

**¶ 519] THE PENSION PROTECTION ACT, 2006:
ELECTION YEARS AND TAX LEGISLATION
DO NOT MIX**

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The title “Election Years and Tax Legislation Do Not Mix” does not refer to the innumerable provisions of the “Pension Protection Act” (PPA) for the wool trust fund and the sun road, exception to the local furnishing requirements for Alaska hydroelectric projects, suspension of duties on liquid crystal devices and ceiling fans, or new business for appraisers, accountants, and attorneys.

The title refers to several hundred pages of exempt organization and charitable contribution provisions that in many cases fix what is not generally broken, without consideration of the cost of new layers of regulation, or the irrationality of various prohibitions.

Doubtless Congress acted with the best of intent to fix problems. Hardly anyone defends abuses of the nonprofit organization provisions or the charitable donation provisions, and certainly this author does not. And many other provisions of the PPA, such as for tax-free charitable distributions from IRAs, are very beneficial. The new charitable deduction provisions are generally excellent and worthwhile.

It remains a legitimate question whether the problems addressed by “reforms” were serious and whether the cure is worse than the disease. The broader question is whether nonprofit organizations could do more good, could deliver more soup and shelters, if they did not have to spend so much time and money on compliance, with requirements imposed by legislators and regulators hundreds of miles away for how to deliver soup and shelters.

This article first summarizes each new provision relevant to charitable donations and to exempt organizations, and then discusses their implications.¹

This analysis will cover the following topics:

1. Charitable contribution provisions of the PPA ¶519.1
2. Charitable contribution restrictions (reforms) of the PPA ¶519.2
3. General exempt organization provisions of the PPA . ¶519.3
4. DAF provisions of the PPA ¶519.4
5. SO provisions of the PPA ¶519.5

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¹ The effective dates of these provisions vary and are not given, and the expiration dates of various provisions also vary. The text of the Act should be consulted for these specifics, as well as for other requirements.

△ Charitable Giving—See Cross Reference Table

6. Private foundation provisions of the PPA ¶519.6
 7. Corrections in the Tax Relief and Health Care Act,
 2006 ¶519.7

Charitable Contribution Provisions of the PPA

¶519.1] Charitable distributions from certain IRAs. Individuals above age 70½ may make qualified charitable distributions from traditional IRAs and Roth IRAs up to \$100,000 per year, in 2006 and 2007, and exclude those distributions from income. Because the distribution is excluded from income, it is not deductible as a charitable contribution.

Qualified charitable distributions require that the distribution be made directly by the IRA trustee to an IRC § 170(b)(1)(A) organization, other than supporting organizations (SOs) or donor advised funds (DAFs). This excludes private foundations and split-interest trusts. They also require that no benefit be received by the donor and that substantiation requirements be met. Complex rules apply if any part of the IRA consists of nondeductible contributions.

This provision does not apply to individuals younger than 70½, who must realize income and suffer an early withdrawal penalty. The provision does not apply to distributions from employer sponsored retirement plans, from Simple IRAs, or from simplified employee pensions.

The new provision for qualified charitable distributions from traditional and Roth IRAs will benefit charities, enabling qualified donors who have unnecessarily large IRAs to donate part and to avoid disallowance of part of large donations because of percentage limits. Individuals can already do this at death and now can do it after age 70½. A provision allowing general charitable rollovers of IRAs, without the age 70½ requirement, would be far more beneficial, though it would reduce tax revenue. Elimination of the requirement for a charitable distribution from the IRA trustee would end missteps by well-meaning taxpayers and burdens on IRA trustees. Hopefully, this will be made permanent (rather than ending at the end of 2007).

The ineligibility of distributions to DAFs and to SOs results from legislative hostility toward those entities, rather than from reason. The PPA already prohibits benefits to donors from DAFs, and it is hard to see why donations of IRAs pose problems while donations of cash to DAFs and SOs do not.

Charitable donations of food inventory. Taxpayers in a trade or a business can deduct donations of food inventory of “apparently wholesome food,” subject to restrictions and to percentage limits. The deduction is the lesser of basis plus half of any appreciation or two times basis.

The restrictions are that the donation must be of inventory and must be contributed to an IRC § 501(c)(3) organization other than a

private nonoperating foundation, which must use the contributed inventory only for care of the ill, the needy, or infants and must not sell or exchange it and which must give the donor a written statement that the property will be so used. There are complex rules for adjusting cost of goods sold.

The percentage limit for C corporations is 10% of taxable income. The Katrina Emergency Tax Relief Act, 2005 allowed other businesses to benefit from the provision for the rest of 2005, and that is extended by the PPA through 2007. The percentage limit for sole proprietors, S corporation shareholders, and partners is 10% of net income. The percentage limit for individuals is 10% of the taxpayer's share of net income from all such pass-through entities that make donations of food inventory. Donations remain subject to percentage limits, and excess donations can be carried forward under normal carryforward rules. This is an exception to the usual rule that donations of inventory are limited to the lower of fair market value (FMV) or the taxpayer's basis in the inventory, which is normally cost.

The extended provision for charitable donations of food inventory will help encourage donations to homeless shelters, orphanages, and the like. It laudably has not been encumbered with unnecessary restrictions. Hopefully, the non-C corporation provision will be made permanent (rather than ending at the end of 2007).

Charitable donations by S corporations of property. The basis adjustment when S corporations make charitable donations of property is changed from being the shareholder's flow-through share of the charitable deduction to being the shareholder's pro rata share of the adjusted basis of the contributed property. The Technical Explanation of the Act gives an example: if an S corporation with one shareholder makes a donation of stock with basis of \$200 and FMV of \$500, the shareholder takes a charitable deduction for \$500 (if IRC § 170(e) allows) and adjusts his or her basis in the S corporation stock by \$200.

The new provision adds complexity, though it is technically sound, and is the sort of complexity that the most well meaning taxpayer may never become aware of. It would make more sense to limit the new provision to shareholders whose flow-through contribution exceeds a certain dollar amount, such as \$10,000. The complexity is magnified by the provision only applying to contributions in 2006 and 2007.

Charitable contributions of book inventory. This extends for C corporations a provision for contributions of book inventory from 2005 to 2006 and 2007. However, it does not broaden the deduction to be available to other businesses. The deduction was created by the Katrina Emergency Tax Relief Act, 2005, to be similar to the C corporation provision for contributions of food inventory.

C corporations may deduct donations of book inventory, subject to restrictions and to percentage limits. The deduction is the lesser of basis plus half of any appreciation or two times basis. The restrictions are that the donation must be of book inventory and must be contributed to an IRC § 501(c)(3) organization other than a private nonoperating foundation, which must use the contributed inventory only for care of the ill, the needy, or infants and must not sell or exchange it and which must give the donor a written statement that the property will be so used. The recipient charity must certify in writing that the contributed books are suitable by content, quality, and current status to be used in the recipient's educational programs and will be so used. There are complex rules for adjusting cost of goods sold. The percentage limit for C corporations is 10% of taxable income for this and other charitable contributions.

The extended provision for contributions of book inventory helps encourage donations. Hopefully, the provision will be made permanent (rather than ending at the end of 2007) and broadened beyond C corporations.

Payments to controlling organizations. This provision causes only the excess above FMV, and not the entire amount, of interest, rents, royalties, and annuities paid by a controlled organization to a controlling organization (under IRC § 512(b)(13)) to be taxed to the controlling organization under the unrelated business income tax (UBIT). Under prior law and the new law, amounts are taxed to the controlling organization under the UBIT only to the extent they reduce the net unrelated income (or increase the net unrelated loss) of the controlled organization.

The PPA also imposes three other requirements:

(1) It places a 20% penalty on the excess payment above FMV to deter such non-arm's length transactions that would reduce the taxable income of the controlled organization.

(2) It requires controlling organizations to report such payments, any loans, and any transfers on their Form 990s (Return of Organization Exempt from Income Tax) or other information returns.

(3) The Act requires the Secretary of the Treasury to submit a report by the beginning of 2009 on payments by controlled entities and on IRS enforcement of these provisions.

The new provision on excessive payments to controlling organizations is reasonable, in reducing the tax to the amount of excess and penalizing any such excess, instead of taxing the entire payment. For example, it makes more sense for a nonprofit parent that passively rents property and would not otherwise be taxable on the rent to pay tax only on any rent in excess of FMV from a subsidiary, and not on the entire amount of rent. Hopefully, the provision will be made permanent (rather than ending at the end of 2007).

Charitable contributions for conservation purposes. This provision increases the percentage limits and carryover periods for qualified conservation contributions. The usual percentage limit for individuals contributing capital gain property to public charities is 30% of the contribution base, and the usual carryover period is five years. The PPA increases that for qualified conservation contributions for

- (1) individuals generally to 50% and 15 years;
- (2) individual farmers and ranchers to 100% and 15 years; and
- (3) corporate farmers and ranchers to 100% and 15 years so long as the land remains available for agriculture or livestock production (whether or not it is actually so used).

A qualified farmer or rancher is a taxpayer whose gross income from the trade or business of farming is greater than half the taxpayer's gross income for the tax year.

The other definitions remain the same. A qualified conservation contribution remains defined as a contribution to a qualified organization for conservation purposes

- (1) of the donor's entire interest except for a qualified mineral interest or
- (2) a remainder interest or
- (3) a perpetual restriction on use

A qualified organization remains defined as specified government units, public charities that meet specified support tests, and specified SOs. A conservation purpose is either for

- (1) outdoor recreation by or education of the public,
- (2) protection of a natural habitat,
- (3) preservation of open space that produces a significant public benefit for scenic enjoyment or under a clear government conservation policy, or
- (4) preservation of an historically important land area or building.

The new provision for conservation contributions will encourage such contributions. Hopefully, the provision will be made permanent (rather than ending with contributions in tax years beginning before 2008).

Charitable Contribution Restrictions (Reforms) of the PPA

¶ 519.2] Reporting of insurance contracts benefiting exempt organizations. This reporting requirement (not a prohibition) is aimed at exempt organizations and other investors jointly investing in pools of insurance contracts, presumably viatical contracts on individuals with terminal illnesses. An exempt organization, on acquiring any interest in an applicable insurance contract

that is part of a pool of such contracts, must file an information report.

An applicable insurance contract is defined as one in which both an exempt organization and someone else hold or have held an interest directly or indirectly. There are three exceptions:

- (1) if each person has an insurable interest in the insured person
- (2) if the sole interest of the exempt organization or of each other person is as a named beneficiary
- (3) if the sole interest of the nonexempt person is as a trustee acting as fiduciary only for the exempt organization or as a gratuitous beneficiary

The provision for joint interests in insurance contract pools seems reasonable, since it is gaining information to allow the IRS to determine if a problem exists and since it makes exceptions for nonabusive insurance arrangements (such as an individual giving an insurance policy on their life 50% to a child and 50% to an exempt organization).

Restrictions on charitable deductions for historic easements. The requirements for donating easements in registered historic districts are revised to provide that, while location alone in such a district does not allow a charitable deduction, a qualified conservation contribution is deductible so long as qualified real property interests in exteriors of buildings preserve the entire exterior (not just the front or facade) and prohibit change that would be inconsistent with their historical character.

The substantiation requirements are expanded to require the filing with the tax return claiming the deduction of (1) a qualified appraisal with photographs of the entire exterior of the building (except the roof, if impracticable) and (2) descriptions of all current restrictions on development of the building such as zoning laws and neighborhood covenants. If the deduction exceeds \$10,000, a \$500 fee must be sent to the IRS.

An agreement is required between the donor and the donee stating, under penalty of perjury, that the donee is a qualified organization, whose purpose is historic preservation, environmental protection, land conservation, or open space preservation, and that the donee has the resources and the commitment to manage and to enforce the restriction. Another rule requires reducing the charitable deduction to factor in any rehabilitation credit for the preceding five tax years.

The definitions are the same as above of qualified conservation contributions, qualified real property interests, qualified organizations, and conservation purposes.

The restriction on historic easements will have the effect of preserving fewer buildings, by requiring nondisturbance of the sides and rear as well as the front. The requirement to describe current restrictions on development seems unnecessary, since the PPA

requires prohibiting change that would be inconsistent with the building's historical character and requires the donee to certify that it will enforce the easement and the restrictions.

Restrictions on charitable deductions for taxidermy property. The deduction for charitable contributions of taxidermy property is reduced, if the contribution is by the taxidermist or the person paying the taxidermist, to the lesser of the taxpayer's basis or FMV, whether or not the contributions are for a related use. Basis does not include indirect costs such as transporting the animal or hunting it.

There apparently was an abuse, and this kills, stuffs, and mounts it.

Restrictions on charitable deductions for property without actual exempt use. The deduction for the FMV of tangible personal property that is not actually used for exempt purposes or that is disposed of during the three years after contribution, is recovered to the extent the deduction exceeded the donor's tax basis and if the deduction exceeded \$5000. If the donee disposes of the property in the tax year of contribution, the excess deduction cannot be taken. If the donee disposes of the property after that but during three years from the date of contribution, the donor has to include the excess deduction as income. The existing requirement for donees to file Form 8282 (Donee Information Return (Sale, Exchange, or Other Disposition of Donated Property) if donated property is disposed of within two years is changed to three years, and the donee must describe its use of the property and state whether it was a related use.

There is an exception, so that no adjustment of the tax benefit occurs, if the donee gives a written certification under penalty of perjury that the use was actually related to its exempt purposes or that the intended use was related, but became impossible or infeasible.

A new penalty of \$10,000 is owed by anyone stating that property has a related use, knowing that it is not intended for a related use.

This provision taking away tax benefits when the requirements are not met at least has an exception to address the situation where the intended use could not occur.

Restrictions on charitable deductions for clothing and household items. The deduction for contributing clothing and household items is greatly restricted. If an item is not in good used condition, there is no deduction, unless the claimed deduction is more than \$500 and if a qualified appraisal is attached to the tax return. If an item is in good used condition, the deduction remains limited to FMV if less than basis, which is usually cost, but the Secretary of Treasury is authorized to promulgate regulations

denying deductions for items with minimal value (such as used underwear).

Household items include furniture and other furnishings, electronics and appliances, and linens, but do not include paintings or other art works, antiques, jewelry, or collections.

This provision addresses the problem of overvaluation and is more reasonable than the Senate Finance Committee staff proposal.

Restrictions on charitable deductions for cash gifts. This new restriction denies deductions for cash gifts unless the donor has a bank record or a written record from the donee. This effectively denies deductions for cash contributions into buckets at traffic lights, into kettles at mall entrances, into plates at worship services, or to children fundraising at the door.

This restriction will reduce contributions to some very worthy charities, in situations where writing checks or giving receipts is simply not practicable.

Restrictions on charitable deductions for fractional interests in tangible personal property. This new restriction limits the value of additional contributions of fractional interests in tangible personal property (such as a painting) to the initial valuation (unless the value has dropped) for both income, gift, and estate tax purposes. If property is rising in value, this penalizes fractional gifts by limiting later deductions.

It also recaptures all prior deductions

(1) if all the donor's remaining interest is not contributed within ten years from the initial contribution, or on the donor's death if earlier, and requires a penalty of 10% of the recaptured amount plus interest; or

(2) if the donee does not take substantial physical possession (such as its percentage of use time) or does not use the property for an exempt use.

The recapture of gift tax deductions could mean that a valuable property whose gift tax deduction was recapture would use up the donor's remaining gift tax exemption and require the payment of gift tax for having made a gift.

It denies any deduction if at the time of a fractional gift all interests in the property are not owned by the donor and/or the donee organization.

The new provision will deter lifetime fractional gifts, instead of keeping a painting or other property until death, because of the limitation on deductions in contributing additional interests and because of the absolute requirement of the donee having physical possession for its fraction of the year, even if the donee does not want possession and attendant costs each year. It can be quite unfair if gift tax charitable deductions are recaptured, something that should be eliminated. It is not clear if the estate value will be FMV at death or at the time of contribution, and if the former, there would be a

mismatch between the higher estate inclusion amount and the lower estate charitable deduction.

Penalties for overstatement of valuations of property. The Act lowers the permissible variance of claimed values and appraisals from finally determined values for charitable contributions.

Taxpayers incur substantial valuation misstatement penalties for income tax charitable deductions if the claimed value is 150% or more of the finally determined value and gross valuation misstatement penalties if the claimed value is 200% or more of the finally determined value. They incur penalties for estate and gift tax valuations if the claimed value is 65% or less or 40% or less respectively than the finally determined value. The reasonable cause exception is no longer available in cases of gross misstatement penalties.

Appraisers face penalties for appraisals that result in substantial or gross valuation misstatements, of the greater of \$1,000 or 10% of the understatement of tax, up to a maximum of 125% of their appraisal fee. Appraisers may offer the defense that it was more likely than not the appraisal was correct. Other requirements for appraisers are imposed, including definitions of qualified appraisers.

In Notice 2006-96,² the IRS gave transitional guidance about the definitions of qualified appraisals and qualified appraisers.

The changes of valuation penalties seem unfair, since they do not apply to all valuations but just to charitable contribution valuations and some estate and gift tax valuations. Unique property such as artwork cannot be appraised with such exactitude. Donations of property for a related use are a good thing, not an evil to threaten.

The PPA also has a provision exempting blood collector organizations from certain excise taxes, which is not summarized here.

General Exempt Organization Provisions of the PPA

¶ 519.3] Increased excise taxes on excess benefit transactions. The PPA increases the excise taxes for excess benefit transactions, so that organization managers of IRC § 501(c)(3) public charities and IRC § 501(c)(4) organizations can be taxed not \$10,000 but \$20,000 per prohibited transaction.

Excess benefit transactions are defined by IRC § 4958(f) to involve a disqualified person receiving an economic benefit worth more than the value of consideration given. The initial tax on the excess benefit is 25% on the disqualified person and 10% on the organization manager up to an old limit of \$10,000 and up to the new limit of \$20,000, if the organization manager knowingly participated in the excess benefit transaction willfully and not because of reasonable cause.

² Notice 2006-96, 2006-46, IRB 902.

△ Charitable Giving—See Cross Reference Table

The new penalty levels adjust for inflation, and deter participation in prohibited acts.

Notification requirement for non-990 filers. The PPA requires small organizations (those excused from filing Form 990 because gross receipts are normally not above \$25,000) to provide a notice to the IRS annually, in electronic form. That notice must give the organization's legal name, any other name under which it operates, the mailing address, the web site, if any, the taxpayer identification number, a principal officer's name and address, and evidence the organization's income is not generally above \$25,000.

The notices are open to public inspection.

The Act also imposes the penalty of revocation of exemption. A nonfiler that does not provide notice for three consecutive years has its exempt status revoked. A filing organization that does not file Form 990 for three consecutive years also has its exemption revoked. If the organization shows reasonable cause for not filing the notice, the IRS has discretion to reinstate the exemption retroactively. The Act does not impose a dollar penalty for not filing the notice.

The annual notice by small organizations should not be burdensome, so long as they learn about the requirement before they suffer automatic revocation of exemption and so long as the notice is not enlarged by the IRS to become tantamount to an application for exemption and a Form 990. The original reason for exempting the smallest organizations from Form 1023 (Application for Recognition of Exemption), and organizations not generally receiving more than \$25,000 from Form 990 was simply a recognition that these would be very burdensome for small organizations, diverting a large portion of their limited resources from charitable activities to compliance.

Disclosures to state officials. The Act requires the IRS to disclose to appropriate state officers various proposed actions toward nonprofit organizations beyond the existing requirement for the IRS to disclose final actions toward nonprofits. The existing requirement was for the IRS to disclose to the appropriate state officer

- (1) denial of an exemption application under IRC § 501(c)(3);
- (2) revocation of an exemption under IRC § 501(c)(3);
- (3) notices of deficiency for taxes under Chapters 41 or 42 or IRC § 507; and
- (4) on written request, such returns and filed information relating to those disclosures as are relevant to state enforcement.

The new requirement is for the IRS also to disclose to the appropriate state officer

- (1) a notice of proposed denial of an exemption application under IRC § 501(c)(3),
- (2) a notice of proposed revocation of an exemption under IRC § 501(c)(3),

(3) a proposed deficiency for taxes under Chapters 41 or 42 or IRC § 507,

(4) such returns and filed information relating to those disclosures, as well as

(5) organizations that have applied for exemption under IRC § 501(c)(3).

The Act also permits the IRS to disclose or open to inspection the returns and related filings of an organization that is exempt under any IRC § 501(c) subsection, if those of an IRC § 501(c)(3) organization may constitute evidence of noncompliance with state laws, or if those of other IRC § 501(c) organizations are for the purpose of and necessary for administering state laws on charitable solicitations or charitable assets. The Act also allows returns and return information filed under IRC § 6104(c) to be disclosed in civil administrative or judicial proceedings to enforce state laws, but provides a high penalty for willful unauthorized disclosure. There are various other safeguards and rules.

These provisions enable the states to coordinate better with the IRS in enforcing parallel state exemption requirements and to gain evidence in enforcing charitable solicitation and charitable asset regulations. They make it difficult for an organization to take inconsistent positions in federal and state enforcement actions. But they also multiply an organization's difficulties if it is wrongly accused by the IRS of violating federal tax provisions.

Disclosure of unrelated business income tax returns. The Act adds a requirement that IRC § 501(c)(3) organizations disclose their unrelated business income tax returns (Form 990-T, Exempt Organization Business Income Tax Return (and Proxy Tax under Section 6033(e)) to the prior requirement that they disclose their Form 990. There is an exception for information that the IRS agrees would adversely affect the organization, much like the prior exception to Form 990 disclosures for such things as trade secrets and proprietary processes.

Nonprofit organizations argued that it was unfair to be required to disclose taxable business returns, when businesses carrying on the same activity were not required to disclose their returns. However, nonprofits can form separate taxable subsidiaries that file separate returns and taxes, to which the same rules will apply as for businesses.³

Additional requirements for credit counseling organizations. The Act lists requirements for a credit counseling organization to qualify as either an IRC § 501(c)(3) or 501(c)(4) organization, in terms of fees, board independence, relationship to businesses that lend, repair credit, provide debt management plan services, or

³ See generally Wendell R. Bird, "Taxable Subsidiaries of Exempt Organizations," 4 Practical Tax Lawyer 53, 1990.

provide payment processing, and prohibits activities such as lending and loan facilitation (except no interest loans) or referral fees for debt management plan services. To qualify under IRC § 501(c)(3), the organization's revenues from creditor payments and debt management plans cannot exceed certain levels (ultimately 50%), thereby requiring substantial contributions.

These requirements help provide clear rules for qualification and help ensure that credit counseling organizations that operate as nonprofits have typical characteristics of nonprofit organizations.

DAF Provisions of the PPA

[§ 519.4] New definition of and requirements for DAF. The Act, for the first time,⁴ defines DAFs⁵ as funds or accounts

- which are separately identified by reference to contributions of a donor or donors;
- which are owned and controlled by a sponsoring organization; and
- with respect to which a donor (or a person appointed or designed by the donor) has (or expects to have) advisory privileges about either distribution or investment of amounts held in the fund or account.

It also excludes from the definition of DAFs any fund or account

- which makes distributions only to a single identified organization or a governmental entity or
- with respect to which a donor (or a person appointed or designated by the donor) advises only as to which individuals receive grants for travel, study, or similar purposes if (1) the advisory privileges are only in the person's capacity as a member of a committee all of which is appointed by the sponsoring organization; (2) no combination of the donor (or a person appointed or designated by the donor) controls the committee, directly or indirectly; and (3) all grants are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization and designed to ensure that grants comply with IRC §§ 4945(g)(1), (2), or (3).

The Secretary of the Treasury has discretion to exempt additional funds from treatment as a DAF.

The definition will subject many funds to these rules that are not perceived as DAFs, such as university endowments with limited donor power of recommendation and will prevent disaster relief funds from operating as DAFs.

New prohibited and restricted grants by DAFs. New IRC § 4966 Act entirely prohibits grants from DAFs, which are termed taxable distributions to

⁴ See generally Wendell R. Bird, "Donor Advised Funds and Community Foundations," 13 *Taxation of Exempts* 68, Sept.-Oct. 2001.

⁵ IRC § 4966(d)(2)(A).

- individuals and
- any entity for a noncharitable purpose (a purpose not specified in IRC § 170(c)(2)(B)).

The penalty for any such taxable distribution is that the sponsoring organization pays a 20% tax on the amount of the taxable distribution, and any fund manager owes a 5% tax who agrees to the distribution knowing that it is a taxable distribution (up to \$10,000).

Fund managers are broadly defined to include “the employees of the sponsoring organization having authority or responsibility with respect to such act,” as well as officers, directors, and trustees of sponsoring organizations.

The Act requires expenditure responsibility if certain grants are made from DAFs, though allowing them to

- private nonoperating foundations;
- other organizations not described in IRC § 170(b)(1)(A) (including nearly all foreign organizations);
- Type I or II SOs if the donor or any designee directly or indirectly controls one of their supported organization (this and the next category are called “disqualified SOs”); and
- Type III SOs except if they are functionally integrated.⁶

The Act allows the other types of grants made by DAFs, without expenditure responsibility to

- IRC § 170(b)(1)(A) organizations except SOs falling under the above rule;
- the sponsoring charity; and
- other DAFs.

The prohibition against grants to individuals will end worthwhile support of needy individuals through DAFs. The prohibition against grants to foreign organizations without expenditure responsibility will drastically reduce worthwhile support of foreign organizations, particularly smaller ones that may be the only ones providing relevant service in some countries or may be more efficient than larger ones.

The prohibition on donor benefits is sufficient to end abuses. The taxable distribution rules are unnecessary, in this author’s view, and simply end or reduce some worthwhile charitable grants.

New prohibited benefit rules for DAFs and sponsoring organizations. New IRC § 4967 prohibits and penalizes advice that results in any targeted person receiving a nonincidental benefit, directly or indirectly. The penalty for the targeted person is 125% of the prohibited benefit, and for the fund manager who agreed to making the prohibited grant can be 10% (up to \$10,000 per

⁶ “Functionally integrated” is defined in IRC § 4943(f)(5)(B).

distribution). These taxes are not applied if excess benefits taxes are imposed under IRC § 4958.

The targeted persons, identified in new IRC § 4958(f)(7), with respect to a DAF are as follows:

- donors and designees and investment advisors defined in IRC § 4966(d)(2)(A)(iii) as donors or any person appointed or designated by the donor who have advisory privileges with respect to the distribution or investment of amounts held in the fund or account by reason of the donor's status as a donor

- members of the family of the foregoing
- entities controlled 35% by any of the foregoing

This prohibited benefit prohibition is justified and attacks the abuses in DAFs identified by congressional hearings.

New excess benefit rules for DAFs and sponsoring organizations. The Act expands IRC § 4958(c)(2) to treat as per se excess benefits from DAFs any benefit from a DAF to a donor, investment advisor, or related person. The penalty is 25% of the grant, loan, compensation, or similar payment, plus repayment to the sponsoring organization (not into any DAF).

The things prohibited as excess benefits are

- “any” grant, loan, compensation, or other similar payment from the DAF to a targeted person under IRC § 4958(f)(7) and
- excessive compensation to investment advisors (who face similar penalties).

The targeted persons are again those described in IRC § 4958(f)(7) with respect to a DAF (summarized above) and are investment advisors described in new IRC § 4958(f)(8) with respect to a sponsoring organization:

- an investment advisor defined in new IRC § 4958(f)(8)(B) in respect to a sponsoring organization as any person (other than an employee of the sponsoring organization) compensated by the organization for managing the investment of, or providing investment advice about, assets maintained in DAFs of the supporting organization

- members of the family of an investment advisor
- entities controlled 35% by any of the foregoing

This excess benefit prohibition sufficiently overlaps the IRC § 4967 prohibited benefit prohibition that they should be a single prohibition in relation to donors and their designees.

New excess business holding rules for DAFs and sponsoring organizations. The Act essentially applies the private foundation prohibition on excess business holdings (IRC § 4943) to DAFs, and also to SOs. This is not summarized, but should be carefully considered when a DAF and a disqualified person both own a stock or another investment interests.

New requirements for sponsoring organizations. The Act imposes several information requirements on sponsoring organizations of DAFs:

- The Form 1023 must give notice that the applicant maintains or intends to establish DAFs.
- The Form 990 for sponsoring organizations must list the number of DAFs, the total assets held by all DAFs, the total contributions to DAFs, and the total distributions from DAFs.
- Receipts (written acknowledgments) from sponsoring organizations, which must be received for donors to deduct contributions to DAFs, must expressly state that the organization has exclusive legal control over assets contributed to DAFs.
- The receipt requirement is also a condition of a gift tax or an estate tax charitable deduction.

However, the Act does not impose the 5% distribution requirement on DAFs, which had been proposed by the Senate Finance Committee and passed by the Senate in its Tax Relief Act, 2005.⁷

New Treasury study on DAFs and SOs. The Act requires the Treasury to undertake a one-year study on DAFs, with a focus on whether such a 5% payout requirement should be imposed, whether deductions should be allowed for contributions to DAFs of assets that are retained or that benefit the donor or related parties, and whether retained advisory powers conflict with the rule that charitable gifts are not completed until control is surrendered.

Cost and effectiveness of the new provision. The prohibited benefit rule makes sense. The other requirements are both odd and costly. They are odd because they are generally stricter than the private foundation rules, which contain a number of exceptions to prohibitions on self-dealing and taxable expenditures that the DAF rules do not contain. The DAF requirements are costly because they will impose both transitional costs and ongoing administrative costs on DAFs, without much benefit in terms of reduction of true abuses. Every additional layer of regulation of this sort takes charity money away from charitable activities and redirects it to compliance, whether internal administrative costs or external accounting and legal costs. Donors have an array of much more than 1000 sponsoring organizations of DAFs to choose among and have been doing an impressive job of bringing about grants to charitable activities.

Notice 2006-109. The IRS provided interim guidance about the application of the new PPA provisions to DAFs. The DAF section excludes certain employer-sponsored disaster relief funds from the definition of DAFs, and clarifies how educational grants awarded

⁷ Wendell R. Bird, "Congress Offers No Relief but Much Red Tape for Charities and Foundations," 17 *Taxation of Exempts* 201, Mar.-Apr. 2006.

prior to enactment of the PPA will be treated under the new excise taxes on grants to individuals.

The Notice also provides guidance on how DAFs and private foundations may determine whether a potential grantee is a Type I, II, or III SO, until further guidance is issued.

To determine whether a grantee is an SO (under IRC § 509(a)(3)), a grantor may rely on information about the grantee's public charity status in the IRS Business Master File and a grantor must also verify that the grantee is still listed in Publication 78 or must obtain a copy of the "current" IRS letter recognizing the grantee as exempt.

Criteria for determining whether a grantee SO is a Type I or Type II follow:

- A grantor may rely on a written representation signed by an officer, director, or trustee of the grantee, so long as (1) it describes how the grantee's officers, directors, or trustees are selected, and references any provisions in governing documents that establish a Type I or II relationship and (2) the grantor collects and reviews copies of the governing documents of the grantee (and if relevant of the supported organization(s)).

- Alternatively, a grantor can rely on a reasoned written opinion of counsel of either the grantor or the grantee.

- A DAF sponsoring organization or a private foundation grantor may also need to obtain a list of the grantee's supported organizations to determine whether any is controlled by disqualified persons of the private foundation (if not, the foundation must exercise expenditure responsibility).

Criteria for determining whether a grantee SO is a functionally integrated Type III follow:

- A grantor may rely on a written representation signed by an officer, director, or trustee of the grantee, so long as (1) it identifies the supported organization(s) with which the grantee is functionally integrated; (2) the grantor collects and reviews copies of the governing documents of the grantee (and if relevant of the supported organization(s)) and any other documents setting out the relationship of grantee to supported organizations if not reflected in the governing documents; and (3) the grantor collects and reviews a written representation signed by an officer, director, or trustee of each of the supported organizations with which the grantee represents it is functionally integrated, describing the activities of the grantee, and confirming that but for the involvement of the grantee engaging in activities the SO would normally engage in those activities itself.

- Alternatively, a grantor can rely on a reasoned written opinion of counsel of either the grantor or the grantee.

- A DAF sponsoring organization or a private foundation grantor may also need to obtain a list of the grantee's supported organizations to determine whether any is controlled by disqualified persons

of the private foundation (if not, the foundation must exercise expenditure responsibility).

The Notice also gives standards for determining control and further defines functionally integrated Type IIIs until regulations are issued.

SO Provisions of the PPA

¶519.5] New prohibitions for SOs. The definitions of Type I, II, and III organizations are upgraded from the regulations to IRC § 509(a)(3)(B). The SO must be

- operated, supervised, or controlled by one or more organizations described in paragraph (1) or (2);
- supervised or controlled in connection with one or more such organizations; or
- operated in connection with one or more such organizations.

Type I organizations are now prohibited from accepting any contribution from a person who controls the supported organization directly or indirectly, either alone or with family members or entities controlled 35% by them.

Type III organizations are now prohibited from

- supporting any foreign organization (with a three year transitional provision) and
- accepting any contribution from a person who controls the supported organization directly or indirectly, either alone or with family members or entities controlled 35% by them.

Type III SOs also must meet a stricter responsiveness test and in the future “shall” be required by regulations to “make distributions of a percentage of either income or assets to supported organizations” unless they are functionally integrated.

All SOs must now list in their Form 990s their supported organizations, their own categorization under Types I-III, and a certification that the SO meets the requirements of IRC § 509(a)(3)(C).

New excess benefit rules for SOs. The Act expands IRC § 4958(c)(3) to treat as per se excess benefits from SOs

- any grant, loan, compensation, or other similar payment by an SO (of any type) to a substantial contributor, family member, or entity 35% controlled by either or
- any loan by an SO to a disqualified person other than a public charity under IRC §§ 509(a)(1), (2), or (4).

According to Congress’ Technical Explanation, this prohibition includes expense reimbursements.

A substantial contributor is defined with an exception for any public charity under IRC §§ 509(a)(1), (2), or (4). Disqualified persons

include, by new IRC § 4958(f)(1)(D), the usual disqualified persons under IRC § 4958 in relation to the SO.

New excess business holding rules for SOs. The Act essentially applies the private foundation prohibition on excess business holdings (IRC § 4943) to Type III SOs that are not functionally integrated and to certain Type II SOs, as well as to DAFs. This should be carefully considered when a DAF and a disqualified person both own a stock or another investment interests. Disqualified person is defined using the broader IRC § 4958 definition, rather than the IRC § 4946 definition.

New prohibition of many grants from private foundations to SOs. The Act provides that grants from nonoperating private foundations to SOs are prohibited as taxable expenditures unless they employ expenditure responsibility and do not count as qualifying distributions (IRC § 4942(g)(4)), if they are to

- Type III SOs that are not functionally integrated or
- Type I or II SOs if a disqualified person of the private foundation directly or indirectly controls the SO or a supported organization or if forthcoming regulations require such treatment.

Cost and effectiveness of the new provision. Each new provision probably relates to some instances of abuse. And hard cases can make bad law, as Justice Holmes said. Each new provision has a target, but also becomes a pit inviting accidents. SOs either must incur high accounting and legal costs to determine whether each grant violates these very complex provisions, or will encounter pitfalls where they are least expected. There is a cost from each added layer of regulations, which in effect reduces expenditures for charitable activities and increases expenditures for compliance.

Notice 2006-109 provided interim guidance about the applications of the new PPA provisions to SOs as well as to DAFs. It clarifies the applicability date for excess benefit transactions by SOs, where payments are made under certain binding written contracts and other legal obligations (such as employment relations) that existed on August 17, 2006.

In Announcement 2006-93, the IRS also very helpfully outlined the procedure for SOs to change to other public charity status (IRC § 509(a)(1) or (2)). The expedited guidance resulted from disqualification of SOs from qualified charitable distributions from IRAs under the Act.

Private Foundation Provisions of the PPA

¶ 519.6] Increased excise taxes on private foundations. The PPA increases the excise taxes on private foundations. The excise taxes are on self-dealing (IRC § 4941), failure to make minimum distributions (IRC § 4942), excess business holdings (IRC § 4943), jeopardizing investments (IRC § 4944), and taxable expenditures

(IRC § 4945). The PPA generally doubles the percentage and dollar amount of taxes on foundation managers as follows:

self-dealing	from 2.5% to 5%, and \$10,000 to \$20,000 per act on foundation managers for initial and additional tax
failure to make minimum distributions	from 15% to 30% of the undistributed amount on the foundation
excess business holdings	from 5% to 10% of the value of the holdings
jeopardizing investments	from 5% to 10%, and \$5,000 to \$10,000 per act on foundation and managers, and for the additional tax from \$10,000 to \$20,000 on managers
taxable expenditures	from 5% to 10% on the foundation, on managers from 2.5% to 5% and \$5,000 to \$10,000, and for the additional tax on managers \$10,000 to \$20,000

The new provisions for higher excise taxes are reasonable, since the prior dollar limits were not adjusted for inflation.

Increase in the excise tax base for the net investment income. The PPA also expands the tax base for the net investment income tax, which is 2% or potentially 1%. It adds to the former base (interest, dividends, rents, payments with respect to securities loans, and royalties) items of investment income that are similar (such as capital gains, income from notional principal contracts, and annuities). It allows consideration of capital gains to be deferred if property used for the foundation's exempt purposes for at least a year is exchanged for property of like kind. This new provision effectively reverses the *Zemurray Foundation* decision.⁸

The new provision will not have a substantial effect on foundations because the tax base is only for a 2% excise tax.

Restriction on some grants from private foundations to SOs. The Act prohibits grants from nonoperating private foundations to SOs as taxable expenditures, unless expenditure responsibility requirements are met, and provides that they do not count as qualifying distributions (IRC § 4942(g)(4)), if they are to

blt Type III SOs that are not functionally integrated or

- Type I or II SOs if a disqualified person of the private foundation directly or indirectly controls the SO or a supported organization or if forthcoming regulations require such treatment.

⁸ *Zemurray Foundation v. US*, 755 F2d 404, 413 (CA-5, 1985), affg in relevant part 53 AFTR2d 842 (DC La., 1983).

The Act also prohibits grants from private foundations to those Type I and III SOs that the foundation controls directly or indirectly, because it prohibits Type I and III SOs from accepting any contribution from a person who controls the supported organization directly or indirectly, either alone or with family members or entities controlled 35% by them.

Notice 2006-109 provides guidance on how DAFs and private foundations may determine whether a potential grantee is a Type I, II, or III SO, as summarized above.

Restriction on grants from SOs to private foundations. As summarized above, the Act also prohibits certain transactions (excess benefits) from SOs of any type to those private foundations that control the SO, directly or indirectly, such as

- any grant, loan, compensation, or other similar payment by an SO (of any type) to a substantial contributor, family member, or entity 35% controlled by either a substantial contributor, a family member, or both and
- any loan by an SO to a disqualified person other than a public charity under IRC §§ 509(a)(1), (2), or (4).

Restriction on grants from DAFs to private foundations. As noted above, DAFs now may only make grants to nonoperating foundations if they perform expenditure responsibility. The IRS has for some time taken the position that a DAF may not make a grant to a nonoperating foundation controlled by the donor-advisor to the DAF or related persons.

Corrections in the Tax Relief and Health Care Act, 2006

¶519.7] Charitable remainder trusts. One correction amended IRC § 664(c) to change the prior rule that a charitable remainder trust with any unrelated business income no longer loses its tax exempt status for the year, but instead is subject to unrelated business income tax on the amount.

Corporate contributions of scientific property and computer technology. Another provision extended for two years (through 2007) the corporate deduction for donations of computer technology and equipment for educational purposes (under IRC § 170(e)(6)(G)) and expanded it to items assembled as well as constructed.

Conclusion. Complex just got more complex. A few provisions of the PPA address real and significant abuses. Most provisions regulate or prohibit nonabuses. Whether a grant to or from a DAF or an SO is permitted, is restricted until certain information is obtained or is prohibited is something that few nonattorneys and nonaccountants will accurately be able to determine.⁹

⁹ Note: Any advice contained in this article is not intended or prepared to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties that may be imposed under tax law on such taxpayer. The information contained herein is of general principles and is not intended to address the specific facts or all applicable provisions for any particular person. This article is not intended to and does not offer legal advice and reliance should be placed only on one's own legal, accounting, and tax advisors. Statutes, regulations, cases, and rulings have changed and will change over time in these areas, and state laws and interpretations often differ in these areas so state laws are not addressed at all.