

tax-exempt exempts

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CONGRESS OFFERS NO RELIEF BUT MUCH RED TAPE FOR

The nonprofit organization provisions of the Tax Relief Act of 2005 are burdensome and frequently unreasonable.

CHARITIES AND FOUNDATIONS

WENDELL R. BIRD

After two years of controversy, provoked by press reports of a limited number of abuses by charities and concern by leaders of the Senate Finance Committee, the Senate passed the Tax Relief Act of 2005 (S. 2020). Its combination of necessary extensions of other provisions and far-reaching provisions for nonprofit organizations makes final enactment likely in some form. The nonprofit organization provisions rival prior legislation, like the Tax Reform Act of 1969, for fundamental change. They build on a "Staff Discussion Draft" released by the Senate Finance Committee in 2004, and many hostile proposals continue to lurk in the waters for the future.

Recent regulatory proposals

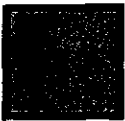
Senators Charles Grassley (R-Iowa) and Senator Max Baucus (D-Mont.), the chair and ranking minority member of the Senate Finance Committee, reacted to media reports of high salaries and benefits received by officers and directors of nonprofit organizations in May 2004. These reports included a foundation paying for family vacations to Australia and six European countries, a foundation having a \$36

million jet and using it for a board member's speaking trips, and a foundation promising retirement benefits of \$1.8 million (which was growing) to 14 part-time trustees who were paid board fees.

The Committee staff released an unofficial "Staff Discussion Draft" on 6/21/04,¹ which is summarized and discussed below. This draft led to a closed-door round-table meeting with exempt organization representatives on 7/22/04, and the creation of a Panel on the Nonprofit Sector that was convened by Independent Sector. Shortly before the round-table meeting, the American Bar Association's Section of Taxation, along with other organizations, delivered a white paper, which was thoughtful and generally critical of the Staff Discussion Draft, on 7/19/04.²

The Joint Committee on Taxation staff issued a report, "Options To Improve Compliance and Reform Tax Expenditures," on 1/27/05.³ Nearly a third of its 368 pages dealt with exempt organizations, and most of the proposals were adapted from the "Staff Discussion Draft." Later last year, the Panel on the Non-

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**NONPROFIT
ORGANIZATION
PROVISIONS
RIVAL PRIOR
LEGISLATION,
LIKE THE TAX
REFORM ACT OF
1969, FOR
FUNDAMENTAL
CHANGE.**

profit Sector released its final report, with numerous reform proposals and a great deal of careful thought, in June 2005.⁴

The Senate Finance Committee followed up on its 2004 hearings with hearings on "Charities and Charitable Giving: Proposals for Reform," on 4/5/05, and by holding hearings on conservation easements on 6/8/05. The House Ways and Means Committee held hearings on an "Overview of the Tax-Exempt Sector," on 4/20/05. Senator Rick Santorum (R-Pa.), concerned about the Senate Finance Committee's atmosphere of hostility toward nonprofit organizations, convened Senate hearings on "How the Nonprofit Sector Meets the Needs of America's Communities," to call attention to the numerous good deeds of charities, on 9/13/05.⁵

The Senate passed the Tax Relief Act of 2005 on 11/18/05.⁶ Its provisions for nonprofit organizations and charitable contributions are summarized below. As of this writing, the bill has not passed the House or been signed by the President, but its eventual enactment appears likely (doubtless with some modifications) because of various necessary provisions not touching on exempt organizations.

The Senate Discussion Draft

As of early 2006, the Senate Finance Committee Staff Discussion Draft is still on the committee's Web site, and has only been fractionally implemented in the Tax Relief Act of 2005. The leading staff members have not changed. Therefore, it appears to remain as an expression of staff objectives that could yet be enacted during the course of 2006.⁷

New five-year requalification, DAF regulations, and supporting organization restrictions ("Exempt Status Reforms"). Among the exempt status reforms called for in the Draft is a requirement that organizations requalify for exemption every five years. This would expand what the Service requires an organization to submit in applying or reapplying for exemption, adding a conflicts-of-interest policy, as well as "evidence of accreditation" (ostensibly voluntary) and "management policies regarding best practices" that the Draft merely "encourages."⁸

A requalification requirement would greatly increase costs of all exempt organizations, shifting dollars and management time

from charitable activities to professional fees. The additional budget required for the Service to re-exempt all organizations would seem better spent on more inquiry and prosecution in cases of actual abuse, or on more audits.

The Draft would create a new regime for donor advised funds (DAFs), most of which was written into the Tax Relief Act of 2005. Under the Draft proposals:⁹

1. Contributions to a DAF other than cash or publicly traded securities would have to be sold within one year of contribution and a plan for sale would have to exist at the time of gift (alternatively, a DAF would be able to accept only cash or publicly traded securities).
2. A DAF would not be permitted to make grants to a non-operating private foundation or to individuals.
3. A DAF would have to secure an acknowledgment from the grantee that the grant will not convey a private benefit to the advising donor.
4. A DAF would have to meet an aggregate annual payout consisting solely of grants paid equal to 5% of the DAF's assets. Failure to meet the payout requirement would result in a tax similar to that applicable to private nonoperating foundations.
5. Individual accounts in a DAF would have to meet a minimum activity threshold.
6. A DAF would be required to disclose its existence on its Form 990 and show satisfaction of the payout and all other requirements.

¹ Senate Finance Committee, "Staff Discussion Draft" (undated) (hereinafter "Draft"); see www.senate.gov.

² Richard A. Shaw (Chair), ABA Section of Taxation, "Senate Finance Committee Staff Discussion Draft of June 21, 2004" (7/19/04).

³ U.S. House of Representatives, "Options To Improve Compliance and Reform Tax Expenditures" 198-337 (1/27/05); see www.house.gov/jct/s-2-05.pdf.

⁴ Panel on the Nonprofit Sector, "Strengthening Transparency[,] Governance[,] Accountability of Charitable Organizations" (June 2005); see www.nonprofitpanel.org.

⁵ Information on the congressional hearings is at www.nonprofitpanel.org.

⁶ S. 2020, 109th Cong., 1st Sess. (Nov. 18, 2005) (hereinafter "Tax Relief Act"); see <http://thomas.loc.gov/cgi-bin/query/C?c109:./temp/>

⁷ See, e.g., "Grassley to Seek More Charitable Reforms Including Executive Compensation Changes," *BNA Daily Tax Report*, 1/13/06, G-1.

⁸ Draft at 1.

⁹ Draft at 2.

7. Grants by a DAF to non-domestic organizations would be permitted only if such an organization appeared on an IRS published list of approved foreign organizations.
8. DAF grants would be permitted to satisfy a donor's charitable pledge.
9. A DAF's investment managers would be hired according to arm's-length principles.
10. A DAF generally would not be permitted to expend amounts for grantee selection, such as site visits, that extend beyond basic due diligence of grant approval.
11. Fees for referrals or transfers of funds to a DAF would be limited.

These proposals are discussed in connection with the Tax Relief Act of 2005 below.

Type III (Section 509(a)(3)) supporting organizations would be eliminated under the Draft, because of their abuses, and replaced by DAFs.¹⁰

Such organizations already are regulated by the Service, in that they have to apply and qualify for exemption, and have to file Form 990 unless an exception applies. They are prohibited from private inurement. With enforcement tools available against abuses, the charitable activities of many worthwhile organizations should not be potentially eliminated.

The Draft does not address the fate of the tens of thousands of existing Type IIIs. To grandfather them would permit the continuance of the very organizations that the staff believes are carrying on abuses, and to close them down might violate trust documents and would repeal donor controls that were legal and relied upon at the time of funding.

The Draft proposes that charities determined by the Service to be accommodating parties to a listed tax shelter transaction or reported transaction with a significant purpose of tax avoidance, unless they "received affirmation that the transaction is not a listed or reported

transaction," would both lose their Section 170 status and pay a 100% tax on benefits received.¹¹

This sanction would apply to a charity that did not knowingly accommodate a tax shelter, but merely accommodated one unknowingly, and failed to get an affirmation that it did not know it needed to ask for. In such a case, it would be unfair. Such a drastic penalty for negligence, instead of willfulness, and only on the Service's say so, is far stricter and higher than most other first-tier penalties.

New public charity prohibited transactions and private foundation restrictions. Proposals dealing with "Insider and Disqualified Person Reforms" begin with the suggestion to apply the private foundation rules prohibiting self-dealing¹² to public charities, except for the self-dealing rule on excessive compensation (because that is covered by a separate provision for charities).¹³ The Draft proposal would broaden the definition of "disqualified persons" to include both "persons with substantial influence" and persons related to "affiliated or supporting entities."¹⁴

This seems unnecessary and burdensome. Public charities, unlike private foundations, almost always have an independent majority on the governing board, and generally are supported by outside donors or fee payers who have access to their financial information.¹⁵ With this oversight, public charities often benefit from bargain sale contributions, below-market leases, below-market loans, loan guarantees, and other fair transactions with disqualified persons. Board members of affiliated or supporting entities should not be treated as enemies.

The Draft also would modify (the Joint Committee staff report said "eliminate") the rebuttable presumption of reasonableness of compensation, and the permissible reliance on expert opinion, that now exists if certain procedures are followed.¹⁶

This would make it difficult for nonprofit organizations in some fields to attract talent that requires substantial compensation because, besides the risk to the organization, the executive would remain at risk of disgorgement and a 25% excess benefit tax.¹⁷ It would remove the safe harbor while leaving the voyage necessary.

The list of disqualified persons in Section 4946(a)(1) would get a new member—"a corporation or partnership with respect to which a disqualified person is a person of substantial influence."¹⁸

¹⁰ *Id.*

¹¹ Draft at 3.

¹² Section 4941.

¹³ Section 4958.

¹⁴ Draft at 3-4.

¹⁵ Unless they are excepted (see Section 6033) due, for example, to gross revenue below \$25,000 a year.

¹⁶ Draft at 4.

¹⁷ Sections 4958(a)(1), (b).

¹⁸ Draft at 4.

**THE
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DURING 2006.**

**A
REQUALIFICATION
REQUIREMENT
WOULD GREATLY
INCREASE COSTS
OF ALL EXEMPT
ORGANIZATIONS.**

This seems unnecessary. The definition already includes a corporation or partnership in which disqualified persons own more than 35%. The difference between the two is that the 35% rule is a meaningful bright line, while "substantial influence" would be a guarantee of constant litigation.

The Draft would increase the taxes on foundation managers (but not on the foundations themselves), by an unstated amount.¹⁹

It also proposes either prohibition, or limitation to a "de minimis amount," of trustee fees.²⁰

This, too, appears unfair. Current law already prohibits and penalizes excess compensation by foundations.²¹ The responsibilities of nonprofit directors and trustees are steadily increasing, partly in reaction to the Draft and the Tax Relief Act of 2005. Many foundations involve the trustees extensively in grant review and analysis. Many seek to involve highly compensated individuals, who would not serve on a public corporation's board without significant compensation.

The staff advocates limiting compensation of disqualified persons at nonoperating foundations to "comparable federal government rates for similar work and similar time." It also advocates "filing of additional supporting material with the IRS, which would be publicly available," for compensation of such people above \$75,000 a year, and for compensation of non-disqualified persons above \$200,000 a year (including severance payments). It would require annual advance board approval of all such compensation.²²

It is difficult to see why disqualified persons should not be able to receive compensation at comparable nonprofit organization rates, instead of comparable federal government rates, for similar work. Further, such a rule would set off an endless debate over which of the millions of federal government positions are comparable. The Federal Reserve pays considerably more than other federal agencies, and judicial and congressional secretarial positions pay considerably more than similar positions at many agencies, for example.

New private foundation and travel restrictions. Of all the suggested legislative changes of the past few years, the biggest storm was over the proposal to limit the amount of administrative expense that foundations may count toward minimum distribution requirements.²³ The Draft proposes that nonoperating foun-

dations with administrative expenses exceeding 10% of total expenses would be required to file supporting material with the Service for review as to whether expenses were reasonable and necessary. That filing would have to be publicly available. Nonoperating foundations with administrative expenses exceeding 35% would not be able to count them as qualifying distributions.²⁴

Limits of this sort are counterproductive at a time when the Department of Homeland Security and the Treasury's Best Practices seek extensive foundation investigation for foreign grants, and when Congress and the Service annually increase the complexity and administrative burdens of keeping a foundation in compliance with the law. As mentioned above, other provisions already restrict excessive compensation, which is the abuse that the staff seeks to curtail by limiting expenses.

The staff also recommends that the excise tax on net investment income²⁵ be waived for foundations that pay out more than 12% of "non-charitable use assets return" in grants.²⁶

Presumably the word "return" is an error, because all foundations are already required to distribute much more than 12% of their investment return (being required to distribute an amount equal, with adjustments, to 5% of the value of non-charitable use assets²⁷).

The staff goes on to recommend that all private foundations be prohibited from making grants to donor advised funds.²⁸

This goes far beyond what is necessary to address the problem of foundations meeting their minimum distribution requirement by granting funds to a DAF, and parking the funds there instead of further distributing them. That problem can be solved simply by legislating that amounts granted to DAFs do not count toward minimum distributions until they are distributed. Foundations, however, have many legitimate reasons for donating to DAFs; for example, the DAF can review foreign grants that

¹⁹ *Id.*

²⁰ Draft at 5.

²¹ Sections 4945(d)(5), 4941(d)(1)(D).

²² Draft at 5.

²³ Section 4942(g)(4).

²⁴ Draft at 5-6.

²⁵ Section 4940(a).

²⁶ Draft at 6.

²⁷ Section 4942(e).

²⁸ Draft at 6.

the foundation is not equipped to review, and the DAF can hold an investment that the foundation does not feel equipped to hold or comfortable in holding.

For travel expenses, the Draft would limit charities and foundations to "the applicable U.S. government rate" for "paying expenses for travel, meals, and accommodation." Violations would be punished by imposing a 10% tax on the charity for the excess payment, and by requiring disgorgement of the excess by the individual. Public charities, but not foundations, could gain exemption for expenses that the board of directors individually approved, and that the charity disclosed on the Form 990.²⁹

This limit is unreasonable. Charities and foundations do not have the U.S. government's negotiated rates with hotels and airlines, and anyone who has worked for the government knows the frustration of having to travel to major metropolitan areas and struggling to hold expenses to the unrealistic prescribed rates. The vast majority of people working for charities already take a significant or even drastic pay cut, without being punished by being limited to nonexistent hotel and airfare rates. Boards of directors, whose compensation is proposed for the chopping block, have more important things to do than micro-manage each expense report; public companies would not allow their boards to be so burdened.

New state prosecutions. The Senate Finance Committee staff would give states the "authority to pursue certain Federal tax law violations by exempt organizations with approval of the IRS."³⁰

This "Federal-State Coordination" seems unnecessary, because most states either copy or incorporate the requirements of Section 501(c)(3) and, for private foundations, of Sections 4940-4945.³¹ It also is an invitation for inconsistent state court decisions on federal tax issues.

New forms and financial statements. The staff would require the Form 990 to be signed by the CEO with "a declaration under penalties of perjury that the chief executive officer has put in place processes and procedures to

ensure that the organization's Federal information return and tax return (including Form 990T) complies with the Code and that the CEO was provided reasonable assurance of the accuracy and completeness of all material aspects of the return."³²

This potential criminal liability would make uncompensated CEOs extinct, and impose massive costs on nonprofit organizations. Businesses subject to Sarbanes-Oxley have experienced average additional accounting costs of above \$10 million per year each. The drafting, revision, and implementation of "processes and procedures" has become a major profit center for large accounting firms, and for smaller nonprofit organizations would be the enormously complex machine that no one knows how to operate.

The staff also would double penalties for failure to file (including late filing) or for incomplete returns (apparently including inaccurate returns). It would triple the penalties for organizations with gross receipts over \$2 million per year, and would revoke exemptions for consecutive years of nonfiling. The staff also would impose a separate penalty of \$20 per day for "each failure to include required information on a filed 990 (for example, failure to check a required box)," up to a maximum per return of \$20,000 or 5% of gross receipts; and additional penalties on CEOs signing the return and on paid preparers "including employees."³³

The doubling of penalties is unobjectionable, in view of inflation. But the separate \$20 per day for "each failure to include required information," such as an unchecked box, seems extreme. One bane of tax preparation software is that it often unchecks boxes that the preparer actually checked and thought were properly marked. Nonprofit organizations are often unsure whether a schedule to the Form 990 or 990-PF applies at all, and would quickly reach the \$20,000 penalty level (for example, if a 10-line schedule were by misunderstanding left blank for merely 100 days, because a letter from the Service never will arrive soon enough to notify an organization that a section should have been filled in). Also, the revocation for nonfiling would work a hardship for organizations that thought in good faith they were exempt from filing Form 990 (for example, thinking mistakenly that they were integrated auxiliaries of associations and



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²⁹ *Id.*

³⁰ Draft at 7.

³¹ E.g., Fla. Stat. Ann. sections 617.2003, 617.0834(1).

³² Draft at 8.

³³ *Id.*

**IT SEEMS UNFAIR
AND UNJUSTIFIED
TO DISCRIMINATE
BETWEEN
CHARITABLE GIFT
VALUATIONS AND
OTHER
VALUATIONS.**

conventions of churches, or that they were part of a group exemption with the central organization reporting).

Another staff proposal is that "extensions of greater than 4 months would be considered a failure to file."³⁴

This also seems extreme. Nonprofit organizations often have to extend beyond four months for legitimate reasons—an entity in which they invested or whose stock was donated is late in sending K-1s or 1099s, or a complex issue has not been researched and resolved, or an outside accounting firm is unable to complete the return by the first extension. If there is not a legitimate reason for a second extension, existing law already provides that the Service will deny the request, and the return must be filed quickly. But the fact that "extensions of greater than 4 months" have been granted shows that the Service found the reasons valid.

The staff would require a timetable for electronic filing systems, which the Service is already accomplishing, and would enable the Service to require electronic filing.³⁵

It also would require organizations with gross receipts above \$250,000 to have an independent audit with certification "regarding the organization's exposure to the unrelated business tax," require organizations with gross receipts between \$100,000 and \$250,000 to have an independent review, and require all Form 990s to be reviewed by an independent auditor for conformity to Form 990 filing standards.³⁶

This obviously would impose significant costs on nonprofit organizations that do not currently have independent audits or reviews, and at the very time the Senate Finance Committee is telling them to reduce their non-grant expenses and to increase their investigation of foreign grants. Because the audits or reviews "would be a public document," the cost charged by the auditor likely would be still higher, to account for liability exposure from plaintiffs alleging they relied on the audit or review, particularly if the private cause of action proposal were enacted. The staff proposal also would impose a requirement without a reason in many cases: a small nonprofit with an unusual grant pushing it into the review range or the audit range would find that grant very expensive, and a family foundation with no donors to which it was accountable would find an audit or a review a waste of money.

The staff would require disclosure in Form 990 and attachments of the formation of taxable subsidiaries, transactions with them, transactions with insiders, "ancillary joint ventures," partnership interests and the nonprofit organization's role, and tax opinions on agreements with insiders and on conflicts of interest.³⁷

The staff would mandate that charities do what a large number of business do not find cost-effective, and create and include in Form 990 "a detailed description of the organization's annual performance goals and measurements for meeting those goals" for the past year and coming year.³⁸

This would consume either substantial funds for costly consultants or substantial time of the management—and in many cases an additional make-work officer. Charities are not stupid. If such performance goals and metrics are helpful, they prepare them or seek to prepare them. If they are not, they should have the freedom not to be required to expend consulting fees or management salaries to perform make-work.

New public disclosures. The committee staff would require charities, on request, to disclose the charity's investments.³⁹ There is much discussion about whether similar disclosure of private foundation investments is beneficial or burdensome.

The staff also would require all nonprofit organizations to disclose their financial statements to the public.⁴⁰

This would increase the costs charged by auditors, since it potentially subjects them to liability claims by members of the public allegedly relying on the financial statements. Yet it would largely duplicate information already disclosed in the Form 990 series. It would impose a requirement not shouldered by nonpublic businesses, which generally are not required to have audits at all, and are not required to distribute financial statements beyond shareholders to the general public.

The staff would repeal the current right of an exempt organization to post its Form 990s

³⁴ Draft at 8.

³⁵ Draft at 9.

³⁶ *Id.*

³⁷ Draft at 9.

³⁸ Draft at 10.

³⁹ *Id.*

⁴⁰ *Id.*

on Guidestar, or similar Web sites, and require that the posting be on the exempt organization's Web site. It also would require posting of financial statements for the past five years.⁴¹

The first requirement would replace an easier-to-use alternative with the need to go to each organization's Web site and negotiate different software and different printing procedures. The second requirement would increase costs, as noted in the preceding comment.

The staff would require disclosure (presumably by the Service) of all audits and closing agreements, without any redaction unless the audit was "initiated pursuant to a voluntary disclosure by the tax-exempt organization."⁴²

It also would require public disclosure of exempt organization returns of taxable income, and "affiliated organization returns," which would be largely taxable subsidiaries' returns and possibly partnership returns if the exempt organization is a partner.⁴³

That would discriminate against nonprofit organizations and their taxable affiliates in comparison to businesses. Businesses do not have to disclose their tax returns publicly, and there are severe penalties for the Service disclosing them. Yet businesses owned by nonprofit organizations, or even businesses in which a nonprofit organization owned more than a certain percentage, would lose their financial privacy and would be required to make public disclosure. Income reported and taxed as business income by nonprofit organizations would similarly lose its privacy and be subject to public disclosure.

New burdens and liabilities. The staff would impose many specific obligations (and thus liabilities) on governing boards, for which it would deny or limit compensation. A board member would be charged to "perform his or her duties ... with the care an ordinarily prudent person in a like position would exercise under similar circumstances." An individual with special skills or expertise would have "a duty to use such skills or expertise." Federal liability for breach of these

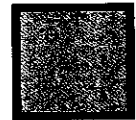
duties would be established. The board itself would be required to:⁴⁴

- Establish basic organizational and management policies and procedures of organization and review any proposed deviations.
- Establish, review, and approve program objectives and performance measures and review and approve significant transactions.
- Review and approve the auditing and accounting principles and practices used in preparing the organization's financial statements. Each such auditor may be retained for only five years.
- Review and approve the organization's budget and financial objectives as well as significant investments, joint ventures, and business transactions.
- Evaluate whether the business is being properly managed.
- Establish a conflicts of interest policy.
- Establish and oversee a compliance program to address regulatory and liability concerns.
- Establish procedures to address complaints and prevent retaliation against whistleblowers.

This list, far broader than that imposed on business boards of directors, would scare away many qualified board members, cause many volunteer board members to insist on substantial compensation, and cause any board member to insist on costly director and officer insurance. It expressly would impose liability—"Federal liability for breach of these duties"—though it is silent about whether a private right of action would be created. Another section of the Draft would create a private cause of action, as well as Tax Court equity authority, as discussed below.

The staff proposes that the "IRS would have the authority to require the removal of any board member, officer, or employee of an exempt organization who has been found to have violated self-dealing rules, conflicts of interest, excess benefit transaction rules, private inurement rules, or charitable solicitation rules." The Service could bar them from serving any exempt organization for a period of years, and could revoke an exemption or impose a lesser penalty if an organization knowingly retained a scofflaw.⁴⁵

The staff would require the federal government to "give favorable consideration," in



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PROHIBITED
TRANSACTION
RULES FOR
DONOR
ADVISED FUNDS
WOULD BE FAR
STRICTER THAN
PRIVATE
FOUNDATION
RULES.**

⁴¹ Draft at 11.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ Draft at 12-13.

⁴⁵ Draft at 13-14.

making grants and awarding contracts, to those nonprofit organizations that are accredited (see the next topic) by Service-approved entities that establish "best practices." It would require the Service to "establish best practices/governance requirements/accreditation for charities participating in the Combined Federal Campaign," to serve as a prerequisite for participation.⁴⁶

These requirements are as reasonable, or as unreasonable, as the Service's best practices, governance requirements, and accreditation. They would, however, impose costs on organizations that seek to qualify, using donor dollars for compliance rather than for exempt activities, and will increase the hurdles for smaller or newer organizations to qualify. They would also create problems and litigation for religious organizations that seek to participate in faith-based initiatives, because imposing requirements for their governance or accreditation may well conflict with their religious structure or entangle government in regulating religious operations, while their exemption may cause courts to say they are preferred. Either way, there would be litigation by religious organizations or by organizations advocating strict separation of church and state.

The staff would also give the Service "the authority to base charitable status or authority of a charity to accept charitable donations on whether an organization is accredited," and to "initiate its own accreditation efforts" as well as "to support accreditation of charities nationwide." Accreditation would include establishing best practices and reviewing organizations on an ongoing basis for compliance.⁴⁷

This would be a major expansion of the regulatory state into the once-independent sector. It would impose considerable costs on nonprofit organizations, not only for the "dues" and accreditation fees that the IRS acknowledges accrediting organizations would charge, but for the additional personnel to staff the red tape department to fill out the forms, write the policies, conduct the self-studies, and otherwise qualify for accreditation and re-accreditation. It would hurt most the smaller, newer organizations that are trying to grow rapidly to serve unmet needs, and to provide competition to the older organizations that would be better able to navigate through the red tape. Nonprofit organizations that exercise their freedom to seek accreditation already have

agencies to which they can apply; this would replace that freedom with an expensive mandate.

Today, an organization that wants to provide soup to the needy can apply for exemption and serve the hungry; tomorrow, such an organization may have to spend funds for, wait for, and take required steps to maintain its accreditation in order to serve less soup to fewer hungry people. It is odd that, at the very time deregulation is more and more practiced vis-a-vis the private sector, regulation is more and more proposed toward the nonprofit sector.

The staff would create "a Federal standard" and apply the prudent investor rule nationwide toward investments by nonprofit organizations.⁴⁸

This proposal seems oblivious to the ongoing debate about whether compliance with modern portfolio theory is a more modern standard, or is a form of compliance with the prudent investor rule. The proposal is silent on the major difference between applying the standard to the overall portfolio, or to each individual investment. It federalizes an issue that the Service is not much equipped to review, and that has been a state issue of responsibility for a century.

New funding for regulation, enforcement, and education. The staff would allocate the tax on private foundation net investment income to the Service for exempt organizations enforcement, or else would impose a filing fee in connection with Form 990 (including Form 990-PF). It would grant \$25 million to the states each year for exempt organizations oversight and enforcement. It would also have the Service share information with state attorneys general and the U.S. Postal Service.⁴⁹ In addition, it would also grant \$25 million to nonprofit organizations that teach best practices and publicize organizations following them.⁵⁰

New lawsuits and remedies. The staff would give the Tax Court dramatic new equitable powers "to rescind transactions, surcharge trustees... substitute trustees, divest assets, enjoin activities and appoint receivers."⁵¹

⁴⁶ Draft at 14.

⁴⁷ *Id.*

⁴⁸ Draft at 15.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ Draft at 16.

This would greatly increase litigation and costs. Lawsuits that are now dismissed because the board acted in good faith and in the exercise of business judgment, without personal benefit, would have a new life as plaintiffs argue that equitable remedies should apply to surcharge trustees, substitute trustees, enjoin activities, or replace the board with receivers.

A board member, as well as the Service, could "seek the removal of any director/board member or officer by the Tax Court," based not just on fraud or gross negligence, but based instead on "fail[ure] to perform his or her duties ... with the care an ordinarily prudent person in a like position would exercise." The staff expressly says that "[a]ny director/trustee ... may bring a proceeding." It also follows the Civil Rights Attorney Fee Act⁵² to say that the court may award the complainant, who partially succeeds, reasonable attorney fees and expenses.⁵³

This would greatly increase litigation, and liability exposure, for nonprofit board members and nonprofit organizations themselves. It would give a new weapon to the dissenters every time there is a difference of opinion on the board. More litigation means higher legal costs for organizations to defend themselves and indemnify directors, for those things insurance does not cover, and higher director and officer insurance premiums. The prospect of having to pay attorney fees to the dissident would cause nonprofits to capitulate on some issues when they should not, and pay large attorney fee awards when they do not capitulate and then lose. There has been no shortage of litigation with attorney fee claims under the Civil Rights Attorney Fee Act.

"Any individual" could submit a complaint to the IRS for review, to bring a proceeding "in the right of a corporation/trust," after making a demand for action by the organization. The IRS would "retain control of the suit," much like a *qui tam* action. If the complaint partially succeeded, the court could award attorney fees and other expenses.⁵⁴

This provision is modeled after derivative actions in connection with businesses, or *qui tam* actions in connection with government contracts.

⁵² 42 U.S.C. section 1988.

⁵³ Draft at 16-17.

⁵⁴ Draft at 17-18.

⁵⁵ U.S. House of Representatives, "Options To Improve Compliance and Reform Tax Expenditures," 198-337 (1/27/05); see www.house.gov/jct/s-2-05.pdf.

It would produce lawsuits that do not now exist, which would cost charities money to defend. While it would allow for attorney fees to be awarded against the complainant if he or she loses, such awards are rarely made and are rarely collectible.

Other provisions. The Draft also contains provisions for credit counseling organizations; conversions of nonprofits to for-profit organizations; standards for filing of Form 990s (the concept is undefined and ambiguous); disclosure of material changes in activities, operations, and structure; joint cost allocations; disclosure of corporate charitable gifts over \$10,000 in the aggregate; and a provision for resolving valuation disputes by arbitration.

Joint Committee staff report.

The report by the staff of the Joint Committee on Taxation, "Options To Improve Compliance and Reform Tax Expenditures,"⁵⁵ as mentioned earlier, adopted many of the proposals of the Discussion Draft, and added others. It proposed:

- A five-year review of the exempt status of nonprofit organizations (both charities and foundations).
- Application of foundation self-dealing rules to public charities.
- Elimination of the rebuttable presumption of reasonableness of compensation.
- An annual notice by organizations not required to file Form 990.
- Increases in excise taxes on both charities and foundations.
- Public disclosure of Form 990-Ts (showing taxes imposed).
- Broadening the tax base for foundation investment income.
- Adding exemption requirements for credit counseling organizations.
- Limiting contributions of conservation easements.
- Recapturing the contribution deduction for property not used for exempt purposes (or instead limiting the deduction for all property to the donor's cost basis).
- Limiting deductions for contributions of clothing and household items.

Tax Relief Act and nonprofit organizations

On 12/8/05, the House passed the Tax Relief Extension Reconciliation Act (H. R. 4297).

While in some ways the functional analogue of the Senate's Tax Relief Act, its provisions are far different, and would make no important changes aimed squarely at charities and foundations (save for a one-year extension of Section 170(e)(6)). Not so its Senate counterpart.⁵⁶

Charitable contribution provisions. These provisions of the Senate bill include some that are familiar to legislation watchers, having appeared in several iterations of the unsuccessful CARE Acts.

Charitable deductions for nonitemizers. Senate bill section 301 would modify the present rule that only taxpayers who itemize deductions may deduct charitable contributions. It generally would allow individuals who do not itemize a charitable deduction for cash contributions, beginning 2006 and through the end of 2007, determined without regard to any carryover. Only contributions in excess of \$210 for an individual, or \$420 for a joint return, would be deductible by either itemizers of nonitemizers.⁵⁷ The purpose of this change is to encourage charitable contributions by nonitemizers, and the purpose for the limitation on cash contributions is to avoid abuse. The language about nonitemizers deducting "the amount allowable under subsection (a)" of Section 170 fails to impose on nonitemizers the percentage limits under Section 170(b); the restriction on gifts in trust, etc., under Section 170(f); the restriction on donations connected with athletic ticket rights under Section 170(l); etc.⁵⁸ This could open a new loophole, by which individuals wishing to take large cash charitable deductions (without carryforward) would forgo itemized deductions in order to avoid these restrictions.

Contributions from IRAs. Bill section 302 would allow "qualified charitable distributions" from individual retirement plans, on or after the individual reaches age 70-1/2, to either an organization described in Section 170(c) or certain split-interest trusts (charitable remainder trusts of which the individual or spouse is the sole income beneficiary, pooled income funds, and charitable gift annuities). No income would be realized, and no charitable deduction taken.⁵⁹ This provision would apply to distributions after 2005 and before 2008. It would facilitate a sensible type of charitable contribution in a sensible way. It unfortunately would not apply to, or waive early withdrawal penalties for, people who are younger than 70-

1/2 and also wish to make distributions from individual retirement plans, but the reason is doubtless the revenue effect.

Contributions of conservation easements. Bill section 307 would apply a new percentage limit to qualified conservation contributions, in order to encourage them.

For individuals, the proposal effectively would apply a 50% limit (50% of adjusted gross income (AGI) computed without regard to any net operating loss carryback⁶⁰), instead of a 30% limit on deductions,⁶¹ and would allow a carryover for 15 tax years instead of five tax years, as is the case for other contributions (by itemizers). The new provision also would exempt qualified conservation contributions from the requirements of Section 170(b)(1)(A)-(D). It, too, would apply to tax years beginning after 2005 and before 2008.⁶² The new provision would offer a 100% limit if the individual donor is a qualified farmer or rancher for the tax year of donation, which is defined to include taxpayers whose gross income from the trade or business of farming (within the meaning of Section 2032A(e)(5)) is greater than 50% of gross income for the tax year.

This "encouragement of contributions" of qualified conservation interests doubtless would produce cases of qualified farmer or rancher taxpayers whose income tax is substantially reduced due to the magnitude of their contributions. This could be seen as either an inequity or a success in bringing major conservation contributions. Congress seems to have made the choice of encouraging such contributions, even to the point of allowing donors who meet the definition of "trade or business of farming" to offset 100% of AGI, and other donors to offset 50% of AGI. There doubtless

⁵⁶ Some of the comments below overlap comments of the author contributed to the ABA Tax Section's Committee on Exempt Organizations for its consolidated comments on S. 2020.

⁵⁷ Proposed new Sections 170(o), 170(a)(4).

⁵⁸ The language also fails to impose on nonitemizers the substantiation requirements of Section 170(f)(8). However, those requirements are also imposed via the reference in Section 170(a) to contributions being "verified under regulations prescribed by the Secretary."

⁵⁹ Proposed new Section 408(d)(8).

⁶⁰ The new provision's 50% limit (or 100% limit) would aggregate with other charitable contributions under Section 170(b)(1)(A).

⁶¹ Current Section 170(h) governs qualified conservation contributions, and subjects them to a limit of 30% of AGI.

⁶² Proposed new Section 170(b)(1)(E).

would be a high proportion of newly hatched farmers or ranchers in the year of contribution, but the Service can question their authenticity. At least there is a meaningful definition that taxpayers know in advance they must meet, and that the Service can enforce.

For corporations, the provision would add a new percentage limit for qualified conservation contributions equal to 10% of taxable income.⁶³ It also would allow a carryforward of up to 15 years. Unlike the individual deduction, this corporate limit would apply only to those corporations that are qualified farmers or ranchers and whose stock is not readily tradable on an established securities market.⁶⁴

It would make sense for Congress to apply the 15-year carryforward to all qualified conservation contributions by corporations, not just those by qualified farmer or rancher corporations. By contrast, the provision for individuals allows the 15-year carryforward for all donors, not just qualified farmers or ranchers. Because the corporate deduction limit is much lower than the individual deduction limit, its carryforward potentially is more significant in encouraging corporate qualified conservation contributions.

Other charitable contribution provisions. There are less broadly applicable charitable contribution provisions, not summarized here, involving corporate donations of computer technology and equipment (bill section 217), contributions of food inventory (bill section 303), contributions of book inventory (bill section 305), basis adjustments for S corporation contributions of property (bill section 304), contributions of self-created literary, musical, artistic, and scholarly compositions (bill section 308), charitable volunteers and their mileage reimbursements (bill section 309), corporate contributions to the mathematics and science partnership program (bill section 310), and, of course, contributions of taxidermy property (bill section 315).

Nonprofit organization regulations and reforms. While the preceding sections are designed to encourage contributions, there are other changes to curtail abuses in contributions.

Contributions of historical easements. Section 314 would impose special rules for conservation easements or restrictions for certified historic structures. The new rules would require that any facade easement (called a "restriction with respect to the exterior of a building") must apply as well to the entire exterior of the building, must prohibit any change to the exterior inconsistent with its historical character, and must include a written agreement certifying under penalty of perjury that the donee is a qualified organization for conservation contributions and has the resources and commitment to manage and enforce the restriction. The donor would have to attach to the relevant tax return the qualified appraisal, photographs of the entire exterior, and a description of all restrictions on development of the building, along with a \$500 filing fee if the deduction claimed is in excess of the greater of (1) 3% of the building's fair market value or (2) \$10,000. Unlike the majority of other provisions, this one would apply to contributions made after 11/15/05 (except the \$500 fee is effective for contributions 180 days after that date), and does not refer to a sunset.⁶⁵

The Senate perceived abuses in this area, and its language is laudably clear. Several changes would benefit the proposal, however.

First, the roof surface is literally encompassed by the language about preserving and photographing "the entire exterior," but preservation of a roof surface has never been viewed as relevant to historical preservation (though preservation of the roofline has). A historical building donated as is, and deteriorating, may be suffering weekly harm from a leaky roof of substandard materials or poor design, and may be much better preserved by more enduring materials and detail that does not affect the street appearance. Similarly, photographing the roof may become an expensive undertaking.

Second, the subheading for bill section 314(b), "Disallowance of Deduction for Structures and Land in Registered Historic Districts," invites misinterpretation. It applies to current Section 170(h)(4)(B), which has no reference to disallowing a deduction but instead defines a "certified historic structure." It is really an

⁶³ The new section's 10% limit would aggregate with other charitable contributions under Section 170(b)(2).

⁶⁴ Proposed revision to Section 170(b)(2). It is possible that the Service, or taxpayers, could read the percentage limit, which is solely for qualified conservation contributions by corporations that are qualified farmers or ranchers, as meaning that there is no deduction for such contributions by other corporations. That would be a misreading, because Section 170(h) otherwise treats qualified conservation contributions as otherwise subject to normal percentage limits and carryforward rules.

⁶⁵ Proposed new Section 170(h)(4)(B).

“Additional Requirement,” not a “Disallowance of Deduction for Structures and Land in Registered Historic Districts.”

Third, the filing fee is placed in Section 170(f), while the requirements for what must be attached to a tax return are placed in Section 170(h). These requirements are already complex and a trap for the unwary. Cross references would solve this problem.

Fourth, the threshold for the \$500 filing fee is based on 3% of the “fair market value of the building (determined immediately before such contribution)” or \$10,000. This would appear to require an appraisal, of not just the facade easement, but of the entire building, if the building’s value is argued to be below \$333,333, or if the contribution’s value is argued to be below 3% of a larger building. An appraisal of an entire building will cost substantially more than an appraisal of the facade easement. It would make sense to value the building by the value at the time in tax records.

Recapture for contributions of exempt use property not used for exempt use. Bill section 316 would amend the provision for contributions of tangible personal property for a related use, essentially limiting to the donor’s basis any contribution of such property that is disposed of by the charity during the tax year of contribution. It would recapture as income the excess deduction over the donor’s basis for a contribution of such property that is disposed of by the charity during the three years beginning on the date of contribution unless the charity makes a specific certification. Recapture would be in the year of disposition, and would not amend a prior year’s return.⁶⁶ A change to the Form 8282 requirement (the reporting requirement if the donee disposes of the property) would lengthen the reporting period from two years to three years.⁶⁷ A new provision would impose criminal penalties for knowing identification of applicable property as having a related use if the contributed property is not so intended.⁶⁸ The rules on recapture and Form 8282 reporting would apply after 6/1/06, while the criminal penalty would apply after the date of enactment.

These changes would encourage donors of such tangible personal property to ensure that it is in fact used initially for a related use, if they want a fair market value deduction. This provision also sensibly would provide for the charity’s certification when the contributed property was intended to have a related use,

and did enjoy a related use, but then the intended use became impossible or infeasible to implement.

This would leave donors at risk if a charity, which initially promises a related use, in fact does not implement a related use, or refuses to sign the certification—even though it would be accurate—simply because of the criminal penalty attached to a knowing misstatement. A donor, by contributing all interest in the property, would lose the ability to ensure that the charity did as it promised, and a timid charity may well refuse to sign a later certification even though it would be fully accurate. It would make sense to provide an alternative to charity certification, allowing the taxpayer to carry the burden of proof that a noncertifying charity did originally use the property for a related use and planned to continue to do so.

Limitation of deduction for contributions of clothing and household items. Bill section 317 would put new limits on deductions for contributions of certain items. If the donor has obtained a qualified appraisal of contributed clothing or household items,⁶⁹ deductions for contributions of those items would be (1) limited to an IRS-listed amount per item for items in good used condition or better, (2) limited to 20% of that IRS-listed amount for items not in that condition, and (3) denied for non-functional items.⁷⁰ There would be an exception for contributed items that the donee sells before the earlier of the donor’s tax return due date (as extended) or actual filing date, if the sale price is reported to the donor and if the deduction claimed is not greater. These changes would apply to contributions after 2006.⁷¹

This would penalize taxpayers who donate items worth more than the IRS lists, and would discourage donations of such items even if the IRS list’s average prices are accurate. Expensive coats, gowns, suits, antiques, and the like can generate more revenue for once-a-year auctions, thrift shops, and other wholly char-

⁶⁶ Proposed revision to Section 170(e)(1)(B).

⁶⁷ Proposed revision to Section 6050L.

⁶⁸ Proposed new Section 6720B.

⁶⁹ This is required in order to deduct more than \$500 for property contributions under Section 170(f)(11).

⁷⁰ Evasion is blocked by providing that food, paintings, antiques, objects of art, jewelry and gems, and collections cannot qualify as “household items.”

⁷¹ Proposed new Section 170(f)(15).

itable activities than average items. It would make sense to allow for the appraisal to justify a higher value than the IRS list, but to limit it in any event to 50% of the taxpayer's cost for each item.

A change to the substantiation provision would require the donee's acknowledgment of a contribution of \$250 or more of clothing or household items to list the number of items, the condition of each, a description of the type of item, and a copy of the IRS-produced list assigning maximum values.⁷² It would make sense to place a cross-reference here to the new provision for clothing and household items, and to place a cross-reference there to the separate substantiation provision.

Additional recordkeeping requirements for certain contributions. Bill section 318 would deny any charitable deduction "for any contribution of a cash, check, or other monetary gift" unless the donor maintained a canceled check, or a receipt or letter from the donee giving its name, the date, and the amount.⁷³

This provision is a mistake. It would most hurt the smallest and most needy charities, and would significantly hurt all charities, for numerous reasons.

First, the "maintains a canceled check" alternative conflicts with changing banking policies and reality. Banking regulations are in the process of eliminating canceled checks over the next two years, regardless of whether the taxpayer wishes to receive them. In the present electronic funds environment, a significant number of taxpayers already do not receive canceled checks. Banks will make electronic copies (which used to be microfilm copies) of canceled checks available, as they do now for a substantial fee, and some but not all banks will provide the option of electronic copies of all canceled checks, but only for either a high account fee or a high minimum balance. Thus, a requirement to maintain canceled checks, at the very time they are becoming extinct and electronic copies are very expensive, does not match reality. It would more match reality to require a taxpayer to obtain copies of the canceled checks if audited.

Second, the "receipt or letter from the donee giving its name, the date, and the amount" is also in conflict with reality, at least

where the total of such gifts is less than a reasonable threshold. A large portion of charities "pass the hat" at periodic events. The new provision would make all such contributions nondeductible, because the logistics of passing the hat at a stadium, a large conference, a play, or a similar event do not allow for donor envelopes and reply receipts. It would be an unfair burden on charities to have to issue receipts for \$1 gifts. It would be a deterrent to \$10 or \$20 gifts to require pens to be passed out, people to give their address (which they may not wish to give), and the hat-passers and the program to wait. The need to prepare and send boxes of receipts would impose great costs on charities, and require additional personnel. Churches and other religious organizations typically "pass the plate," and they receive roughly 50% of all charitable contributions. They may well choose to pass the petition when they pass the plate. Many schools and other charities raise funds by small donations of \$1 a mile for walking or running, or \$5 or \$10 for particular outreaches. School children are certainly not equipped to generate stacks of accurate receipts, and the teachers and administration are not widely regarded as short of workload.

Among the other innumerable and nonabusive examples, the Salvation Army raises small contributions in kettles at the doors of malls across the country to help the poor and others, while Masonic and social service organizations walk between cars at intersections with cans to raise money for hospitals and other charities. No one could seriously suggest that they should stop bell-ringing, or stand when the light turns green, to fill out receipts, or that mall shoppers and drivers should have to block traffic to fill in forms. It seems simply unnecessary, and unfair, to legislate that all these forms of volunteer effort to raise contributions from generous Americans for worthy causes shall become nondeductible.

It would make sense to eliminate this provision, or to apply it only to contributions above a threshold, such as amounts totaling above \$500 per year (\$1,000 in the case of a joint return).

Restrictions on contributions of fractional interests in tangible personal property. Bill section 319 would limit successive gifts of fractional interests in tangible personal property to the lesser of the initial valuation or a lower later valuation.⁷⁴ It would make corresponding changes in the estate and gift tax rules.

⁷² Proposed revision to Section 170(f)(8)(B).

⁷³ Proposed new Section 170(f)(16).

⁷⁴ Proposed new Section 170(p).

This change would discourage contributions of tangible personal property to museums and other nonprofits. It would deter early lifetime contributions of fractional interests in appreciating assets (such as works of art, which have appreciated dramatically over the past 50 years), and encourage delay in making contributions (which charities know means many will never be made). It also would deter gifts of remainders at death.

The estate tax provision apparently would limit the estate tax charitable valuation of an appreciating asset to the income tax charitable valuation of an initial fractional contribution, since dead people rarely make successive contributions of fractional interests.⁷⁵ Until now, it has been common for individuals donating a fractional interest during life to donate the remaining interest at death. They may, for example, have sentimental reasons for keeping some interest in the asset, or they perhaps cannot use the charitable deduction for an entire donation over the carryover period.

This estate tax provision would appear to work an unfairness, since the fractional asset would be taxed in the estate at its fair market value at the time, and yet would be deducted at the earlier lifetime valuation, if lower. It would make sense to modify the new rule by providing that the estate tax charitable deduction would not in any event be a lower value than the value of the property included in the gross estate.

This new provision, and a corresponding gift tax provision,⁷⁶ would also require the Treasury to provide for recapture of a charitable deduction if the property "is not in the physical possession of the donee" for its ownership fraction of the year. This is fine if the donee wants to exhibit or otherwise hold the work of art or other tangible personal property. But it imposes high costs—for storage, transport, and insurance—if the donee is not yet ready to exhibit or otherwise use the work of art or other property, or does not have room to store it. Museums do not want to see donors at the door with paintings that must be "physically possessed" by the museum for a fraction of the year—or else—and could have good reason to let the donor store the painting without charge until the museum is ready to exhibit or store it. Annual shuttling of a painting or a statute between the fractional donor and the museum is very expensive, and holds a high risk of damage or theft. It would make

sense to make an exception for property that is physically possessed by the donor at the donee's request.

Liabilities for substantial and gross overstatements of valuations. Bill section 320 would change the definition of substantial valuation misstatements, for charitable contributions only, from 200% to 150% of the final value, and would change the definition of gross valuation misstatements, for charitable contributions only, from 400% to 200% of the final value. This would affect penalties on taxpayers.⁷⁷ Another provision would impose penalties on appraisers whose appraisals violated these modified thresholds, at the greater of (1) 10% of the amount of the understatement, (2) \$1,000, or (3) 125% of the appraisal income.⁷⁸

It seems unfair and unjustified to discriminate between charitable gift valuations and other valuations. There is no defense for valuation misstatements, but valuation is not an exact science. There are no mathematical theorems. The reason why noncharitable valuations do not trigger penalties until they are 200% or 400% of final valuations is that there is room for reasonable people to differ. There is no obvious reason why the margins of error, and the penalties, for charitable valuations should be less favorable than for other valuations. The assets being valued for charitable gifts generally are the same types of assets as those being valued for gift tax, estate tax, business exchanges, or the like, and logically the same rules should govern. In fact, the margins of error for charitable valuations perhaps should be greater, because public policy encourages substantial charitable donations, but taxes substantial noncharitable gifts (above the exclusion levels) and noncharitable bequests (above the exclusion). Higher liability means higher appraisal costs and thicker appraisal reports, but not necessarily any improvement in accuracy.

Other operational provisions. There are other less universally relevant provisions, not summarized here, included among the reform provisions. These include penalizing involvement by exempt organizations in tax shelter transactions (bill section 311), imposing an excise tax on acquiring interests in certain insur-

⁷⁵ Proposed new Section 2055(g).

⁷⁶ Proposed new Section 2522(d).

⁷⁷ Proposed new Section 6662(i).

⁷⁸ Proposed new Section 6695A.

ance contracts (bill section 312), doubling most of the excise taxes on private foundations (bill section 313), imposing additional exemption requirements for credit counseling organizations (bill section 321), broadening the base for the tax on private foundation net investment income (bill section 322), defining conventions or associations of churches (bill section 323), requiring notifications by entities not currently required to file Form 990 (bill section 324), and disclosing to state officials the Service's proposed actions toward exempt organizations (bill section 325). All of these but bill sections 312 and 323 come from the Staff Discussion Draft.

Donor advised fund provisions. The Tax Relief Act, as passed by the Senate, imposes private foundation-like requirements and taxes on donor advised funds (DAFs).

Minimum distribution requirements for DAFs. Bill section 331 would create three new private foundation-like excise taxes—for failure to meet minimum distributions by sponsoring organizations or individual DAFs, for prohibited distributions, and for prohibited benefits. All of these new taxes could be abated by the Service, in the same manner as excess benefits taxes.⁷⁹ They would be effective for tax years beginning after the date of enactment.

These three new prohibited transaction rules would be far stricter than the private foundation rules. They lack the exceptions offered by the private foundation rules, such as expenditure responsibility or equivalency determinations, and have tax rates far higher than those on private foundations and managers, even after considering the increase elsewhere in the Tax Relief Act. There is not much tax "relief" here.

Minimum distributions. The new tax on failure to meet minimum distributions would apply to sponsoring organizations that fail to distribute required amounts from either the aggregate of DAFs or from each individual DAF.⁸⁰ The tax would be 30% of the undistributed amount (increasing to 100% if the distribution were not made within the tax year when an initial tax is imposed). The minimum distribution for the aggregate assets of all DAFs would be 5% per tax year, which would have to be distributed by the end of the next tax year (except it would be 3% for the first tax year

and 4% for the second after enactment of the Tax Relief Act). The minimum distribution for each individual DAF per year would be the greater of (1) \$250 or (2) 2.5% of the greater of either the minimum initial contribution amount or the required minimum balance. There would be special rules for illiquid funds.

Distributions would count as qualifying distributions only if they were to an organization described in Section 170(b)(1)(A) (other than supporting organizations) or Section 170(f)(17)(B)(ii), or were set-asides that met future Treasury regulations. Excess distributions could be carried forward for five years.

This would have the effect of disqualifying distributions to nearly all foreign organizations, however worthy and well-screened, or to charitable funds of non-public charity organizations, or to nonabusive supporting organizations (such as university endowments), or to needy individuals (unless the scholarship exception applies, as summarized below).

DAFs would be defined very broadly to mean any fund or account that is separately identified with reference to a donor, and that gives the donor advisory privileges toward distributions or investments. There would be an exception for donor advice for grants for travel, study, or other similar purposes, if the donor did not control the committee, but only if the fund "satisf[ies] requirements similar to those described in section 4945(g)," which would mean paying a high user fee and getting a private letter ruling from the IRS. There would be a second exception for funds or accounts that the Treasury "may" exempt based on the committee not being controlled by the donor or related parties, or benefiting a single identified charity, but that may never come into existence and may never be meaningfully wide.

These provisions would have the effect of treating innumerable scholarship funds, restricted gifts, restricted investments, and other donations involving donor input as DAFs and subjecting them to these regulations. It would be costly and onerous for scholarship funds to seek private letter rulings to approve scholarship procedures. Those that are not already using outside selection bodies probably would not be well-enough served by them to permit express-line approval of the procedures. There would be no alternative at all for restricted gifts, which the language literally encircles with red

⁷⁹ Section 4963.

⁸⁰ Proposed new Section 4967.

tape. There would be no grandfathering provision, and no transitional period (except the 3% and 4% levels for sponsoring organizations and illiquid funds, mentioned above).

Prohibited distributions. The new tax on prohibited distributions would apply to any distributions from DAFs except distributions to (1) Section 170(b)(1)(A) organizations (other than supporting organizations), (2) the sponsoring charity (for its general fund, not a DAF), or (3) a Section 170(f)(17)(B)(ii) organization.⁸¹ The tax would be 20% on the donor or donor advisor, and 5% on the fund manager who agreed to the distribution, unless the fund manager showed that agreement was not willful and was for reasonable cause. The tax on a fund manager would apply to not only an officer, director, or trustee, but to an employee who agreed to implement the donor advice.

This would not just disqualify, but effectively prohibit distributions to nearly all foreign organizations, to charitable funds of non-public charity organizations, to nonabusive supporting organizations, or to needy individuals (unless the scholarship exception applies).

Prohibited benefits. The new tax on prohibited benefits would apply to distributions from DAFs that give more than incidental benefit to any person (other than a Section 170(b)(1)(A) organization).⁸² The tax would be 25% on the donor or donor advisor, 25% on the recipient, and 10% on the fund manager who agreed to the distribution unless the fund manager showed that agreement was not willful and was for reasonable cause.

This would base the new tax on the distribution, not on the benefit, and consequently could be grossly disproportionate. A donor advising a \$100,000 distribution, and receiving two free seats at a \$250 a seat dinner, would be taxed on 20% of \$100,000, not on 20% of \$500. The same would be true of the foundation employee who agreed to (implemented) the distribution.

Prohibited transactions for DAFs. Furthermore, donors, donor advisors, and investment advisors would be treated as disqualified persons, as would their family members or their 35%-controlled entities, under bill section 332. Thus, for public charities sponsoring DAFs, any benefit to these new disqualified persons ("any grant, loan, compensation, or other payment") would be an excess benefit. For private foundations sponsoring DAFs, any ben-

efit to these new disqualified persons would be self-dealing, unless it came within the self-dealing exceptions (like customary fees to an investment manager). The public charity tax on excess benefits, and the private foundation tax on self-dealing, would apply to any such "grant, loan, compensation, or other payment."⁸³

This change would render donors, donor advisors, investment advisors, family members, and controlled entities as disqualified persons toward the sponsoring organization, and not just toward the DAF. It would, for the first time, treat investment advisors (those other than donors) as disqualified persons, and would mean that investment advisors of one or more DAFs could not receive any compensation or payment from that DAF or from the sponsoring organization generally. It would effectively prohibit sponsoring organizations from using outside investment advisors for DAFs at all, unless they were uncompensated, which would leave the business of investing in amateur hands, except for sponsoring organizations large enough to hire in-house investment advisors as employees.⁸⁴ It further would mean that the board, officers, employees, and independent contractors of a sponsoring organization could not have their own DAFs there, because receiving reasonable compensation for service toward the sponsoring organization would become prohibited, since they had advisory powers toward a single DAF.

These rules would be far stricter than either the public charity rules of Section 4958 or the private foundation rules of Section 4941, because they would make any "grant, loan, compensation, or other payment" an excess benefit transaction without exceptions. By contrast, the excess benefit rules of Section 4958 allow reasonable transactions, and the self-dealing rules of Section 4941 allow for six exceptions. It is difficult to see why the DAF rules should be stricter than the general excess benefit rules or the private foundation rules. Moreover, the publicized abuses of

⁸¹ Proposed new Section 4968.

⁸² Proposed new Section 4969.

⁸³ Proposed revisions to Sections 4958(f) and 4946(a)(1).

⁸⁴ The only exception is that an investment advisor who is "an employee of such organization" may be "compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds."

DAFs do not involve private foundation DAFs, because the private foundation rules already are sufficiently strict. Thus, it is difficult to see why the DAF rules should apply to private foundation DAFs at all.

Finally, these provisions would appear to forbid bargain sale contributions, redemptions of contributed corporate stock, charitable remainder unitrusts or charitable lead trusts involving sponsoring organizations and donors who separately have DAFs, and other perfectly valid contribution techniques.

Restrictions on charitable deductions. Bill section 333 would allow income tax deductions for contributions to DAFs only if the sponsoring organizations (1) were not Type III supporting organizations or Section 170(c)(3), (c)(4), or (c)(5) organizations, and (2) gave the donor a contemporaneous written acknowledgment that the organization has exclusive legal control over the contributed assets.⁸⁵ It would allow estate and gift tax deductions only if the same requirements were met, except that sponsoring organizations could be Section 170(c)(5) cemetery companies.⁸⁶ The Treasury would be instructed to exclude certain Type I and II (Section 509(a)(1) and (2)) supporting organizations as well by regulation.

Form 990s and exemption of sponsoring organizations. Bill section 334 would require a DAF's Form 990 to list the total number, aggregate value, and aggregate contributions to DAFs. If the information was not provided for *any* DAF, the statute of limitations on the Form 990 would not begin to run until three years after the information was furnished.⁸⁷ It also would require Form 1023s to state whether the applicant organization maintains or intends to maintain any DAFs.⁸⁸

The open-ended definition of DAFs (discussed above) creates a problem because sponsoring organizations might not realize that scholarship funds with the donor on the committee, restricted gifts with donor input, donor-managed accounts,⁸⁹ or other donations

came within the definition of DAFs. It also does not make sense to leave the statute of limitations open indefinitely, when the statute of limitations for private foundations runs in six years where information is omitted.⁹⁰

Supporting organization provisions. A new regulatory regime similarly would be created for supporting organizations (SOs), beyond what already exists.⁹¹ One surprising aspect is that it generally would apply to Type I, II, and III SOs, while publicized problems and congressional concern about abuse have been limited to Type III SOs, which are subject to the least control by the supported organizations. The control by supported organizations of Type I and II SOs effectively prevents the abuses that the new provisions target. Type I and II SOs typically are endowments formed by universities or other charities, separate entities formed in health care reorganizations, separate entities formed to hold real estate or other high-liability assets of charities, and the like. Also surprising is that the new regulatory regime generally would be stricter than the private foundation regulatory regime, which generally is considered quite rigorous, if not unreasonable.

Requirements for SOs. Bill section 341 would bring the definitions of Type I, II, and III SOs from the regulations into the Code, and would add requirements as well.

Type III SOs would have to include in any application for exemption, or notification of change of purpose or activity, letters from each supported organization acknowledging that they know they have been so designated, and provide to each supported organization such information as regulations require. Type III SOs also could not have more than five supported organizations (except that existing Type IIIs could continue with more, but not add any unless they were under the limit of five). Neither could they have any supported organization "not organized in the United States" (with no grandfathering of existing supported organizations, because the requirement would take effect 180 days after enactment). Type III SOs could not make any contributions to or for the use of DAFs.⁹²

Much of this is reasonable, but the prohibition on supported organizations not organized in the U.S. is xenophobic. The Service has demonstrated the falsity of its claim that most support of terrorists comes from charities (inferentially, U.S. charities) by revoking

⁸⁵ Proposed new Section 170(f)(17).

⁸⁶ Proposed new Sections 2055(e)(5) and 2522(c)(13).

⁸⁷ Proposed new Sections 6033(h) and 6501(c)(11).

⁸⁸ Proposed new Section 508(f).

⁸⁹ Ltr. Rul. 200445023, Ltr. Rul. 20445024; see Silverman, "A New Strategy for Giving Away Your Money," *Wall St. J.*, 10/6/04, page D1.

⁹⁰ Section 6501(e).

⁹¹ Section 509(a)(3); Reg. 1.509.

⁹² Proposed new Section 509(f)(1).

only five exemptions for support of terrorists in the four years following 9/11. Many worthwhile charities or nongovernmental organizations are organized in foreign countries, as is their right, and may even be required to do so in order to serve legitimate needs in those foreign countries. The world is growing more global, and this provision restricts American generosity toward needs abroad.

Moreover, "friends of" organizations that support worthy international organizations essentially would be prohibited. There is no evidence that such organizations have been used to practice any abuses. The provision would give them only 180 days to convert to Section 509(a) or (b) public charities. Yet they may not be able to show public support, because they have been operating under a standard that did not require it, and may not have been conducting regular fundraising. Further, they may not be able to qualify at all as Section 501(c)(3) organizations, because a primary purpose and activity of support of an international charity may not be an exempt purpose or activity *except* as a supporting organization. The other alternative is for "friends of" organizations to become Type I or II organizations, but that would require them to be more controlled by foreign organizations, which Congress apparently does not think is a good thing.

The prohibition on Type III SO distributions to DAFs would foreclose not only ongoing distributions but terminating distributions. Yet terminating distributions to DAFs may be worthwhile simply to cut expenses to maximize funds available for charitable purposes, and make the funds more easily regulated instead of less so.

Type I and III SOs (but not Type IIs) would be disqualified if they accepted any gift or contribution from any person who controlled, directly or indirectly, alone or with family members or 35%-controlled entities, the governing body of a supported organization.⁹³ This would effectively prohibit a conflict of interest on the part of the supported organization.

These restrictions would not reach charitable trusts that otherwise are Type III SOs solely because the supported organization is a beneficiary and has the power to enforce the trust to its benefit.

Minimum distribution requirements for Type III SOs. Bill section 342 is similar to the minimum distribution requirement for DAFs,

summarized above. It differs in that the minimum distribution would generally be the greater of 85% of adjusted net income or 5% of the fair market value of aggregate assets (less in the two years beginning with enactment).⁹⁴ It shares the same problems.

Excess benefit transactions for SOs. Also similar to the to the excess benefit provision for DAFs, summarized above, and partaking of the same problems, is bill section 343.⁹⁵ Particularly onerous is its definition of an excess benefit transaction, and of the prohibited act, as "any grant, loan, compensation, or other payment" to a substantial contributor or related person (family member or 35%-controlled entity). This would be much stricter than the private foundation prohibition on self-dealing, which has six exceptions, and which allows disqualified persons to lose that status. For example, reasonable compensation for services is permitted in the case of a private foundation, but otherwise reasonable compensation to a person who made the mistake of being generous and donating \$5,000 to a supported public charity or to a SO would be totally forbidden. Here, a substantial contributor appears never to lose that status, and the creator of a trust-form SO never loses that status.

Excess business holdings requirement for SOs. Bill section 344 effectively would apply the private foundation prohibition on excess business holdings⁹⁶ to Type III SOs, and to Type II SOs that accept any contribution from any disqualified person. However, it confuses a simple application of the private foundation rule by adding yet another special-purpose definition of disqualified persons. This one would include as disqualified persons anyone "in a position to exercise substantial influence over the affairs of the organization" (or members of the family or 35%-controlled entities). It would allow Type III organizations to own a business enterprise "for the benefit of the community pursuant to the direction of a State attorney general or a State official with jurisdiction," though it is not clear whether "pursuant to the direction" means a directive or supervision.⁹⁷

⁹³ Proposed new Section 509(f)(2).

⁹⁴ Proposed new Section 4959.

⁹⁵ Proposed new Section 4958(c)(3).

⁹⁶ Section 4943.

⁹⁷ Proposed new Section 4943(e).

This provision apparently would mark a substantial contributor forever as a disqualified person, and apparently would treat as irrelevant whether such a person had any control over the Type III or II SO as opposed to merely donating twice, as a ship passing in the night.

Restriction on private foundation grants to SOs. Bill section 345 would treat grants from nonoperating private foundations to any supporting organizations as not counting toward foundation minimum distribution requirements.⁹⁸ It also would treat such grants as taxable expenditures, without exceptions.⁹⁹

This is bizarre. Type I and II SOs generally are exactly the sorts of donees to which private foundations are encouraged to make grants—endowments formed by universities or other charities, separate entities formed in health care reorganizations, separate entities formed to hold real estate or other high-liability assets of charities, and the like. Type III SOs often are the same sorts of donees, and are generally nonabusive. It is difficult to see any harm in a private foundation making a grant to an endowment for a charity. These new provisions would not allow any of the reasonable exceptions of the private foundation rules. Foundation distributions to noncharity organizations, including other private foundations, otherwise count toward minimum distributions if they are re-granted within a specified time, yet that would not be the case for distributions to SOs.¹⁰⁰ Foundation grants to even nonexempt entities are not taxable expenditures if they meet an exception, such as complying with expenditure responsibility requirements.¹⁰¹

Form 990s of SOs. Bill section 346 would require that all SOs file Form 990s, list the supported organizations, state the type of SO in

each instance, and certify that Code requirements are met. It also would require the Form 990s of Type III SOs to state whether they have received (and evidently would require them to receive) a letter from the supported organization acknowledging that it knows it is a supported organization, detailing the type of support provided (in view of the new minimum distribution), and explaining how that support furthers its charitable purposes.

This would impose burdens on small SOs (which currently are exempt from filing Form 990) and on all supported organizations (which would have to generate detailed letters for each SO). It seems more meaningful simply to require that when they file with the Service, all SOs provide their Form 990s, their financial statements in the absence of a Form 990, or financial reports in the absence of either to all supported organizations.

Conclusion

The nonprofit organization provisions of the Tax Relief Act of 2005 could better be called the Tax Red Tape Act of 2005, because they are burdensome and frequently unreasonable. Burdensome regulation of nonprofit organizations has the unavoidable consequence of taking funds away from charitable beneficiaries and redirecting them to new administrative costs and professional fees. It is odd that the U.S. has generally deregulated business in the past 25 years, but is significantly adding regulations to nonprofit organizations. Certainly no one can justify abuses, and some of the provisions—such as minimum distributions from donor advised funds and from supporting organizations—are worthwhile. There are much simpler ways, however, to deal with many of the perceived problems, and many of the proposals seem oblivious to cost-benefit analysis—they are unnecessarily costly or not cost-effective in accomplishing laudable objectives. ■

⁹⁸ Proposed revision to Section 4942(g)(4).

⁹⁹ Proposed new Section 4945(d)(4).

¹⁰⁰ Section 4942(g).

¹⁰¹ Section 4945(h).