New Charitable Giving Incentives and Exempt Organization Reforms Pension Protection Act of 2006

The House and Senate recently passed H.R. 4, the Pension Protection Act of 2006 (the "Act"), legislation aimed primarily at reforming the employer-based pension system. President Bush is expected to sign this bill into law shortly. In addition to pension reforms, the legislation contains a significant set of charitable giving incentives and exempt organization reforms, many of which have been included repeatedly in unsuccessful charitable reform legislation over the past four years. However, this is hardly the complete package of reforms that has been discussed at great length during recent years. A bill passed last fall by the Senate, for example, had included the popular charitable deduction for non-itemizers as well as more expansive reforms for supporting organizations and donor-advised funds, which do not appear in the Act.

Summarized below are the significant charitable giving incentives and exempt organization reforms in the Pension Protection Act. A separate technical corrections bill to be considered in the fall could modify some of these provisions and lobbying is already underway by certain groups interested in the charitable reform and exempt organization provisions. We will provide an update of significant legislative changes if they are enacted.

Charitable Giving Incentives

The Act's key charitable giving incentive is the IRA charitable rollover. While the IRA rollover has been a mainstay of charitable giving legislation proposed over the last several years, it has always been coupled with the charitable deduction for non-itemizers, which was ultimately dropped as too costly in terms of lost tax revenue. Unless otherwise noted, the charitable giving incentives described below apply to contributions made in taxable years beginning after December 31, 2005 and are effective for 2006 and 2007, but will expire at the end of 2007 absent further legislation.

IRA charitable rollover

This provision would permit individuals age 70½ and older to exclude from taxable income distributions from a traditional or Roth individual retirement account (IRA), up to $100,000, if given for charitable purposes. To qualify, the distribution would need to be made directly to any charitable organization including most public charities, but excluding private foundations, split-interest vehicles such as charitable remainder trusts, section 509(a)(3) supporting organizations, and donor-advised funds (more on this topic later). All regular distribution rules with respect to traditional or Roth IRAs remain in place, making a gift from a Roth IRA ill-advised in most instances since Roth IRA distributions are non-taxable if certain requirements are met. Even though the gift is not deductible (it is simply not included in income), the donor must nevertheless receive substantiation from the charitable donee as required for deductible charitable gifts.

S corporation charitable contributions

Under the Act, when an S corporation makes a charitable contribution, the shareholder's basis in the S corporation stock would be reduced by the shareholder's pro rata basis in the donated property (not, as current law requires, by the pro rata fair market value of the donated property). The legislative history indicates that the intention of this provision is to allow shareholders of an S corporation to deduct gifts of appreciated property of the corporation to the extent of fair market value as partners in a partnership are permitted to do.

Enhanced deduction for contributions of book and food inventory

Taxpayers engaged in a trade or business, including corporations, that donate "apparently wholesome food" inventory to charity will be entitled to a deduction of the lesser of fair market value or 2 times the donor's basis (this enhanced deduction had been set to expire at the end of 2005). The same rules apply to C corporations contributing books to public schools providing elementary or secondary education (kindergarten through grade 12), subject to certain certification requirements.

Enhanced deduction for conservation contributions

Real property donated for conservation purposes to public charities will be deductible up to 50% of an individual's adjusted gross income with a 15-year carryover of excess contributions instead of the otherwise applicable 5 years. Farmers and ranchers are entitled to deduct up to 100% of a conservation contribution (also with a 15-year carryover), although if the donated property is available for agriculture or livestock production, the property must remain available for these purposes.

Exempt Organization Reforms

Public disclosure of Form 990-T

Effective for returns filed after the date of enactment, the Act makes the IRS Form 990-T, the income tax return used to report a tax-exempt organization's unrelated business taxable income (UBTI), subject to the same public disclosure requirements as the Form 990 information return. The legislative history indicates that the current rule permitting an organization to withhold certain confidential information from disclosure (if the IRS determines that public disclosure would adversely affect the organization) would also apply to information contained in the Form 990-T.

Passive income from controlled entities not necessarily UBTI

Rents, royalties, interest and annuities paid by a controlled organization to its tax-exempt parent are no longer subject to a special rule contained in IRC section 512(b)(13) that requires the exempt parent to treat such amounts as UBTI, so long as: (i) the payment is made pursuant to a binding written contract *in effect on the date of enactment* (or a renewal of the contract on substantially similar terms); and (ii) the payment does not exceed the amount that would have been paid if the payment had been determined under the principles of IRC section 482 (translation: the payment does not exceed fair market value). If the payment exceeds fair market value, the excess amount is considered UBTI and the exempt parent is subject to an additional 20% tax on that amount. This provision applies retroactively to payments received or accrued after December 31, 2005, and expires on December 31, 2007. For returns due after the date of enactment, an exempt parent that receives rents, royalties, interest or annuities from a controlled organization is required to report these payments on its annual information return, as well as any loans or transfers between it and a controlled organization.

Increased excise taxes for private foundation and intermediate sanctions rule violations

The Act generally doubles the excise taxes assessed with respect to violations of the private foundation rules. The Act also doubles the dollar limitations on the maximum excise tax that can be imposed on foundation managers for self-dealing and intermediate sanctions violations to $20,000 per act or transaction. This provision is effective for taxable years beginning after the date of enactment.

Private foundation net investment income excise tax expanded

The Act expands a private foundation's net investment income to include items of income that are "substantially similar" to those currently enumerated in IRC section 4940, effective for taxable years beginning after the date of enactment. Gross investment income now includes income from notional principal contracts and annuities, while capital gain net income now includes capital gains and losses from the sale or other disposition of assets used to further an exempt purpose and not just those held to produce interest, dividends, rents and royalties. Under a new provision that is dependent on the adoption of implementing regulations, a private foundation can exclude from net investment income capital gains from the sale or disposition of assets used for a period of not less than one year for its exempt purposes, so long as the entire property is exchanged for like-kind property to be used primarily for its exempt purposes. A private foundation may not carry back any losses from the sale or other disposition of assets.

IRS filing requirement for small organizations

For annual periods beginning after 2006, organizations not previously required to file a Form 990 because their gross receipts are below $25,000 are required to file an annual notice with the IRS electronically containing basic contact information and the continuing basis for the organization's tax-exempt status.

IRS disclosure of information to state officials

The Act permits the IRS to disclose information to state charity and tax officials about organizations for which the IRS has proposed to refuse or revoke tax-exempt status, as well as with respect to certain other IRS actions, to the extent necessary to administer state laws regulating charities. This provision applies to requests from state officials made after the date of enactment.

IRS reporting requirements for and Treasury study of charity-owned life insurance

The Act attempts to address potentially abusive charity-owned life insurance schemes by requiring a tax-exempt organization to report to the IRS an acquisition of an interest in a life insurance contract in which a third party also holds an interest and that is part of a structured transaction that involves a pool of such contracts. This provision is effective for 2 years after the date of enactment. The Act also directs the Secretary of the Treasury to prepare a study for the Senate Finance Committee and House Ways and Means Committee on the acquisition of interests in life insurance contracts by tax-exempt organizations and whether this is consistent with tax-exempt status.

IRS filing requirement for split-interest trusts

Penalties are increased on split-interest trusts having both charitable and non-charitable interests (such as charitable remainder trusts) for failure to file a return and show correct and complete information. The Form 1041-A exemption for split-interest trusts that distribute all net income currently no longer applies. Such trusts must file both the Form 1041-A and the currently required Form 5227, although neither form must be disclosed to the public. This provision applies to returns for taxable years beginning after December 31, 2006.

Additional exempt status requirements for credit counseling organizations

The Act requires that organizations providing credit counseling services satisfy a number of new organizational and operational requirements, including restrictions on loans to debtors, fees charged for activities incidental to counseling services and refusing services to consumers as well as various governance and business holdings rules.

Donor-Advised Funds

Donor-advised funds (DAFs) provide a donor with an immediate tax deduction and the ability to retain advisory privileges over how contributions will ultimately be distributed for charitable purposes. Any public charity could establish a DAF, although they are found most commonly at community foundations and educational institutions. In recent years, so-called "commercial" donor-advised funds sponsored by mutual fund companies have become very popular. The absence of any substantive provisions in the tax law governing DAFs has led to IRS concern about possible abuses and recent Congressional interest in regulating these charitable giving vehicles. Except as noted below, all of the DAF provisions are effective for tax years beginning after the date of enactment.

Codified definition of donor-advised fund

The Act defines "donor-advised fund," which is not currently defined in the IRC or Treasury regulations, as a separately identified fund or account owned and controlled by a sponsoring organization (generally, a charity other than a private foundation or governmental unit) with respect to which a donor or person appointed by the donor to advise the DAF (a donor advisor) has or expects to have advisory privileges over the distribution or investment of amounts held in such fund or account by reason of the person's status as a donor. The definition excludes funds that make distributions to a single organization, certain committee-advised funds that make travel and scholarship grants and funds that receive a special exemption from the IRS.

No charitable deduction permitted for DAFs maintained by certain supporting organizations

A taxpayer who makes a gift to a DAF maintained by a Type III supporting organization, other than a functionally integrated Type III supporting organization (described below), is not entitled to a charitable deduction for the contribution. This provision applies to contributions made beginning 180 days after the date of enactment.

DAFs subject to excess business holdings rules

The excess business holdings rules, which place restrictions on a private foundation's holdings in a business enterprise, are made applicable to DAFs by the Act. A DAF's holdings in business enterprises will be aggregated with those of its donors, donor advisors, their family members and 35% controlled entities to determine whether the applicable threshold (generally, a 20% ownership interest) has been exceeded. The Act provides transition rules for decreasing the DAF's present holdings if the statutory threshold has been exceeded. For new gifts of interests in a business enterprise, the DAF will have 5 years to divest of holdings above the statutory threshold.

DAF donors and investment advisors as disqualified persons for intermediate sanctions purposes

The Act specifies that, for intermediate sanctions purposes, the following persons are disqualified persons with respect to a DAF (but not necessarily with respect to the sponsoring organization): DAF donors and donor advisors, as well as family members and 35% controlled entities of these individuals. In addition, the Act provides that an investment advisor (and the advisor's family members and 35% controlled entities) with respect to a DAF are disqualified persons with respect to the sponsoring organization that maintains the DAF. This provision applies to transactions that occur after the date of enactment.

125% excise tax for distributions that result in more than incidental benefit to donor

If a donor or donor advisor exercises his or her advisory authority with respect to a DAF and directs the sponsoring organization to make a distribution that results in the donor or any disqualified person with respect to the DAF receiving more than an "incidental benefit" (a term not defined in the statute), a 125% tax is imposed on the amount of the benefit. Any fund manager who agrees to make such a distribution is also subject to a 10% tax on the amount of the benefit (not to exceed $10,000).

Excise tax on certain distributions

The sponsoring organization is subject to a 20% excise tax if a DAF makes a distribution to any individual or for any non-charitable purpose or for a charitable purpose where the sponsoring organization does not exercise "expenditure responsibility" (to ensure that the distribution is spent only for the purposes for which it was given). An additional 5% tax (not to exceed $10,000) is imposed on any fund manager who approves such a distribution. The excise tax does not apply to distributions made to charities described in IRC section 170(b)(1)(A), the sponsoring organization or another DAF.

Substantiation requirements for DAF donors
To be entitled to a charitable deduction for a gift to a DAF, the donor is required to obtain a written acknowledgement from the sponsoring organization stating that the organization has exclusive legal control over the contributed assets. This provision applies to contributions made after 180 days after the date of enactment.

IRS reporting and disclosure requirements for DAFs
Sponsoring organizations are subject to additional reporting and disclosure requirements, such as providing detail on the number of DAFs they control as well as the aggregate asset value of and contributions to their DAFs. In addition, an organization applying for tax-exempt status is required (beginning after the date of enactment) to state whether it maintains or intends to maintain a DAF and how the DAF would operate.

Supporting Organizations

Treasury to conduct study on supporting organizations and donor-advised funds
Within one year of the date of enactment of the Act, the Secretary of the Treasury is directed to undertake a study and submit to the Senate Finance Committee and the House Ways and Means Committee a report on the organization and operation of DAFs and supporting organizations (SOs). An SO is an organization described in IRC section 509(a)(3) that attains its public charity status by reason of a close relationship with one or more other public charities (its "supported organizations"). Like DAFs, SOs have been viewed by the IRS as potentially abusive.

Among other things, the Treasury study will consider the appropriateness of a charitable deduction if the person making the contribution is benefited, whether DAFs should be subject to minimum distribution requirements and whether the retention of rights or privileges by donors with respect to amounts transferred to DAFs and SOs is consistent with the treatment of the transfers as completed gifts.

Special rules targeted to "Type III" SOs
"Type III" supporting organizations are those organizations "operated in connection with" the charities they were organized to support. This type of SO is subject to a lower level of control by its supported charities than the "Type I" and "Type II" varieties, and therefore has been perceived by some to be more subject to abuse. Unless otherwise noted, the following provisions are effective on the date of enactment.

- <u>Functionally integrated Type III SOs.</u> The Act creates a new variety of Type III SO that is presumably considered less prone to abuse than other Type III SOs (as the rules described below demonstrate). In general, a functionally integrated Type III SO is one that carries on activities that its supported organizations would otherwise have to do themselves (rather than providing grants to the supported organizations).

- <u>IRS regulations to address distribution requirements.</u> New regulations will address payments required by non-functionally integrated Type III SOs. The regulations will require such organizations to make distributions of a percentage of either income or assets to supported organizations.

- <u>Foreign organizations cannot be supported charities.</u> After the date of enactment, a Type III SO may not support an organization that is not organized in the United States. A 3-year transition rule applies to Type III SOs that support a foreign organization as of the date of enactment. While the legislative history indicates that this provision will prevent so-called "friends of" organizations (formed to support a foreign charity such as a school or university) from being established as SOs, it may still be possible to form such organizations as Type I SOs.

- Application of excess business holdings rules. The Act applies the private foundation excess business holdings rules to non-functionally integrated Type III SOs (and, in limited circumstances, Type II SOs) in substantially the same manner as is described in the application of these rules to DAFs above. The Act provides transition rules for holdings in existence at the time of enactment.

- Type III SO must provide information to its supported charities. A Type III SO must provide to each of its supported organizations such information regarding the SO as may be determined by the IRS (such as its governing documents, annual report and annual IRS information returns) to ensure the SO's responsiveness to its supported organizations' needs and demands.

- Trusts must demonstrate close and continuous relationship with supported charities. A Type III SO organized as a trust must demonstrate that it has a close and continuous relationship with its supporting organizations to satisfy the responsiveness test for Type III SO status (it is no longer sufficient to show that the supported organization is a beneficiary and that it has the power to enforce the trust and compel an accounting). The Act provides a one-year transition rule for existing trusts.

Automatic intermediate sanctions violations; expanded definition of disqualified person

Under the Act, an "excess benefit transaction" subject to IRS intermediate sanctions would automatically include any grant, loan, compensation or other payment by an SO to a substantial contributor (or to such person's family members or 35% controlled entities) as well as any loan provided by an SO to a "disqualified person," a group that includes substantial contributors and an organization's other insiders. An excess benefit would be deemed to be conferred regardless of the reasonableness of the compensation paid. This provision is effective retroactively for transactions that occur after July 25, 2006. The Act also expands the definition of disqualified person as that term is applied to SOs to include any disqualified person of a supported organization of the SO.

Grants from private foundations curtailed

Effective for distributions and expenditures made after the date of enactment, private non-operating foundations can no longer make qualifying grants to a Type III SO (unless it is a functionally integrated Type III SO) or to any other type of SO that is controlled by disqualified persons of the private foundation. The rule requires such amounts to be treated as taxable expenditures.

Contributions to SO from those who control supported charity jeopardize SO status

Effective on the date of enactment, a Type I or III SO that accepts any contributions from a person (including a family member or 35% controlled entity) who directly or indirectly controls the governing board of a charity the SO supports will lose its SO status and be treated as a private foundation.

Additional IRS disclosure requirements for SOs

For taxable years ending after the date of enactment, the Act requires every SO to file an annual information return with the IRS that contains information about the type of SO it is (I, II or III) and the charities it supports as well as a certification that it is not controlled directly or indirectly by "disqualified persons" (generally, the organization's insiders and substantial contributors).

Charitable Giving Reforms

Gifts of fractional interests

Under the Act, a donor's deduction for a gift to charity of a fractional interest in property (for example, an undivided one-quarter interest in a painting), will be determined by its present fair market value; however, subsequent gifts of a fraction or all of the remaining interest may be deducted only based on the value used to determine the original fractional interest (or fair market value, if less). A donor who fails to contribute all of the remaining interest in the property to the same donee within 10 years of the initial gift or the donor's death (if sooner) must recapture all charitable income and gift tax deductions plus interest and pay an additional 10% tax on the recaptured amount. The same rule applies if the charity fails to take actual possession of the contributed property for the relevant period or to use it for exempt purposes. This provision applies to gifts of fractional interests made after the date of enactment.

Limits on and substantiation requirements for donations of clothing and household items

Effective after the date of enactment, no charitable deduction will be allowed for gifts of clothing or household items (excluding food, art and jewelry) unless in good used condition or better and the IRS may by regulation deny a deduction for such a gift with minimal monetary value. However, if the deduction claimed for a single donated item is greater than $500 and a qualified appraisal is included with the taxpayer's return, a deduction may be permitted, notwithstanding the condition of the contributed item.

Recapture rule for certain donations of tangible personal property

Charitable gifts of tangible personal property may be deducted at fair market value, provided the property is used in furtherance of the organization's tax-exempt purposes. Under the Act, if a charity disposes of contributed property within the year of the gift, the donor's deduction is limited to basis unless the charity certifies either that the property was used for tax-exempt purposes or that its intended use became impossible or infeasible to implement. If disposed of in a later year but within 3 years of the contribution, the donor must include as ordinary income the difference between the claimed deduction for the property and basis, unless the charity provides the certification described above. A charitable donee that sells or disposes of any contributed property other than cash or marketable securities must now file the required Form 8282 to report a disposition within 3 years of receipt, not 2 years as previously required. These provisions apply to contributions made and returns filed after September 1, 2006. Effective after the date of enactment, a $10,000 penalty is imposed on anyone who identifies property as having a tax-exempt use knowing that the contributed property is not actually intended for that use.

Restrictions on charitable contributions of easements in registered historic districts

A charitable deduction is currently allowed for a gift of a conservation easement on the facade of a building in a registered historic district to a qualified conservation organization. Effective for contributions made after July 25, 2006, the Act requires that the easement preserve the entire exterior of the building (including space above the building, its sides, rear and the front) and prohibit any change in the building's exterior that is inconsistent with its historical character. A qualified appraisal must be attached to the taxpayer's return for the year of gift together with photographs and a description of all current legal and administrative restrictions on development and the donor and charitable donee must enter into a written agreement certifying that the donee is a qualified organization with resources to manage and enforce the restrictions. If the deduction for the facade easement exceeds $10,000, the taxpayer must pay a $500 enforcement fee to the IRS. The charitable deduction is reduced by any rehabilitation tax credit claimed with respect to the donated property.

Stricter rules for appraisals and appraisers

Under present law, a taxpayer must obtain an appraisal of any property with a value of more than $5,000 ($10,000 if closely-held stock) unless the gift is of cash or marketable securities. Under the Act, penalties are increased on the taxpayer who makes a substantial valuation misstatement. More detailed criteria are now established for persons who may act as qualified appraisers, and penalties on such persons are increased for substantial or gross valuation misstatements. These provisions are applicable to returns filed after the date of enactment.

Mixed media - special rules for contributions of taxidermy property

Not aimed apparently at the devotees of Damien Hirst but rather at the junkets of exotic animal hunters and their attempts to write off costs of traveling abroad and donating stuffed trophies, the Act requires that a deduction for a gift of taxidermy property (that is, a work of art including any dead animal or part thereof that is stuffed or mounted) be limited for income tax deduction purposes to the lesser of the taxpayer's basis in the property or fair market value. This provision applies retroactively to contributions made after July 25, 2006.

Cancelled check or receipt required for charitable contributions of money

The Act provides that, regardless of the amount of a charitable gift of money, a donor can satisfy applicable recordkeeping requirements only by maintaining as a record of the contribution either a bank record or written communication from the donee showing the name of the donee organization and the date and amount of the contribution. This provision is effective for contributions made in taxable years beginning after the date of enactment.

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