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EO Special Edition

Charitable Giving and Exempt Organization Provisions of the Pension Protection Act of 2006

To Our Clients and Friends September 2006

This *EO Special Edition* consists of four parts that address provisions applicable to tax-exempt organizations contained in the Pension Protection Act of 2006 (the "Act"). The Act was signed into law by President Bush on August 17, 2006. The four parts are:

Part One: Charitable Giving — Act Permits IRA Distributions to Charity but Tightens Other Charitable Giving Rules;

Part Two: New Rules for Donor-Advised Funds;

Part Three: New Law Aims to Reform Supporting Organizations; and

Part Four: Reforms Involving Disclosure and Information Rules, UBIT, Excise Tax Rates, and Other Exempt Organization Matters.

The Act is complex and, at times, imprecise. Therefore, there will be a need for regulations from the Treasury Department, a process that is likely to take a year or more. Hopefully, the Internal Revenue Service will issue formal and informal intermediate guidance. We will issue subsequent alerts as additional guidance is provided.

PART ONE: CHARITABLE GIVING – ACT PERMITS IRA DISTRIBUTIONS TO CHARITY BUT TIGHTENS OTHER CHARITABLE GIVING RULES

The Act includes important charitable giving provisions, which will affect the decisions made by donors and the fundraising approaches used by charities. These provisions contain several positive changes for various forms of charitable giving – gifts of individual retirement account ("IRA") assets, gifts of appreciated property by subchapter S corporations, and gifts of qualified conservation easements – but these changes expire at the end of 2007. Most of the permanent changes under the Act could make some charitable gifts – particularly gifts of certain personal property and façade easements – less appealing to donors and charities alike.

IRA Rollovers

Perhaps the most touted and long-awaited aspect of the Act (and one reason it drew wide support from charities) is the provision permitting individuals to make tax-free distributions to charities from traditional or Roth IRAs. Under prior law, an individual could make charitable gifts of IRA assets during his or her lifetime only by first taking a distribution from the IRA, which would be wholly or partially subject to income tax. Now, however, an individual who has attained the age of 70½ years may direct that up to $100,000 per year be distributed from his or her IRA to charity without any adverse income tax consequences. The Joint Committee Report[1] states that the distribution to charity may be counted toward the minimum distribution requirements that become applicable to traditional IRAs once the beneficiary attains age 70½.

There are, however, some important limitations. The donee organization cannot be a supporting organization or a donor-advised fund, and as a general rule, a private foundation is eligible for an IRA rollover only if it is an operating foundation. The IRA distribution must be made in 2006 or 2007, and it must be made directly to the charity. The individual cannot receive any *quid pro quo* or consideration for the distribution, and he or she must obtain written substantiation from the donee organization that it received the distribution and provided no goods or services in consideration for it.

An individual may not claim an IRA distribution to charity as a tax-deductible charitable contribution because funds deposited in an IRA typically escape taxation when initially deposited, and those funds escape taxation when distributed to charity, as explained below. Since the distribution to charity is not a deductible charitable contribution, the distributable amount is not limited by the annual percentage limitations that apply to deductible charitable gifts by an individual.

The Act, however, creates an income tax incentive for making charitable gifts from IRAs. The entire distribution to charity may be treated as a distribution of amounts that would otherwise be taxable gross income to the individual, even if on a strictly *pro rata* basis the distribution would consist in part of *after-tax* contributions to the IRA that would otherwise *not* be included in the individual's gross income. For the individual, that means any future distributions from the IRA will be treated, to a disproportionate degree, as a tax-free return of the individual's after-tax contributions to the IRA. In effect, the Act permits individuals to reduce the income tax burden that they will bear on the amounts they themselves eventually draw out of their IRAs.

The Joint Committee Report offers the example of an individual with a traditional IRA balance of $100,000, consisting of $80,000 in *pre-tax* contributions and $20,000 in *after-tax* contributions. Upon distribution to the donor, the pre-tax contributions would be treated as part of the individual's gross income (and subject to tax), whereas the after-tax contributions would be excluded from gross income and would not be taxable. By making an $80,000 distribution to charity, the individual is able to force out the $80,000 in pre-tax contributions first and treat the entire remaining balance (to the extent it is distributed to the individual) as a non-taxable return of the $20,000 he or she contributed to the IRA on an after-tax basis.

[Effective: August 17, 2006 through December 31, 2007]

Qualified Appraisals

For contributions of property (other than cash or publicly traded securities) for which a deduction greater than $5,000 is claimed, donors have long been required to provide a "qualified appraisal" and have been liable for penalty taxes if they underpaid their taxes as a result of a "substantial valuation misstatement." Under the Act, the threshold for what constitutes a substantial valuation misstatement is lowered, and a penalty is imposed on appraisers as well as donors. Furthermore, appraisers face more stringent rules in order to be classified as qualified appraisers.

The penalty tax on donors for underpayment of taxes due to a substantial valuation misstatement remains at 20% of the amount of the underpayment – or 40% if the valuation that led to the underpayment of tax represents a "gross" misstatement. However, for income tax purposes, the threshold for a substantial valuation misstatement has been reduced from 200% to 150% of the correct value. For example, if a painting deductible at fair market value is finally determined to be worth $100,000 but a deduction of $150,000 is claimed, there is a substantial valuation misstatement. (Under prior law, the threshold for

the claimed deduction in this hypothetical situation would have been $200,000.) Also for income tax purposes, a valuation is now a "gross" misstatement if it is 200% or more of the correct value; the prior threshold was 400% of the correct value. Hence, if a painting is worth $100,000, there is a gross valuation misstatement if the claimed value is $200,000 or more, instead of $400,000 or more under prior law.

For the appraiser whose appraisal supports a deduction involving either a substantial or gross valuation misstatement, the penalty is generally the greater of $1,000 or 10% of the amount of the donor's underpayment of tax. However, in no event can the penalty exceed 125% of the gross income received by the appraiser from preparing the appraisal. No penalty is imposed if the appraiser establishes to the satisfaction of the Internal Revenue Service (the "IRS") that the value claimed in the appraisal was "more likely than not" the proper value. This provision for "administrative grace" appears designed to prevent disputes between the IRS and appraisers from ending up in court.

Appraisers, however, may now be suspended or barred from presenting appraisals to the IRS even if their behavior does not rise to the level of "aiding and abetting" the understatement of a tax liability. Hence, the IRS need not show (as it did under prior law) that the appraiser knew the appraisal would result in understatement of a tax liability.

The new, statutory definition of "qualified appraiser" is significantly more restrictive than the existing definition under the Treasury Regulations. Broadly speaking, the appraiser must be an individual who:

- has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience standards that will be set forth in future Treasury regulations;
- regularly performs appraisals for compensation;
- demonstrates verifiable education and experience in valuing the type of property being appraised;
- has not been prohibited from practicing before the IRS during the three-year period ending on the date of the appraisal; and
- meets other IRS requirements (*e.g.*, lack of financial interest and other requirements the IRS may in the future set forth in regulations).

[Effective: August 17, 2006. However, the misstatement thresholds and appraiser penalties are applicable to any return filed after July 25, 2006 on which a deduction is claimed for a façade easement.]

Gifts of Tangible Personal Property

Donors of items of tangible personal property, such as artwork, a collection of books, or sports memorabilia, face significant new limitations under the Act in addition to the tighter appraisal requirements described above. Even though Section 170(e)[2] allows donors to continue to deduct the fair market value of tangible personal property donated for a "related use" to a public charity or to a private operating foundation, adverse tax consequences could occur in future tax years unless donors and charities carefully follow a complex set of new rules.

"Related Use" Gifts. If the donee organization sells or otherwise disposes of donated property within three years following the gift, the donor's deduction will be reduced to the donor's basis *unless* the donee organization provides a certification, under penalties of perjury, that either (i) describes how it used the property in furtherance of the organization's purposes or (ii) states how it intended to use the property at the time of the contribution and certifies that this intended use became "impossible or infeasible to implement." A $10,000 fine and criminal sanctions could apply to the organization for making certifications that are knowingly inaccurate.

If the donee organization does not provide that certification and disposes of the property before the last day of the tax year in which the gift is made, the donor's deduction is limited to the cost basis of the donated item. (It is not clear whether the statute refers to the tax year of the donor or the donee.) If instead, the donee organization disposes of the property after the end of the first tax year but within three years of the gift, the deduction will be "recaptured" (*i.e.*, treated as ordinary income) in the year the property is disposed of to the extent the deduction exceeded the donor's basis in the contributed property. This "recapture" applies to both the income tax charitable deduction and the gift tax charitable deduction.

[Effective: Contributions made after September 1, 2006]

Form 8282. The donee organization must file an expanded version of IRS Form 8282 (Donee Information Return) if, within three years of the donation, it disposes of donated property valued by the donor at more than $5,000. Form 8282 was previously required only for property disposed of within two years of the donation. The additional information that the donee organization must provide includes a description of the donee's use of the property, a statement of whether the use was a "related use," and the certification described above, if applicable. The IRS has not yet made available a new version of the form. Notably, the three-year time horizon for filing Form 8282 applies even for gifts that were made before the effective date of the new "related use" rules.

[Effective: Forms 8282 filed after September 1, 2006]

Fractional Interests in Tangible Personal Property. Donors commonly contribute tangible personal property to charities, such as artwork, antiques, and historical memorabilia, in fractional or percentage shares. Among other benefits, fractional interest gifts enable the donor to divide the deduction among multiple tax years, thereby increasing the likelihood (under the annual percentage limitations) that the donor will be able to absorb the full value of the deduction. Traditionally, if the property appreciated in value, the appreciation would be taken into account at the time each additional fractional interest was contributed. The Act sharply limits the flexibility and appeal of fractional interest giving.

First, the charitable deduction is lost at the outset or, if taken at the outset, is subject to full "recapture" (with interest) if:

- the donor does not own "all interest" in the donated property immediately prior to the initial gift of a fractional interest, or together the donor and donee organization do not own "all interest" prior to the donor's subsequent gift of a fractional interest;

- the donor fails to contribute all of his or her interest in the property to the charity by the time of the donor's death or the 10th anniversary of the initial fractional gift, whichever occurs first; or

- the donee organization does not have "substantial physical possession" of the property and has not used it for a "related use" (*e.g.*, exhibition or research) by the time of the donor's death or the 10th anniversary of the initial fractional gift, whichever occurs first.

The Act contemplates special regulations to permit deductible fractional interest contributions when multiple persons own fractional interests in property, provided they make "proportional contributions" to the charity.

Second, for contributions of fractional interest made after the initial contribution, the donor's deduction must now be calculated with reference to the fair market value used at the time the *initial* contribution was made. The only exception to that rule would be in the situation where the donated property has depreciated in value, in which case the deduction would be based on the reduced fair market value of the property.

The Act appears to create an incentive for donors to complete their fractional gifts during their lifetime. For estate tax purposes, the donor's estate may now take a charitable deduction for a fractional interest based only on the fair market value of the property at the time of the donor's initial contribution, unless the property has declined in value (in which case the date-of-death fair market value is used). Because the date-of-death fair market value of the asset presumably would be used for purposes of determining the amount to be included in the donor's estate, the estate could be whipsawed if the property has appreciated since the donor's initial contribution. In other words, the estate could be forced to pay estate tax on an asset that is in fact going to charity. It is not clear that Congress intended this result, and perhaps there will be clarifying guidance that will harmonize the amount included in a decedent's gross estate with the amount for which an estate tax charitable deduction is allowed.

The relatively harsh effect of the new fractional interest rules is notable. Unlike the new "related use" rules (discussed above), the donor stands to lose the entire deduction, not simply the portion representing appreciation over the donor's basis, and the donor must pay both interest and a penalty tax equal to 10% of the income tax deduction recaptured *and* 10% of the gift tax deduction recaptured – in essence, a tax that could be as high as 20%.

[Effective: August 17, 2006]

Taxidermy Property. The Act provides the Internal Revenue Code with what is believed to be its first-ever definition of taxidermy property: a "work of art which (i) is the reproduction or preservation of an animal, in whole or in part, (ii) is prepared, stuffed or mounted for purposes of recreating one or more characteristics of such an animal, and (iii) contains a part of the body of a dead animal." Donors who prepare, stuff, or mount their own taxidermy property are limited to deducting the cost of preparing, stuffing, and mounting it – and may not deduct the cost, for example, of finding, killing and retrieving it. And if the cost of preparing, stuffing and mounting the object exceed its fair market value, the deduction continues to be limited to the object's fair market value. Donors who collect taxidermy property prepared by others will continue to be able to deduct fair market value – subject, of course, to the new appraisal, related use, and fractional interest rules. It is not clear whether a donor could successfully avoid the effect of this rule by proving that a particular stuffed animal is *not* a "work of art" and as such outside the statutory definition of "taxidermy property."

[Effective: Contributions made after July 25, 2006]

Gifts by an S Corporation

The Act improves the tax incentives for a subchapter S corporation to make charitable gifts of appreciated property during 2006 and 2007. Traditionally, even though the S corporation's charitable deduction was passed through on a *pro rata* basis to its shareholders, each shareholder's basis in his or her S corporation stock was reduced by an amount equal to the fair market value of the donated property. Hence, whatever benefit the shareholder might have received from the charitable deduction could have been partly offset by the increased capital gains tax eventually payable upon disposition of his or her S corporation shares. For gifts in 2006 and 2007, however, the shareholder's basis in the S corporation shares will be reduced only by his or her *pro rata* share of the S corporation's *basis* in the donated property. For gifts of cash, the change will make no difference for the shareholder. However, if an S corporation owns appreciated property (*e.g.*, real estate, works of art, or shares of stock), the Act creates a "window of opportunity" for a tax-advantaged charitable gift this year or next. Individuals who inherit S corporation shares and have a stepped-up basis in those shares may wish to consider the impact of the Act on their tax planning.

[Effective: Contributions made in tax years beginning after December 31, 2005 through tax years beginning before January 1, 2008]

Conservation Easements Generally

The Act creates a temporary incentive for individuals and corporations – especially those engaged in the farming or ranching business – to contribute conservation easements to charity. During 2006 and 2007, an individual generally may deduct up to 50% of his or her adjusted gross income for charitable gifts of qualified conservation easements (an increase from the usual 30% threshold), and he or she is entitled to a 15-year "carryforward" for any amounts that cannot be deducted in the year of the gift (an increase from the usual five-year carryforward period). Certain farmers and ranchers qualify for a deduction of up to 100% of their adjusted gross income for an easement placed on farm land or ranch land in 2006 or 2007, also with a 15-year carryforward for unused deductions. Similar rules apply to certain corporations engaged in the farming or ranching business.

[Effective: Contributions made in tax years beginning after December 31, 2005 through tax years beginning before January 1, 2008]

Façade Easements

The Act eliminates the charitable deduction for the charitable gift of a restriction on the exterior of a building (commonly called a "façade easement") located in a registered and duly certified historic district unless four new requirements are met:

- the restriction preserves "the entire exterior of the building (including the front, sides, rear and height of the building)" and prohibits changes in the building inconsistent with the historical character of the exterior;

- the donor and the donee organization enter into a written agreement certifying, under penalty of perjury, that the donee is a qualified charity with a purpose of environmental protection, land conservation, open space preservation, or historic preservation and that the donee has the resources to manage and enforce the restriction and a commitment to do so;

- the donor includes with his or her tax return a qualified appraisal, photographs of the entire exterior of the building, and a description of all restrictions on the development of the building; and

- the donor pays a $500 filing fee to the IRS (if the claimed deduction is more than $10,000). The fees collected in connection with façade easements are to be used for the enforcement of those provisions of the Internal Revenue Code that govern the deductibility of *all* conservation easements (not simply façade easements).

Buildings that are on the National Register of Historic Places are eligible for the deduction without meeting these four requirements.

[Effective: Façade easements donated to charity after July 25, 2006, but filing fee applicable only to contributions made February 13, 2007 or later (i.e., at least 180 days after enactment of the Act)]

The Act reduces the amount of the deduction for a qualifying façade easement to account for any rehabilitation tax credits allowed to the donor during the five preceding tax years.

[Effective: August 17, 2006]

The Act distinguishes between historic land and historic buildings. A conservation easement on land that is located in a registered and duly certified historic district does not qualify for a charitable deduction *unless* the land is on the National Register of Historic Places or is a qualifying easement for some other reason (*e.g.*, preservation of open space or a relatively natural habitat).

[Effective: August 17, 2006]

Cash Gifts under $250

Cash gifts remain the most tax-favored form of giving. However, the Act disallows the income tax charitable deduction altogether for "monetary" gifts under $250 unless the donor maintains a written record of the contribution. The written record must be either a "bank record or written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution." Although the Treasury Regulations have traditionally required written substantiation for cash gifts under $250, the old rule was relatively flexible and permitted any "reliable written record." By disregarding any record other than a cancelled check or a receipt from the charity itself, the new rule means that other types of records – even seemingly reliable ones such as a monthly credit card bill – will no longer suffice.

The substantiation rule for a gift of $250 or more is unchanged by the Act. Those gifts may be substantiated *only* by a written acknowledgement from the charity.

To assist donors with the new regulatory burden, charities may wish to begin substantiating all cash charitable gifts with a letter or other form of written receipt. Receipts for gifts under $250 would not have to state whether any goods or services were provided in exchange for the gift unless the gift exceeded the $75 threshold at which point *quid quo pro* substantiation is required under other tax rules.

[Effective: Contributions made in tax years beginning after August 17, 2006 (for individuals, this means tax years beginning January 1, 2007)]

Gifts of Clothing and Other Household Items

Generally speaking, a charitable deduction is no longer allowed for gifts of clothing or household items unless the items are in at least good condition. However, for an item worth more than $500, where the value is substantiated by a qualified appraisal, a deduction is allowable even if the item is in less than good condition. The term "household item" is defined to exclude food, paintings, antiques, other objects of art, jewelry and gems, and collections. The IRS is given authority to adopt regulations identifying items of minimal value (*e.g.*, socks and undergarments) for which no charitable deduction will be allowed.

[Effective: August 17, 2006]

Gifts of Food and Book Inventory

Certain business entities are permitted to take an enhanced charitable deduction for donations of food and book inventory contributed during 2006 and 2007. This measure extends an incentive contained in the Katrina Emergency Tax Relief Act of 2005, which had expired on December 31, 2005.

[Effective: Contributions made after December 31, 2005 through December 31, 2007]

PART TWO: NEW RULES FOR DONOR-ADVISED FUNDS

The Concept of Donor-Advised Funds (DAFs)

A donor-advised fund ("DAF") is a fund created within a public charity whereby the donor (individual or organizational) is permitted to make recommendations as to charitable expenditures from the DAF. A DAF is not a separate legal entity, and the charity maintaining the DAF has legal ownership and control over the assets in the DAF. Although not found in the Internal Revenue Code (the "Code"), this description of a DAF has been widely acknowledged and accepted in practice.

The Act now provides definitions as well as rules for contributing to and making distributions from DAFs maintained by public charities. It establishes new categories of disqualified persons and new excise taxes on "taxable distributions" of DAFs and on prohibited benefits received by certain disqualified persons. The current intermediate sanctions rules are expanded to make certain automatic excess benefit transactions applicable to DAFs, and the private foundation excess business holdings rules are extended to DAFs (but not to their "sponsoring" charity). Finally, the Act introduces additional substantiation requirements, requires additional disclosure on exemption applications and on Form 990, the annual information return, and directs the Treasury Department to conduct a study on the organization and operation of DAFs. A donor or organization considering establishing a DAF should be aware of the new requirements and taxes imposed by the Act. Likewise, all existing DAFs and their sponsoring organizations should determine what changes in their operations are necessary to comply with the new rules.

New Key Definitions Relating to DAFs

Donor-advised fund. A DAF is defined as a fund or account which is separately identified by reference to the contributions of a donor or donors, is owned and controlled by a sponsoring organization, and with respect to which a donor (or any person appointed by the donor)

has, or reasonably expects to have, advisory privileges regarding the distribution or investment of amounts held in the fund or account by reason of the donor's status as a donor.

Specifically excluded from the DAF definition is a fund or account that makes distributions only to a single identified organization or governmental entity and one that makes grants to individuals for travel, study, or other similar purposes, provided that the fund's structure and procedures for making awards meet certain objectivity and non-discrimination criteria.

In addition, the Secretary of the Treasury may exempt a fund from the DAF definition if the fund is advised by a committee not directly or indirectly controlled by the donor or any person appointed by the donor as an advisor to the fund (or any related parties), or it benefits a single identified charitable purpose.

Sponsoring organization. The term "sponsoring organization" is defined as a public charity (other than certain supporting organizations) that maintains one or more DAFs.

Fund manager. A fund manager is an officer, director, or trustee of the sponsoring organization or someone with similar responsibilities. When an act of a sponsoring organization is at issue, the definition also includes those employees of the sponsoring organization who have authority or responsibility over such act or failure to act.

Family member. Family members of an individual include the individual's spouse, ancestors, children, grandchildren, great grandchildren, and siblings (whether by the whole or half blood), as well as the spouses of siblings, children, grandchildren, and great grandchildren.

35% controlled entity. This is a corporation, partnership, trust, or estate in which a substantial contributor or family member owns more than 35 percent of the total combined voting power, profits interest, or beneficial interest.

Donor advisor. A donor advisor is any person appointed or designated by a donor to advise a DAF.

Investment advisor. An investment advisor is any person (other than an employee) compensated by the sponsoring organization for managing the investment or for providing investment advice with respect to the assets in a DAF.

New Categories of Disqualified Persons for Certain Prohibited Transactions and Excess Benefit Transactions

With respect to a DAF, disqualified persons of a DAF include:

- donors;
- donor advisors;
- family members of a donor or donor advisor; and
- 35% controlled entities of any of the above.

With respect to a sponsoring organization, disqualified persons of a sponsoring organization include:

- investment advisors;
- family members of an investment advisor; and
- 35% controlled entities of any of the above.

Taxable Distributions from DAFs – New Code Section 4966

New Code Section 4966 introduces an excise tax on sponsoring organizations and their fund mangers with respect to certain "taxable distributions" made from their DAFs.

A taxable distribution is any grant from a DAF to:

- an individual;
- any person or entity if the distribution is for any non-charitable purpose;
- a private non-operating foundation; or
- certain supporting organizations.

A grant is not considered a taxable distribution (*i.e.*, not subject to the excise tax) if it is made to:

- a charitable organization described in Section 170(b)(1)(A) of the Code (including private operating foundations);
- the sponsoring organization of the DAF;
- any other DAF; or
- any other organization if the sponsoring organization exercises expenditure responsibility over the grant as provided in the private foundation grantmaking regulations.

Under the Act, if a taxable distribution is made from a DAF account, a tax equal to 20% of the amount distributed must be paid by the sponsoring organization and a tax equal to 5% of the amount distributed is imposed on a fund manager who knowingly made a taxable distribution. Interestingly, it appears that under the Act there is no requirement that the taxable distribution be returned to the DAF.

[Effective: Tax years beginning after August 17, 2006]

Prohibited Benefits Tax – New Code Section 4967

New Code Section 4967 imposes a tax on the donor advisor who recommends that the sponsoring organization make a distribution from a DAF which results in more than an "incidental benefit" being received, directly or indirectly, by a disqualified person (as newly defined by the Act) with respect to a DAF. If the benefit received is more than incidental, the tax is 125% of the benefit. The tax is also imposed upon the disqualified person who receives the benefit.

Fund managers of the sponsoring organization who agree to make the distribution knowing that it would confer more than an incidental benefit to a disqualified person with respect to a DAF are subject to a penalty tax of 10% of the benefit, up to $10,000.

Liability for these new prohibited benefit transaction penalties will not be imposed if the distribution has already been subject to an excise tax under the intermediate sanctions rules of Section 4958. There is joint and several liability for the penalties imposed on fund managers and on persons who improperly advised as to the distribution.

[Effective: Tax years beginning after August 17, 2006]

Intermediate Sanctions, Disqualified Persons, and Automatic Excess Benefit Transactions – Section 4958

Sponsoring organizations of DAFs, as public charities, are subject to the intermediate sanctions rules of Section 4958. These rules impose a penalty excise tax on any excess benefit transaction. An "excess benefit transaction" occurs if the value of an economic benefit provided by a public charity directly or indirectly to any "disqualified person" exceeds the value of the consideration received for providing the benefit. An excise tax of 25% of the excess benefit amount is imposed on the disqualified person who received the benefit, with an additional tax if the violation is not corrected within a specific period. In order to "correct" the excess benefit transaction, the disqualified person who received the excess benefit must "undo" the transaction and, to the extent possible, place the organization in a financial position not worse than it would have been in if the excess benefit transaction had not occurred. Additionally, a tax of 10% (now capped at $20,000) of the excess benefit is imposed on an organization's managers if the managers knowingly and willfully participated in the excess benefit transaction.

The Act extends the Section 4958 tax on excess benefit transactions by adding new persons to the list of DAF disqualified persons who can be liable for tax under that Section and by adding a new type of "automatic excess benefit transaction" for DAFs.

New Disqualified Persons for Purposes of Section 4958. The following disqualified persons have been added:

- Investment advisors of sponsoring organizations. Investment advisors are now treated as disqualified persons with respect to sponsoring organizations regardless of their relationship to or influence over the organization. Therefore, any fees paid by a sponsoring organization to any investment advisor, related or not, could subject the investment advisor, as well as the sponsoring organization manager who knowingly and willfully participates, to an excise tax under the intermediate sanctions rules on any excessive amounts paid to the advisor.

  [Effective: August 17, 2006]

- DAF disqualified persons. The Act significantly increases the number of persons who may be liable for an excess benefit transaction with a DAF by expanding the list of DAF disqualified persons for purposes of Section 4958. Disqualified persons now include all donors, donor advisors, their family members, and their 35% controlled entities. The enactment of the new automatic excess benefit transaction rule with respect to DAFs (discussed below), however, is likely to have an even greater impact.

  [Effective: August 17, 2006]

New Automatic Excess Benefit Transaction. The Act expands the intermediate sanctions prohibitions to include a category of transactions between a DAF and its disqualified persons that is *per se* taxable. Any grant, loan, compensation, or other similar payment from a DAF to a disqualified person with respect to the DAF will be subject to tax on all amounts paid and not just on the excessive amounts. This provision applies to payments by DAFs and generally does not apply to a sponsoring organization's payments unless the sponsoring organization is only acting purely as an agent of a particular DAF. For example, a sponsoring organization's payment to a service provider that is a disqualified person with respect to a DAF for accounting services for the organization is not an automatic excess benefit transaction. However, payments made directly from a DAF to a service provider

that is a disqualified person with respect to the DAF would be an automatic excess benefit transaction, and the disqualified person who receives the payment (as well as a manager who knowingly participates) would be subject to the tax. This distinction is not explained in the Act but is explained in the Joint Committee Report. The Report states that a payment by the sponsoring organization to a service provider that is a disqualified person with respect to at least one DAF held by a sponsoring organization will not necessarily be an automatic excess benefit if the amount paid is reasonable and is uniformly charged by the sponsoring organization to all of the sponsoring organization's DAFs as a routine fee.

[Effective: August 17, 2006]

Excess Business Holdings Excise Tax

The Act applies the private foundation excess business holdings rules of Section 4943 to DAFs. These are highly complex rules. Under the private foundation tax regulations, the excess business holdings excise tax applies when a private foundation holds, together with its disqualified persons, more than the permitted holdings of a business enterprise.[3] Permitted holdings are generally defined as 20% of the voting stock of a corporation or the profits interest in a partnership, but in certain circumstances, such holdings can be as much as 35%. If a private foundation exceeds the permitted holdings and does not dispose of the excess holdings in the time period set forth in the Code, a 10% penalty (as increased by the Act) is imposed on the value of the excess business holding. The excess business holdings rules do provide for a *de minimis* exception where the private foundation together with certain other related foundations own not more than 2% of the voting stock of a business enterprise and not more than 2% in value of all outstanding shares of all classes of stock. The private foundation does not need to aggregate its holdings with its disqualified persons to determine if the holdings exceed permissible limits under the *de minimis* exception.

Under the Act, DAFs are now treated as private foundations for purposes of the excess business holdings rule. In applying the excess business holdings rules, each DAF's holdings are aggregated with the holdings of the DAF's disqualified persons, as defined by the Act. The 2% *de minimis* exception can be applied to each DAF (there is no guidance on what might be considered a "related" DAF analogous to related foundations for purposes of this *de minimis* exception or whether the DAF needs to aggregate its holdings with such related DAF).

If a DAF has excess business holdings that were acquired other than by purchase (*i.e.,* contribution or bequest), to avoid the tax, the excess holdings must be disposed of within a five-year period. If the excess business holdings are held beyond that period, a tax of 10% (as increased by the Act) will be imposed on excess holdings. (This five-year period can be extended for an additional five years under limited circumstances upon application to the Secretary of the Treasury.) The rules apply only to holdings of DAFs within public charities and not to holdings of the sponsoring organizations (which are public charities). It is possible that under certain circumstances a DAF may satisfy the disposition requirement by transferring the affected holdings to the sponsoring organization.

The excess business holdings rules may affect sponsoring organizations that permit a donor to contribute and maintain large blocks of voting stock of companies as the corpus of a DAF, those that allow DAF funds to be invested in a single stock, or those whose donors may own a very large interest in a company that exceeds the permitted holdings when aggregated with even a small holding in the DAF. Unless a DAF's holdings fall within the 2% *de minimis* exception, it also may be difficult for sponsoring organizations to monitor excess business

holdings because, outside of the *de minimis* exceptions, the DAF's holdings are aggregated with its disqualified persons for these purposes.

[Effective: Tax years beginning after August 17, 2006]

Substantiation and Deductibility Rules for Contributions to Sponsoring Organizations of DAFs

Under the Act, a deduction for any contribution to a DAF generally is allowable, unless the sponsoring organization is (i) a war veteran's organization, (ii) a domestic fraternal lodge, (iii) a cemetery organization, or (iv) a Type III supporting organization. The Act also requires additional specific substantiation for contributions. A donor will be entitled to a deduction only if the donor receives a contemporaneous written acknowledgement letter from the sponsoring organization that includes a statement that the sponsoring organization has exclusive legal control over the assets.

[Effective: Contributions made after February 13, 2007 (180 days after August 17, 2006)]

Information Disclosure Requirements

Prior to the Act, tax-exempt organizations were not required to disclose specific information about DAF accounts on their Form 990 information returns. Now, every sponsoring organization that maintains DAF accounts must disclose (i) the total number of DAF accounts it owns at the end of the taxable year, (ii) the aggregate value of assets held in those accounts, and (iii) the aggregate contributions to and grants from all DAF accounts during the year.

[Effective: Returns filed for tax years ending after August 17, 2006]

Disclosure on Exemption Application

Prior to the Act, a sponsoring organization was not required to disclose information regarding DAF accounts on its application for tax-exempt status. Now a sponsoring organization must give notice to the IRS as to whether the organization maintains or intends to maintain DAF accounts and the manner in which it intends to operate them.

[Effective: Organizations applying for tax-exempt status after August 17, 2006]

Treasury Department Study on DAFs

The Act directs the Treasury Department to complete a study on the organization and operation of DAFs no later than one year from August 17, 2006. Specifically, Treasury has been asked to determine whether charitable deductions allowed for the income, gift, or estate taxes for contributions to sponsoring organizations of DAFs are appropriate considering the use of contributed assets (including the type, extent, and timing of such use) or the use of the assets of such organizations for the benefit of the person making the charitable contribution (or a person related to such person). The Treasury Department has also been asked to determine whether DAFs should be subject to a payout requirement. Finally, the study will examine whether a donor's retention of rights or privileges with respect to amounts transferred to such organizations (including advisory rights or privileges with respect to the making of grants or the investment of assets) is consistent with the treatment of such transfers as completed gifts that qualify for a deduction for income, gift, or estate taxes.

PART THREE: NEW LAW AIMS TO REFORM SUPPORTING ORGANIZATIONS

Section 509(a)(3) supporting organizations, especially those supporting organizations known as Type III supporting organizations, have been the subject of scrutiny and criticism by some lawmakers and the press in recent years. The Act includes new rules for supporting organizations, with certain rules applicable only to Type III supporting organizations, that attempt to address the problems or perceived problems generating the criticism. As explained below, some of the new rules are aimed at preventing certain persons, such as substantial contributors or persons who control the supporting organizations or their supported organizations, from personally benefiting from that relationship. Other new rules increase the public disclosure required of supporting organizations and attempt to make supporting organizations more responsive to the needs and demands of their supported organizations.

In the past, some donors have found it advantageous from a tax perspective to contribute to a newly created supporting organization instead of a private foundation. The Act, however, not only eliminates some of the advantages of a supporting organization, especially those of Type III supporting organizations, but may have the effect of making private foundations a more appealing option to donors. For example, Type III supporting organizations will now generally be subject to the excess business holdings rules previously applicable only to private foundations and to an annual payout requirement similar to (and possibly greater than) that imposed on private foundations. A donor who is considering a contribution to a supporting organization, instead of a private foundation, should carefully consider the impact the Act may have on that decision. Likewise, all existing supporting organizations, but especially Type III supporting organizations, should determine what changes in their operations are necessary to comply with the new rules.

Background and Definitions

Supporting organization. A supporting organization generally must be organized and operated to benefit and support one or more organizations that are classified as publicly supported organizations under Section 509(a)(1) or (2) (the "supported organizations") and must not be controlled by disqualified persons (other than its managers and organizations described in Section 509(a)(1) or (2)). Section 509(a)(1) and (2) organizations are public charities because they pass a "public support" test whereby generally at least 1/3 of their ongoing receipts are from diverse sources. A supporting organization is treated as a public charity, despite not meeting public support requirements, because of its relationship to one or more supported organizations. Supporting organizations are further categorized as Type I, Type II, or Type III depending on the nature of that relationship. In practice, Type III supporting organizations generally are subject to the least amount of control by their supported organizations and the greatest degree of involvement by their donors, and anecdotal evidence suggests that they may be more susceptible to possible abuse.

Functionally integrated Type III supporting organizations. The Act refers to a kind of Type III supporting organizations described as "functionally integrated." The term grew out of a section of the Treasury Regulations which provides that one way a Type III supporting organization could demonstrate that it was an "integral part" of its supported organizations was to show that it was performing functions or carrying out purposes that would normally be performed or carried out by the supported organization. Type III supporting organizations falling into this category were said to be "functionally integrated," since "but for" the supporting organization, the supported organization would itself carry on the activities performed by the supporting organization. Attaching a formal definition to this sub-category of Type III supporting organizations, the Act states that a Type III supporting organization is "functionally integrated" with its supported organization if it is not required

under the current Treasury Regulations to make payments to a supported organization because its activities perform the functions or carry out the purposes of the supported organization.

Related persons. This summary follows the Joint Committee Report in using the term "related persons" to refer to certain persons who are related to a substantial contributor to a supporting organization or to a person who controls the supporting organization or its supported organization. Those related persons include "family members" and "35% controlled entities." Family members of an individual include the individual's spouse, ancestors, children, grandchildren, great grandchildren, and siblings (whether by the whole or half blood), as well as the spouses of siblings, children, grandchildren, and great grandchildren. A 35% controlled entity is a corporation, partnership, trust, or estate in which a substantial contributor to the supporting organization or a person who controls the supporting organization or its supported organization or family members own more than 35% of the total combined voting power, profits interest, or beneficial interest, respectively.

Provisions of the Act Which Apply to All Supporting Organizations

Automatic Excess Benefit Transaction Rules. Under prior law, supporting organizations, like other types of public charities, were subject to the excess benefit transaction rules of Section 4958 and the excise taxes under those rules (which are often referred to as "intermediate sanctions"). The Act expands the exposure of supporting organizations to Section 4958, thereby separating out supporting organizations from other public charities.

> Payments to substantial contributors and related persons. For purposes of the Section 4958 excess benefit transaction rules, the list of persons who by definition are "disqualified persons" with respect to supporting organizations is now expanded beyond those persons such as managers and other persons in a position to exercise substantial influence to include substantial contributors (other than a Section 509(a)(1) or (2) public charity) and their related persons. The entire amount of a grant, loan, payment of compensation, or "other similar payment" by a supporting organization to a substantial contributor or a related person is an "automatic excess benefit transaction" which triggers the various penalty provisions of Section 4958, even if the payment is reasonable. The term "other similar payment" is not clearly defined, and examples in the Joint Committee Report do not draw a bright line between permissible and prohibited payments. According to the Joint Committee Report, the term "other similar payment" includes an expense reimbursement, but not a payment by a supporting organization to a disqualified person made pursuant to a sale or lease of property.
>
> Loans to disqualified persons. In addition to loans to substantial contributors and their related persons, a loan to any disqualified person with respect to a supporting organization (*i.e.*, any person who was, at any time during the 5-year period ending on the date of the loan, in a position to exercise substantial influence over the supporting organization or any related person) will be an automatic excess benefit transaction.
>
> *[Effective: Transactions occurring after July 25, 2006 (this date first appeared in the bill that was introduced in Congress on July 28, 2006)]*
>
> Overlapping disqualified persons. For Section 4958 purposes, a disqualified person of a supporting organization also is considered a disqualified person of the supported

organization. For example, a substantial contributor to a supporting organization will be a disqualified person of the supported organization.

[Effective: August 17, 2006]

New Disclosure Requirements. Prior to the Act, the general rule was that a public charity is not required to file a Form 990 with the IRS if its annual gross receipts are normally $25,000 or less.[4] Now, however, every Section 509(a)(3) supporting organization is required to file a Form 990 regardless of the organization's gross receipts. On the Form 990, each supporting organization must:

- list its supported organizations;
- indicate whether it is a Type I, Type II, or Type III supporting organization; and
- certify that it is not controlled directly or indirectly by one or more disqualified persons.

[Effective: Forms 990 filed for tax years ending after August 17, 2006]

Grants by Private Nonoperating Foundations to Supporting Organizations

May not be a qualifying distribution. A grant by a private nonoperating foundation to a supporting organization will not be a qualifying distribution that counts toward the foundation's annual payout requirement if the grant is made to:

- a Type III supporting organization, unless it is a functionally integrated supporting organization; or
- a Type I or Type II supporting organization or a functionally integrated Type III supporting organization where a disqualified person with respect to the private foundation controls the supporting organization or its supported organization.

This new rule is harsher than the comparable rule applicable to a grant by a private nonoperating foundation to another private nonoperating foundation, which permits the grant to be treated as a qualifying distribution if the grantee foundation distributes an amount equal to the grant amount within a certain period (the so-called "pass-through" or "out-of-corpus" rules).

May be a taxable expenditure. Any grant to a supporting organization that is not a qualifying distribution, as described above, will also be a taxable expenditure and subject to excise taxes, unless the foundation making the grant exercises expenditure responsibility.

[Effective: Distributions and expenditures after August 17, 2006]

Study on Supporting Organizations. The Act directs the Secretary of the Treasury to undertake a study on the organization and operation of supporting organizations. The study will consider:

- whether income, gift, and estate tax deductions for charitable contributions to supporting organizations are appropriate considering the use of the contributed assets and the use of the assets for the benefit of the donor and related persons;

- whether the retention by donors of rights or privileges with respect to contributed assets (such as advisory rights or privileges with respect to the making of grants or investments) is consistent with the treatment of such contributions as completed gifts that qualify as a charitable deduction for income, gift, or estate taxes; and

- whether the issues raised by sections (i) and (ii), above, are also issues with respect to other forms of charities or charitable donations.

By August 17, 2007, the Secretary of the Treasury must submit a report on the study to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

Additional Provision of the Act That Applies to Type I and Type III Supporting Organizations

Loss of Type I or Type III Status Due to Donor Control. A Type I or Type III supporting organization will lose its status as a supporting organization (and thus will be treated as a private foundation) if it accepts a gift or contribution from a person (other than a Section 509(a)(1) or (2) public charity) who controls the supported organization or from a related person.

[Effective: Tax years beginning after August 17, 2006]

Further Provisions of the Act That Apply to Type III Supporting Organizations

Payout Requirements. The Act directs the Secretary of the Treasury to promulgate new regulations setting out payout requirements for Type III supporting organizations (other than those that are functionally integrated). Although the new Treasury Regulations have not yet been promulgated, according to the Act, they will require each such Type III organization to distribute a percentage of either its income or assets to supported organizations. This payout requirement will make most Type III supporting organizations more like private foundations than public charities.

Excess Business Holdings Rules. The excess business holdings rules of Section 4943, which previously applied only to private foundations, are now applicable to Type III supporting organizations, other than those that are functionally integrated. (The excess business holdings rules also apply now to a small number of Type II supporting organizations.[5]) Under the excess business holdings rules, such a Type III supporting organization, together with its disqualified persons, generally cannot hold more than a 20% interest in a business enterprise. If the supporting organization and disqualified persons together do not have effective control of an enterprise, then the limit is raised to 35%. However, a safe harbor exists under which the supporting organization need not consider the holdings of its disqualified persons if the supporting organization itself holds no more than a 2% interest.

Disqualified persons. For purposes of the excess business holdings rules applicable to Type III supporting organizations, the Act incorporates the definition of disqualified persons found in Section 4958 and then adds to that definition, further distancing the treatment of supporting organizations from that of other public charities. All together, the list of disqualified persons includes:

1. persons who were, at any time during the prior 5-year period, in a position to exercise substantial influence over the supporting organization;

2. family members of an individual with such substantial influence;

3. 35% controlled entities controlled by persons described in (1) or (2);

4. substantial contributors to the supporting organization;

5. family members of substantial contributors;

6. 35% controlled entities controlled by persons described in (4) or (5);

7. organizations controlled by the person or persons who control the supporting organization; and

8. organizations substantially all the contributions to which were made by a substantial contributor to the supporting organization, an officer, director or trustee of the supporting organization (or an individual having powers or responsibilities similar to officers, director or trustees), or an owner of more than 20% of the interest in an entity that is a substantial contributor to the supporting organization.

It may be difficult, if not impossible, for a Type III supporting organization to know what interest in business enterprises all its disqualified persons hold, and without that knowledge a supporting organization may want to play it safe and hold no more than a 2% interest in any business enterprise, or invest only in vehicles that are not considered business enterprises because they qualify as functionally related businesses or because at least 95% of their income is from passive sources, such as dividends, interest, annuities, royalties, rent, and gains from the disposition of certain property.

Exceptions. The Act contains two narrow exceptions to these rules, which, however, will not be helpful to most Type III supporting organizations. The excess business holdings rules do not apply to a Type III supporting organization if the Secretary of the Treasury determines that the excess business holdings are consistent with the purpose or function constituting the basis for the supporting organization's exemption under Section 501(c)(3). A second exception exists for a Type III supporting organization that held assets as of November 18, 2005 on the direction of a state attorney general or other official with jurisdiction over the organization.

Transition rules. Complex transition rules provide Type III supporting organizations with an extended period in which to reduce their business holdings to permitted levels.

[Effective: Tax years beginning after August 17, 2006]

Responsiveness to Supported Organizations. A Type III supporting organization must provide each supported organization with information enabling the supported organization to assure itself that the supporting organization is responsive to the supported organization's needs or demands. The Secretary of the Treasury will determine what information will meet this requirement. The Joint Committee Report, however, states that such information may include the supporting organization's governing documents and any changes to those documents, Forms 990 and 990-T, and an annual report detailing the

support provided, how it was calculated, and the support projected for the next year. The Joint Committee Report also states that the degree to which a supporting organization meets this new requirement will be a factor in determining whether the organization meets the responsiveness test for a Type III supporting organization under the current Treasury Regulations.

[Effective: August 17, 2006]

Qualification of Trusts as Type III Supporting Organizations. Under current Treasury Regulations, a Type III supporting organization that is organized as a trust meets the supporting organization "responsiveness" test if it is a charitable trust under state law, the supported organization is a beneficiary of the trust, and the supported organization has the power to enforce the trust and compel an accounting. Under the Act, it will no longer be enough merely to satisfy these factors – in other words, there will no longer be a safe harbor. While the Act itself does not elaborate, the Joint Committee Report states that the trust will also be required to establish to the satisfaction of the Secretary that it has a close and continuous relationship with the supported organization, such that it is responsive to the needs or demands of the supported organization.

[Effective: August 17, 2006, except for trusts currently relying on the Treasury Regulations, for which the change will be effective August 17, 2007]

No Foreign Organizations as Supported Organizations. A foreign organization may not be a supported organization of any Type III supporting organization.

[Effective: August 17, 2006, except that for an existing Type III supporting organization that has a foreign organization as a supported organization, this provision will not apply until the first day of the third tax year beginning after August 17, 2006]

PART FOUR: REFORMS INVOLVING DISCLOSURE AND INFORMATION RULES, UBIT, EXCISE TAX RATES, AND OTHER EXEMPT ORGANIZATION MATTERS

This Part of the *EO Special Edition* focuses on the many changes made by the Act that affect charities and that are not covered by the other three Parts regarding charitable giving, donor advised funds, and supporting organizations. These changes include new disclosure and information sharing rules, changes to the unrelated business income tax, increased excise tax rates, and expanded categories of income subject to certain private foundation excise taxes.

Expanded Reporting, Disclosure, and Information Sharing Requirements

In response to the perceived need for transparency and increased regulation of charities, Congress has extended the public disclosure requirements currently in place, imposed new certification requirements on small charities, increased reporting surrounding the acquisition of certain interests in insurance contracts, and expanded the ability of state officials to obtain information from the IRS.

Public Disclosure of Form 990-T, Exempt Organization Business Income Tax Return. Congress has extended the public inspection and disclosure requirements and related

penalties already applicable to Forms 990 and 990-PF to the unrelated business income tax returns (Forms 990-T) of Section 501(c)(3) organizations.[6]

[Effective: Returns filed after August 17, 2006]

Notification Requirement for Organizations not Currently Required to File Form 990. Organizations that do not currently file an annual information return because their gross annual receipts do not exceed $25,000 will be required to furnish annually in electronic form (at a time and in a manner to be prescribed by the Secretary of the Treasury in forthcoming regulations) a new report that sets forth the following information:

- the organization's legal name;
- any name under which it operates or does business;
- its mailing address (and Internet web site address, if any);
- its taxpayer identification number;
- the name and address of a principal officer; and
- evidence of the continuing basis for the organization's exemption from filing a Form 990.

In addition, when an organization excepted from filing Form 990 terminates its existence, it must notify the IRS of the termination by notice in electronic form.

Although no monetary penalties are imposed for failure to comply with this new filing requirement, failure to file this information for three years could result in revocation of tax-exempt status (although application can be made for reinstatement).

[Effective: Annual periods beginning after December 31, 2006]

Insurance Contracts in Which Charities Hold an Interest. Over the past few years, there has been a significant increase in the number of transactions where charities have obtained an ownership interest in life insurance or similar contracts (other than simply as the named beneficiary). Because of this, the Act requires the Secretary of the Treasury to undertake a study of such transactions to evaluate whether they are consistent with tax-exempt status, and to report to Congress within 2½ years of enactment. In addition, a charity must file a new information return if the charity makes a "reportable acquisition," defined as an acquisition of a direct or indirect interest in a contract that the charity knows or has reason to know is an "applicable insurance contract," and the acquisition is part of a structured transaction involving a pool of such contracts. An applicable insurance contract includes, among other things, life insurance contracts with respect to which both a charitable organization and a person other than the charitable organization have directly or indirectly held an interest in the contract.

[Effective: Acquisitions occurring after August 17, 2006 through August 17, 2008]

Sharing of Information by the IRS with State Officials. Congress has given the IRS greater latitude to share information about exempt organizations with appropriate state officials. For example, certain proposed actions related to exempt organizations (including a notice of proposed refusal to recognize an organization as exempt under Section 501(c)(3) or a proposed revocation of an organization's Section 501(c)(3) status) may be disclosed to state officials responsible for oversight of charities. The state officials listed are the state attorney general, the state tax officer, and the head of an agency designated by the state attorney general as having primary responsibility for overseeing the solicitation of funds for charitable purposes. In general, such information will be disclosed upon written request by

the state official and only for the purpose of, and to the extent necessary, to administer the state laws regulating exempt organizations.

[Effective: Requests made August 17, 2006 or later]

Unrelated Business Taxable Income Generated by Controlled Entities

Under Section 512(b)(13), specified payments made by an entity controlled by a tax-exempt organization to the controlling tax-exempt organization are included in the latter organization's unrelated business taxable income to the extent that the payment reduces the net unrelated income (or increases any unrelated loss) of the controlled entity. As modified by the Act, that section applies only to the portion of such payments that exceeds the amount of the specified payment that would have been paid or accrued if such payment had been determined under principles of Section 482 (rather than to the entire payment). Section 482 permits the IRS to reallocate the gross income, deductions, credits, and other allowances of related taxpayers in order to prevent the evasion of taxes or to clearly reflect the income of the related organizations. For example, if a controlled subsidiary makes a rent payment to its exempt parent and the payment exceeds fair market value, the amount by which the payment exceeds the fair market value is included in the parent organization's unrelated business taxable income to the extent that such excess payment reduced the unrelated income (or increased the loss) of the controlled subsidiary (determined as if the subsidiary were exempt).

The IRS is required to submit a report to Congress no later than January 1, 2009 on the effectiveness of this provision and the extent to which payments by controlled entities meet the requirement of Section 482.

[Effective: Payments to controlling organizations received after December 31, 2005 and before January 1, 2008]

Expansion of the Base for Tax on Net Investment Income of Private Foundations

Under Section 4940, a private foundation must pay an excise tax of 1% or 2% on its "net investment income." In 1982, the Fifth Circuit decision in the *Zemurray Foundation* case[11] invalidated the section of the Treasury Regulations that included as taxable income for purposes of the Section 4940 tax the income from property held for investment which generally produces "capital gains through appreciation." The Act amends the definition of gross investment income under Section 4940 to include "income from sources similar" to interest, dividends, rents, royalties, and payments with respect to securities loans. It is not entirely clear whether the amendments, in fact, capture one of the intended targets of the tax, property which generates capital gains through appreciation.

It is clear, however, that capital gains from the sale of assets used to further an exempt purpose are now subject to the Section 4940 tax. A limited exception exists for property used by a private foundation for more than one year for a purpose constituting the foundation's basis for exemption, provided the property is exchanged immediately following this period solely for like property which is to be used primarily for exempt purposes.

[Effective: Tax years beginning after August 17, 2006]

Increases in Penalty Excise Taxes

Private Foundations. The Act doubles the following excise taxes relating to certain activities

of private foundations. The Act also doubles the maximum amounts of taxes that may be imposed on foundation managers. The increased tax rates and amounts are shown below.

Section 4941 – Self-Dealing	
• Initial tax on self-dealer	10% of amount involved
• Initial tax on foundation managers	5% of amount involved
• Maximum initial tax on foundation managers	$20,000 per act of self-dealing
• Maximum additional tax on foundation managers	$20,000 per act of self-dealing
Section 4942 – Failure to Distribute Income	
• Initial tax on the foundation	30% of the undistributed amount
Section 4943 – Excess Business Holdings	
• Initial tax on the foundation	10% of the excess holdings
Section 4944 – Jeopardizing Investments	
• Initial tax on the foundation	10% of the amount invested
Section 4945 – Taxable Expenditures	
• Initial tax on the foundation	20% of the amount involved
• Initial tax on foundation managers	5% of the amount involved
• Maximum initial tax on foundation managers	$10,000 per expenditure
• Maximum additional tax on foundation managers	$20,000 per expenditure

[Effective: Tax years beginning after August 17, 2006]

Public Charities and Section 501(c)(4) Social Welfare Organizations. The Act also doubles the maximum amount of tax that may be imposed on the management of a public charity or a Section 501(c)(4) social welfare organization for an excess benefit transaction.

Section 4958 – Excess Benefit Transactions	
• Maximum tax on organization managers	$20,000 per excess benefit transaction

[Effective: Tax years beginning after August 17, 2006]

Split-interest Trusts

Charitable remainder trusts and charitable lead trusts face stiffer penalties under the Act for late or incomplete returns. If the trust has gross income in excess of $250,000, the penalty for a late or incomplete return is increased from $10 to $100 for each day the situation is

uncorrected, up to a maximum of $50,000. For trusts with gross income of $250,000 or less, the penalty is increased from $10 to $20 per day, up to a maximum of $10,000. If the failure to file is "knowing," a penalty of an equal amount is also imposed on the trustee or trustees personally. The Act also provides that information regarding trust beneficiaries that are not charitable organizations (*e.g.*, the unitrust recipient of a charitable remainder unitrust) is not subject to public inspection requirements, even though other information about the trust is subject to public inspection.

[Effective: Returns for tax years beginning January 1, 2007 or later]

Convention or Association of Churches

The Act clarifies that an organization that is otherwise a convention or association of churches will not fail to qualify as such because membership of the organization includes individuals as well as churches or because individuals have voting rights in the organization.

Credit Counseling

New standards have been established for credit counseling organizations that wish to qualify as tax-exempt organizations. These new standards relate to the types of services provided, fees charged, organizational structure, ownership interest in other for-profit entities, and financial relationships with other corporations that provide financial or credit counseling services.

[Effective: For credit counseling organizations that are currently identified as tax-exempt, these new provisions will be applicable to tax years beginning after August 17, 2007. For new organizations, these provisions are applicable to tax years beginning after August 17, 2006.]

Blood Collector Organizations

Prior to the Act, there were no specific exemptions from the fuels, communication (telephone) services, retail truck and trailer, manufacturers, or highway vehicle use excise taxes for sales to blood collector organizations. The IRS, which is authorized to exempt from excise tax certain articles and services to be purchased for the exclusive use of the United States, had exercised its authority to exempt from various excise taxes the American Red Cross, a Congressionally chartered corporation that supplies over half of the nation's blood and blood products. In what amounts to an expansion of this policy beyond the American Red Cross, the Act exempts qualified blood collector organizations from certain excise taxes for certain blood collection activities.

[Effective: January 1, 2007 (the exemption from the highway use tax, however, will be effective for tax periods beginning on or after July 1, 2007)]

Endnotes

[1] Joint Comm. on Taxation, Technical Explanation of H.R.4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, JCX-38-06 (August 3, 2006) ("Joint Committee Report"). The Joint Committee Report provides legislative history that is useful in interpreting the Act and understanding the intent of the legislators.

[2] All Section references are to sections of the Internal Revenue Code of 1986, as amended.

[3] Not all businesses are business enterprises for this purpose. For example, the term "business enterprise" does not include a functionally related business or a trade or business where at least 95% of the gross income is

derived from passive sources (such as interest, dividends, annuities, royalties, rent, and gains from the disposition of certain property).

[4] As described elsewhere in this *EO Special Edition*, Section 509(a)(1) or (2) public charities with gross receipts of less than $25,000 are subject to new electronic notification requirements.

[5] The Act also makes the excess business holdings rules applicable to Type II supporting organizations where the supporting organization accepts any gift or contribution from a person (other than a Section 509a(1) or (2) public charity) who controls the supported organization or from a related person. This type of gift should be uncommon. (Note that the excess business holdings rules are now also applicable to donor-advised funds. See Part Two of this *EO Special Edition*.)

[6] *Zemurray Found. v. United States*, 687 F.2d 97 (5th Cir. 1982).

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