an employer must have taken "adverse action" against an employee based on the filing of a discrimination claim.

In its decision, the court attempted to define exactly what adverse action means.

Justices took the case because lower courts disagreed on that definition. Some felt adverse action needed to be blatantly economic — such as docking an employee's pay or firing them, says Daniel Bordoni, co-chair of the Labor and Employment Law Department at Bond, Schoeneck & King, PLLC.

Other courts said more subtle actions could be considered adverse.

Burlington Northern involved an employee who complained that a supervisor made inappropriate comments about women. And while the company disciplined the supervisor, it also later reassigned the employee to different tasks.

Her pay and benefits remained the same and the new tasks were still within her job description, but they included the less pleasant aspects of her position and they were assignments she did not receive before her complaint, Bordoni says. In the end, the court ruled in her favor, upholding a jury verdict of \$43,500 for mental anguish.

The significant part of the case for employers everywhere is a test justices developed to determine whether an action should be considered adverse, Bordoni says.

The court ruled that an action is adverse if a reasonable person would conclude that the action would discourage someone from filing a discrimination claim. The test opens up a wide variety of actions to litigation, Bordoni says.

For example, under the new test a jury could possibly conclude that a supervisor cutting off an employee in traffic is retaliation, he says.

The court ruled that retaliation isn't limited to events that happen at work and it doesn't even have to come from a supervi-

sor or manager. Moves by co-workers to isolate or ostracize an employee could also be considered retaliation, Bordoni says.

"I don't think retaliation was on an employer's radar screen sufficiently before Burlington Northern," he says. "I don't think employers were on the edge of their seats worrying about retaliation like they worry about race discrimination or sex discrimination."

"This is the wake-up call. You've got to pay attention."

The reason retaliation is such a critical area for employers is that it can be just as economically devastating as discrimination lawsuits. There have been plenty of cases, Bordoni says, where an employer has successfully defended a discrimination charge, but lost an accompanying retaliation claim.

In 2002, the most recent year for which statistics are available, 27 percent of all discrimination and harassment claims filed with the federal Equal Employment Opportunity Commission also included a retaliation claim, according to statistics obtained from Bond, Schoeneck & King. Bordoni says he believes the number is now closer to one-third to one-half and it's only going to rise given the Burlington Northern decision.

The total number of retaliation claims doubled between 1992 and 2002, rising from 11,000 to 22,700, according to the law firm.

Both Bordoni and Hancock & Estabrook's Sciotti advised employers to include measures against retaliation in their work-place policies and training.

"Your front line of defense is your policies and your training," Sciotti says. "You want to try to nip retaliation at the lowest level possible, which is the complaint level. You don't want it to escalate."

"You need to hypersensitize managers to these issues before they become problems." □

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