*2006 and the first quarter of 2007 have been a turbulent period for tax exempt organizations. Three significant pieces of legislation, dramatic changes to the Form 990, various IRS notices, a compensation review by the IRS, and an important IRS defeat in the intermediate sanctions area have all combined to create a wild ride for exempt organizations.*

## Legislative Changes and Related IRS Guidance

**Pension Protection Act**. The Pension Protection Act of 2006 ("PPA") contained a number of changes in areas where some in Congress have perceived a need for reform, including charitable deductions, donations of fractional interests in art, donor-advised funds and supporting organizations (among others). Those changes were outlined in our Client Alert dated August 14, 2006. Since the adoption of the PPA, there has been some guidance issued by the IRS, as well as considerable outcry from the charitable community focusing on various unforeseen adverse consequences stemming from the legislation. Key provisions of the PPA, together with a description of the recent IRS interpretations, are described below.

**IRA Rollover (at Last!)**. For close to 10 years, the charitable world has promoted the enactment of the so-called "IRA rollover" as a way to allow donors with significant wealth in retirement plans to fund charitable gifts during lifetime without the recognition of taxable income. Without such legislation, a donor who withdraws IRA assets and then gives them away is required to include the IRA withdrawal in income and then may not be able to offset the income completely, due to the adjusted gross income limitations on charitable deductions and other limits on itemized deductions. Furthermore, the recognition of income may cause loss of personal and dependent exemptions or increased taxes on social security benefits and other items. For these reasons, past advice has focused on the use of retirement plan assets to fund charitable gifts at death. The new rollover provision is in effect only through 2007, and the heat is on from the planned giving community to extend it beyond this year! Key points to note about the new IRA rollover include:

- A donor (including, apparently, the beneficiaries of inherited IRAs) must have reached age 70 1/2 at the time of making the qualified charitable distribution ("QCD") to take advantage of this provision.
- A donor may exclude from income up to $100,000 of QCDs made from traditional or Roth IRA accounts, but not from other deferred compensation accounts. All IRAs are aggregated for purposes of this rule. For married individuals filing a joint tax return, the limit is $100,000 per individual IRA owner (and, accordingly, a maximum of $200,000 for the couple if both have separate accounts of sufficient size).
- The rollover to charity will count toward the minimum distribution requirements of traditional IRAs.
- The charity must receive the payment directly from the IRA custodian or trustee and must provide the donor with contemporaneous written acknowledgment (the same as for an outright gift). Recent IRS guidance indicates that a check drawn on an IRA account and delivered by the donor/IRA owner to the charity will be considered a direct payment by the IRA trustee/custodian for these purposes.
- A donor must give to a public charity such as a school, hospital, church or other publicly supported organization described by IRC Section 509(a)(1) or (2). Private foundations (other than conduit or operating foundations) are not eligible recipients. In addition, even though they otherwise qualify as public charities for income tax deduction purposes, distributions made to supporting organizations and donor-advised funds are not treated as QCDs for purposes of the legislation. It comes as no surprise, therefore, that the IRS has issued guidance (in Announcement 2006-93) on how a supporting organization can request a change in public charity classification to publicly supported status.

- Although the rules do not permit the donor to claim a separate income tax charitable deduction for the distribution, the entire amount of the QCD must be otherwise allowable as a charitable income tax deduction under IRC Section 170 (ignoring the percentage limitation rules). As a consequence, a QCD cannot be used to fund a pooled income fund gift or a charitable remainder trust, nor can it be used to purchase a charitable gift annuity. Also, the donor cannot receive any quid pro quo benefit. If a benefit is received, the entire amount of the QCD will constitute taxable income.
- Notice 2007-7 states that a QCD may be used to satisfy a donor's preexisting pledge without violating IRS prohibited transaction rules.
- The donors who will benefit in particular from the QCD provisions include those whose gifts exceed applicable adjusted gross income percentage limitations on charitable income tax deductions, donors who do not itemize deductions, and donors in states (including Massachusetts) with no state income tax charitable deduction. Massachusetts has confirmed that a QCD will be excluded from a donor's Massachusetts taxable income.

**Supporting Organizations and Donor Funds**. The PPA applied some of the private foundation rules to certain supporting organizations ("SOs") and donor-advised funds ("DAFs"). These new rules are described in the attached Client Alert on the PPA. Summarized below are some of the key changes and recent IRS guidance on these provisions.

- Amounts paid by a non-operating private foundation to a "Type III" SO (or to another type of SO if disqualified persons of the private foundation control the SO or any of its supported charities) may not be counted as qualifying distributions necessary to satisfy minimum distribution requirements. Similar rules apply to DAFs, treating such amounts as taxable distributions. These rules do not apply to amounts paid to "functionally-integrated Type III SOs," a new category of organization created by the PPA. These organizations are those that perform functions the supported organization would otherwise have to perform itself. However, the IRS recently announced that it has suspended the issuance of determination letters for functionally integrated Type III SOs pending the issuance of further guidance.
- The definition of "taxable expenditure" has been modified so that any amounts paid to non-functionally integrated Type III SOs by private foundations will be treated as taxable expenditures unless the private foundation exercises expenditure responsibility, which generally involves establishing procedures to ensure that the distribution is spent solely for the purposes for which it is made, including obtaining reports from grantees and making those reports available to the IRS.
- To avoid running afoul of the above rules, private foundations and DAFs must now obtain information on each prospective grant recipient confirming not only its status under Section 501(c)(3) but also its status as a public charity under Section 509(a)(1), (2), or (3). Moreover, the grantor organization must request that any SO to which it is considering making distributions provide evidence that it is either (1) a Type I or Type II SO or (2) a functionally integrated Type III SO. The IRS has indicated by written notice that a grantor may rely on representations from the grantee organization in this regard if, acting in good faith, it relies on information in the IRS Business Master File, the grantee's current IRS determination letter, or, in certain circumstances, written representations from a grantee and specified documents in determining whether the grantee is a Type I, Type II, or functionally integrated Type III SO. Alternatively, the grantor may rely upon a reasoned written opinion of counsel.
- The PPA provides that any grant, loan, compensation or other similar payment made by an SO to one of its substantial contributors is automatically considered an excess benefit transaction subject to excise taxes under the intermediate sanctions rules, regardless of whether the payment is reasonable. Payments such as expense reim-

bursements are subject to this rule. The PPA made this rule retroactive to July 25, 2006, but the IRS subsequently issued guidance stating that written contracts binding on August 17, 2006 that provided for payments to substantial contributors would not be subject to this onerous new rule, which is more restrictive than the self-dealing rules applicable to private foundations.

- The PPA at long last codifies the definition of "donor-advised fund" and provides new rules to govern the operation of DAFs. In particular, DAFs become subject to the "intermediate sanctions" rules affecting transactions between a charity and its insiders, as well as the excess business holdings rules that prevent a DAF and its insiders from holding more than a 20% interest in a business enterprise. New rules also impose excise taxes in the event that a DAF makes a distribution that results in any DAF donor receiving more than incidental benefit.

**Form 990-T Disclosure**. The PPA imposes on Section 501(c)(3) organizations a new requirement to make available for public inspection their annual Forms 990-T (generally used to report and calculate tax on unrelated business taxable income ("UBTI")). This is an extension of the public disclosure obligation applicable under prior law to the Form 990. Notably, the PPA did not make a corresponding change to the rules allowing for public inspection of annual returns through the IRS, which generally remains limited to the Form 990. This expansion of the disclosure obligations has generated several interpretive questions for exempt organizations, and a fair amount of hand-wringing. For organizations holding interests in private equity funds and similar pass-through investment vehicles generating UBTI, for example, the Form 990-T's requirement of separately listing the UBTI generated by each partnership (but not, perhaps, the names of those partnerships) has caused concern that such disclosure could violate the confidentiality and non-disclosure obligations often imposed as a condition of participating in these investments. In addition, many IRS forms (*e.g.* the Form 8886 relating to disclosure of reportable transactions) require, without greater specificity, that the form be filed with the organization's annual tax or information return. A number of exempt organizations developed the practice under prior law of filing these forms with their Form 990-T (as their "tax return"). As a result, these forms were not subject to the general disclosure requirements applicable to the Form 990. Absent further guidance, it is unclear whether the obligation to make the Form 990-T publicly available would include any ancillary forms filed with the Form 990-T, such as the Form 8886. The IRS has issued no guidance in this regard.

**Fractional Interest Gifts of Tangibles**. The PPA imposes significant changes in the law relating to gifts of fractional interests in artwork and other tangible personal property. First, no income tax deduction is now available unless, immediately before the gift, all interests in the property were either owned by the donor or by the donor and the donee charity. This prevents fractional interest charitable gifts by individual co-owners unless all co-owners participate in the gift. Second, there is a special limit on the amount of deduction generated by later gifts to the same charitable donee of additional undivided interests in the property. That limit effectively freezes the determination of the amount of the deduction for later gifts to the fair market value of the property at the time of the initial transfer. Since this limit applies for gift and estate tax purposes as well as income tax purposes, and since it applies only for purposes of determining the deduction (and not for purposes of valuing the gift or bequest), it appears to produce the untenable result that subsequent partial interest charitable gifts in appreciating tangible property can give rise to an estate or gift tax liability. And third, if all this is not enough, the benefit of income and gift tax deductions for partial interest gifts can be recaptured (with interest and a 10% penalty tax) if, among other things, the donor fails to complete the gift of the property within 10 years after the initial transfer or, if earlier, before the donor's death. The inartful wording of this provision raises the possibility that the completion of a gift by a bequest will not avoid recapture since a bequest cannot complete the gift before death. There has been considerable ink spilled on this subject, given that it has effectively shut down fractional interest gift planning in this area. *See* Stephanie Strom's article in the New York Times, December 10, 2006, entitled "The Man Museums Love To Hate," focusing on Senator Grassley, the former chairman of the Senate Finance Committee, who was largely responsible for initiating the PPA reforms.

**New Appraisal Rules and Qualifications of Appraisers**. Treasury Regulations have long required an appraisal for any charitable gift of assets, other than cash or marketable securities having a value in excess of $5,000 ($10,000 if closely held stock). Those rules require that the donor obtain an independent appraisal prepared by a qualified appraiser and that the appraisal be (i) summarized on the Form 8283, (ii) signed by the appraiser under penalties of perjury and by a representative of the donee organization or organizations, and (iii) attached to the donor's federal income tax return for the year of gift. The Form 8283 instructions, as recently revised, add two requirements that do not appear in the statute or regulations. First, the appraisal should state specifically that the gift has not been made in order to obtain any permit or other approval from a local or other governing authority or whether the gift was required by a contract. Second, the appraisal itself must be attached to the Form 8283 if the value of the gift exceeds $500,000.

The PPA now requires appraisers to provide a statement of their qualifications in the appraisal itself, in addition to the existing requirements that the appraiser demonstrate education and experience in valuing the type of property fairly appraised and has not been banned from practice before the IRS. The IRS has issued a written notice stating that, to meet the PPA requirements, the appraiser must have earned an appraisal designation from a recognized appraiser organization or have otherwise met minimum education and experience requirements. Also, the appraiser must regularly perform appraisals for which he or she receives compensation. The PPA imposes new penalty provisions on appraisers who prepare appraisals resulting in substantial or gross valuation misstatements of value in connection with a tax filing.

## Prohibited Tax Shelters (TIPRA)

Section 4965 (added by the Tax Increase Prevention and Reconciliation Act of 2005, "TIPRA") was intended to target tax-exempt organizations that serve as "accommodation parties" in tax shelter transactions by facilitating a benefit (such as a tax loss) for a taxable party. The language of the TIPRA provision is quite broad and could be used by the IRS to penalize tax-exempt organizations that unknowingly engage, either directly or indirectly, in transactions the IRS deems to be "prohibited tax shelter transactions." The organization's managers are also subject to penalties for approving such transactions if they know, or have reason to know, that the transaction is prohibited.

Three types of transactions are "prohibited tax shelter transactions" under TIPRA: (1) listed transactions, (2) confidential transactions, and (3) transactions with contractual protection. A tax-exempt organization that is a "party to" one of these transactions is subject to penalties under TIPRA. *Listed transactions* are transactions that the IRS has designated as particularly egregious, and the IRS subjects anyone who engages in them to special reporting and (in some cases) penalty regimes. (A list is maintained on the IRS website.) *Confidential transactions* are those transactions offered under "conditions of confidentiality," which means the investor is offered the opportunity to participate in a transaction; is not permitted to disclose the structure or tax effects to anyone else; and pays an advisor a minimum fee ($250,000 for corporations; $50,000 for others). *Transactions with contractual protection* are those in which there is a right to a refund of fees (or the fees are contingent) depending on the transaction's intended tax consequences.

In February, the IRS issued Notice 2007-18, which contains helpful guidance on the application of the Section 4965 excise tax to certain exempt organizations (and their managers) that are a "party" to a prohibited tax shelter transaction. The notice provides that an exempt entity is a party to a prohibited tax shelter transaction only if it (i) facilitates the transaction by reason of its tax-exempt, tax-indifferent or tax-favored status or (ii) is identified (by type, class or role) in published guidance as a party to such a transaction. If the tax and economic consequences for the other parties to a transaction are not dependent on the entity's tax status, it has not "facilitated" the transaction within the meaning of the notice and is, therefore, not a party for the purposes of the excise tax. Notice 2007-19 substantially alleviates the concern that an exempt organization could be considered a party to a prohibited tax shelter transaction merely by virtue of its

role as a passive investor in a partnership (such as a hedge fund or other investment partnership) that, in turn, engages in such a transaction.

## Tax Relief & Health Care Act of 2006

The Tax Relief & Health Care Act of 2006 ("TRHCA") adopts a new rule concerning the receipt of UBTI by a charitable remainder trust. Under prior law, a charitable remainder trust completely lost its tax exempt status in any year in which it earned UBTI, no matter how inconsequential the amount of UBTI. For tax years beginning after December 31, 2006, a charitable remainder trust that has UBTI no longer loses its exemption; instead a 100% excise tax equal to the amount of UBTI is imposed. This new provision is helpful in that it removes the former draconian penalty for a minor foot fault. It is not likely, however, to incent trustees to adopt more sophisticated investment techniques that cause recognition of any significant amount of UBTI. In addition, since the penalty tax is charged to principal of the trust, the UBTI item appears to remain in the trust's tiering system. If the UBTI item is ordinary income, it may give rise on distribution to an additional 35% federal income tax in the beneficiary's hands. With all this in mind, it is fair to conclude that techniques for avoiding the receipt of UBTI remain most relevant. And on that score, it is worth noting that the IRS has continued to "bless" (through private letter rulings) an existing technique that permits remainder trusts to be commingled with charitable endowments, realizing virtually the identical return realized by the endowment without any UBTI or penalty tax.

## Non-Legislative Developments

**Executive Compensation Compliance Project**. In March of 2007, the IRS issued the much ballyhooed report on the Exempt Organizations Executive Compensation Compliance Project, based on compliance check letters sent to 1223 organizations and detailed examinations of 782 organizations. The report reflected a number of IRS "hot button" issues, such as (i) high compensation, (ii) incomplete or inaccurate completion of the Form 990, (iii) personal use of the organization's assets when such use is not properly reported as compensation, and (iv) loans, especially low-interest loans, made to trustees, officers and other employees. The report also made a number of recommendations to improve Form 990 reporting completeness and accuracy.

**Revised Anti-Terrorist Financing Guidelines**: **Would all charities please place their liquid assets in a zip-top bag and pass through the metal detector?** On September 29, 2006, the Treasury Department issued a new version of the Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities (www.ustreas.gov/press/releases/hp122.htm) (originally issued in November 2002 and revised in December 2005). These Guidelines are intended to assist charities in complying with the Patriot Act and other anti-terrorist legislation, in particular when they engage in international grant-making activities. While the latest revision contains some improvements (for example, the revised Guidelines recognize the need for flexibility in the application of the Guidelines), the revisions did not address all of the concerns of the tax-exempt community. Objections include that the Guidelines significantly exaggerate the extent to which U.S. charities have served as a source of terrorist financing; that the Guidelines continue to impose onerous information collection and reporting requirements that do little to protect charities from terrorist abuse; and that the Treasury Department has not gone far enough to ensure that the Guidelines remain voluntary.

**Changes to the 2006 Form 990**. Once again, the Form 990 has undergone significant changes. The most notable changes affect the disclosure of compensation paid to key employees, trustees, directors and board members by related organizations (in particular, *see* question 75c and the related instructions). While the definition of related organization

was clarified by listing eight specific relationships, and now specifically excludes certain bank or financial institution trustees and certain common independent contractors, it is still overbroad. There were a few positive revisions, including the addition of an exception for reporting the amount of compensation where directors, key employees, trustees or officers serve as volunteers for the exempt organization, and where the organization conducts joint programs or shares facilities or employees.

The 2006 Form 990 requires additional disclosure for organizations maintaining donor-advised funds, organizations with controlled organizations, and organizations paying travel and entertainment expenses for government officials, as well as organizations with conservation easements. Additionally, the revisions to the Form 990 now require all supporting organizations to file, even if their gross receipts are normally less than $25,000.

**Intermediate Sanctions: *Caracci* Reversed**. One of the few IRS victories in the "intermediate sanctions" area had been the Tax Court's decision in *Caracci v. Commissioner*, 118 T.C. 379 (2002), in which the court held that the sale of a home healthcare business by charitable organizations to related for-profit corporations for no consideration other than the assumption of liabilities constituted an excess benefit transaction under IRC Section 4958. On July 11, 2006, the Fifth Circuit reversed the Tax Court's holding in *Caracci* based on improper handling of the case by the IRS and on a number of legal and factual errors at the Tax Court level. The Fifth Circuit found that the IRS began a "cascade of errors" by issuing a deficiency notice based on a "brief, intermediate internal" fair market value analysis when the taxpayers refused to extend the statute of limitations. The court also found that the IRS's defense of its incomplete valuation, which grossly overstated the taxpayers' liability for the duration of a two-year audit and two years of litigation, to be deeply disturbing. In addition, the court found that the IRS expert offered at trial did not remedy these issues, as his analysis was similarly insufficient. The Fifth Circuit was equally harsh in criticizing the actions of the IRS, the quality of the appraisal prepared by the IRS' s independent valuation expert, and the Tax Court's attempt to create its own valuation analysis.

**Massachusetts Guidance on New Unrelated Business Income Tax**. In 2005, Massachusetts enacted a tax on unrelated business income earned by corporations exempt under any provision of Section 501 of the Internal Revenue Code. TIR 06-7 has been issued by the Massachusetts Department of Revenue to advise that, effective for tax years beginning after January 1, 2006, exempt corporations that file the federal Form 990-T will now be required to file a new Massachusetts form, M-990T, modeled on the Form 990-T, not later than the 15th day of the third month following the close of the taxable year (whereas the Federal Form 990-T must be filed no later than the 15th date of the fifth month following the close of the taxable year). Income may be apportioned between Massachusetts and other states in accordance with the basic Massachusetts income apportionment rules. Notably, for exempt corporations with significant property holdings in the Commonwealth, the 2005 legislation did not extend the property measure of the corporate excise tax to IRC Section 501 exempt corporations; only the UBTI of such corporations is subject to the corporate excise tax. Estimated tax payments are required for the federal Form 990-T. No reference is made to charitable trusts that do not appear to have been affected by the new statute.

**Federal Telephone Excise Tax Refund.** Exempt organizations can now receive the telephone excise tax refund for 2006 if the organization paid telephone excise taxes. The instructions to the Form 990-T provide guidance on how to claim the credit (note that it is not necessary to complete the full Form 990-T to claim the credit).

## Hear it all live! MCLE's Annual Nonprofit Law Conference

If this Year in Review has whetted your appetite to learn even more about what's happening in the nonprofit world, here

is the seminar for you! Massachusetts Continuing Legal Education, Inc. is holding its 8th Annual Nonprofit Conference on Wednesday, April 4, in downtown Boston. See a description of the program at http://www.mcle.org/MCLE_Web/MCLE-mail/03132007/nonprofitconf.html. Chaired by our very own Kendi Ozmon and Lorry Spitzer, the seminar will feature current developments, insights from federal and state regulators, and in-depth discussions of nonprofit governance, charitable giving, and investment issues. You don't have to be a lawyer to attend, although lawyer jokes called out from the audience are strongly discouraged.

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